This recession packs a double whammy on consumer spending

By Don Wiggins
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Consumer spending accounts for about 70 percent of the U.S. economy, so it's a big deal. What consumers are currently spending and surveys about their confidence in the future affect the stock market, business inventory purchases, and a host of other forward-looking factors.

Of course, consumer spending has also been one of the major drivers of the recent economic unpleasantness as consumers retrenched, substantially reduced discretionary purchases, and substituted less expensive items for more expensive items in their budget.

Consumers obviously cut spending in tougher times, but this time around, there is a second echo effect that has driven spending lower than in most previous downturns.

For simplicity, let's say a family spends $100 per week on groceries in "normal" economic times. Along comes a housing bubble, and the value of their home goes up — a lot. It makes them feel rich, and they open a home equity line, or refinance their house and take out cash, or run up credit card balances. As a result, spending on groceries goes up to $125 as they buy steak instead of hamburger, or grouper instead of fish sticks.

Along comes a housing bust. Values plummet, home equity lines disappear, refinances are impossible, and credit cards are maxed out. What does the family do? First, they go back to where they started, that is, spending $100 a week on groceries. But there's a problem.

Lenders insist on getting their money back with interest. So, instead of just cutting back to the original level of spending, the family must cut back even more to pay back the debt they accumulated during the good ol' days. They cut to $75 a week by going to Dave Ramsey's diet of "rice and beans," and, for variety, "beans and rice." This is the double whammy.

How long they stay at $75 a week depends on how much debt they ran up, and whether or not the breadwinner is still employed. Staying at $75 has a major dampening effect on their spending.

If they default and don't pay it all back, it causes more problems. Lenders lose money and can't lend to other borrowers, such as businesses, who suffer. The lender's owners also suffer. And the owners are people like you and me who have stocks, bonds, 401(k)s and other investments.
The result is that consumer spending, the engine of the economy, has recovered very slowly this time around. The housing bubble was especially large, and consumers borrowed and spent profligately.

Has consumer spending bottomed out? So far, the results are mixed.

After being mushy for the second half of 2009, there was a small increase in December, though less than most expectations. For the first couple of weeks of January, spending was up, but went down significantly late in the month as the stock market dropped. Consumer confidence has also dropped.

So the jury is still out on when spending will come back to full speed. But one thing is sure: This time has been different.

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