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Consumers Have Been Prop For a Fragile U.S. Economy

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Immediately after Sept. 11, it looked as if the U.S. economy might buckle. Americans hunkered down for war, stock prices plunged, and business investment, already weak, slumped further.

SPENDING SPREE

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But it turns out the terrorist assaults marked the ending phase of a recession, not its intensification. How? Consumers such as Christine Grable in Austin, Texas, kept buying.

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In the wake of Sept. 11, Mrs. Grable and her then-fiance cut back on fancy restaurant meals, concerts and what she calls "joy spending." But their somber mood faded quickly. The couple bought a house in April and jetted off for a Hawaiian honeymoon the following month. Though her employer, **Dell Computer** Corp., was shedding jobs, Mrs. Grable felt confident she would keep hers -- and she has. "It was kind of, jump now and think later," says the 34-year-old marketing specialist.

If Sept. 11 seemed to signal the American way of life was under attack, American-style spending seemed the proper response. "The American economy will be open for business," President Bush assured the nation the evening of Sept. 11. **General Motors** Corp., kicking off a campaign of no-interest financing on new cars, urged consumers to "Keep America rolling."

They did -- and have continued to do so in the year since. The latest evidence came Friday, when the Commerce Department reported consumers had increased their spending[2] by 1% in July, the largest advance in nine months. Even as Americans' incomes, which include wages, interest and government benefits, were flat in July, rising home values, booming mortgage refinancing and low interest rates kept consumers reaching for their wallets.

The vital question now is whether consumers -- whose spending accounts for two-thirds of all U.S. economic activity -- will continue shelling out for cars, appliances, furniture and services. As businesses remain reluctant to increase their expenditures, and economic trouble abroad endangers U.S. exports, consumers are more critical than usual to the economy.

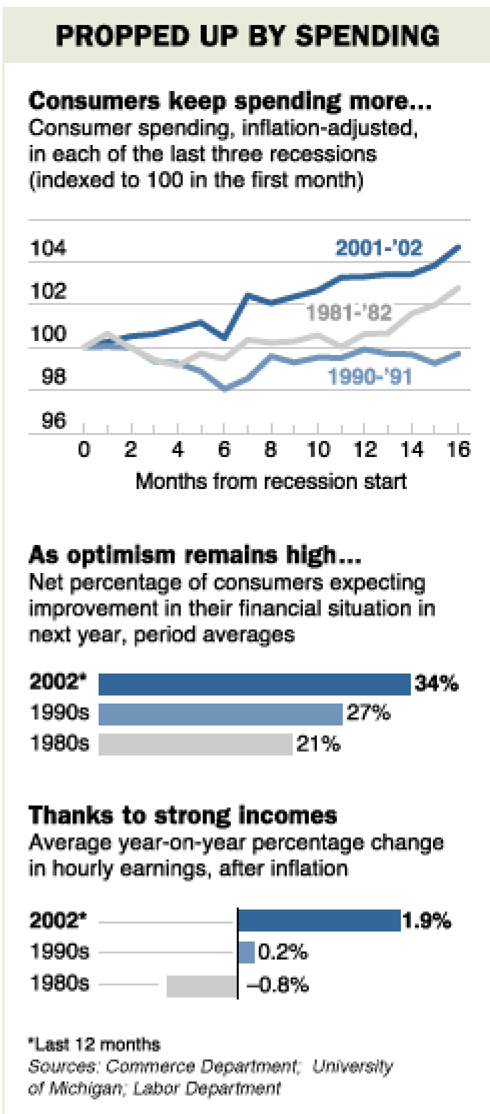
Last fall, consumer purchases saved the U.S. economy from deep recession. The Federal Reserve played a big role by cutting short-term interest rates to a 41-year low. So did the Bush administration and Congress, with a tax cut that began last summer with $300 rebate checks and continued with reduced tax withholdings earlier this year. Auto makers and retailers helped with sharp discounts.

But none of that would have been sufficient if consumers hadn't continued to spend liberally. "We had an event with a powerful psychological impact, with the potential to really cut into consumer spending at a time the economy was already weak," says Laurence Meyer, who retired as a Federal Reserve governor in January. "It's very surprising it had such little impact on the consumer. Maybe it really is true: We love to shop."

What explains Americans' willingness to keep spending? Why weren't people as distracted as they were when Iraq invaded Kuwait back in 1990, setting the stage for the Gulf War and a U.S. recession?

Paychecks and Paranoia

The burst of patriotism in response to the first attack on U.S. soil since Pearl Harbor played a role, as did the quick victory in Afghanistan and the fact that oil prices fell rather than rose as they did in 1990. But that doesn't explain the entire mystery. Simple economic calculations have also been at work. Over the past year, Americans have sized up their financial situations and liked what they saw. Paychecks proved more important than paranoia.



Take-home pay has risen. Mortgage rates have tumbled. Inflation has been tame. Although unemployment has risen, it remained lower than it had been for most of the 1990s and 1980s. The stock market plunged, causing many people to rethink retirement dates and abandon fantasies of exponentially expanding 401(k)s. But for a lot of people, stock losses were offset by the rising value of their biggest asset: their home. Although Americans aren't as upbeat about their finances as they were in the heady days of 1998, surveys by the University of Michigan find consumers more optimistic about their financial future than at all but a handful of occasions in the past three decades.

As the Sept. 11 anniversary approaches, the vitality of consumer spending is once again in question. A wave of corporate scandals has pummeled the stock market, wiping out more wealth and, in some ways, shaking Americans' faith in the nation's institutions to a greater extent than the terrorist attacks did.

The boost to spending from falling mortgage rates and last year's tax cuts eventually will dissipate. Pessimists argue that if the economy goes through a prolonged period of slow growth, then rising unemployment, stagnant wealth and weak income growth could erode the optimism the last decade's prosperity fostered. In that case, the higher debts that have financed much of the recent spending will be harder to support. "Consumers are hardly even aware we've had a recession," says Edward Leamer, a forecaster at the University of California at Los Angeles. "There's certainly no evidence they've come to grips with the fact that the future isn't what it used to be. That adjustment has to be made."

But even if consumers slow their spending for a while to rebuild savings, a jarring collapse of consumer spending seems unlikely -- unless the U.S. economy suffers another devastating blow, such as a far steeper plunge in the stock market or a sustained surge in oil prices. For example, auto sales surged in July and appear to have done so in August as well, in response to a new round of no-interest-financing offers.

Over the course of the recession, which began in March 2001 and appears to have ended in December, inflation-adjusted consumer spending grew at an annual rate of 3.2%, better than in any of the previous five recessions. This year, consumption has accelerated to an annual rate of nearly 4%. Without the burst of spending that followed the attacks, the recession would have lasted longer, and the unemployment rate would have risen higher.

The most important factor in consumers' buy-now, worry-later attitude was continued gains in their purchasing power. In most downturns and the periods that immediately follow them, layoffs and deferred raises constrain household incomes and thus consumers' ability to spend. This time, inflation-adjusted after-tax incomes eked out a small gain during the recession and then rose strongly afterward. During the 12 months ended in July, inflation-adjusted income increased by 4%. At a comparable point in the previous two recoveries, it didn't grow at all.

The Bush tax cut accounted for some of that increase. But consumers also benefited from a more permanent economic change: Gains in productivity growth, which began in the mid-1990s, continued through the recession. With workers producing more for each hour they work, companies can pay higher wages without raising prices. After-inflation hourly earnings are now growing about 2% a year. They hardly grew at all through most of the 1980s and 1990s.

One particularly comforting development for consumers, according to monthly surveys by the University of Michigan, is a steady decline in inflation to its lowest levels since the 1960s. Consumers see it at the cash register, as **Wal-Mart**, **Costco**, **Target** and other discounters have used their buying clout and efficient inventory management to hold down prices.

Falling monthly mortgage payments have been a major spur to consumer spending, too. Mortgage rates tumbled after Sept. 11, rebounded and fell to new lows this summer. That has made it easier for Americans to buy homes and, just as important, to refinance mortgages and pocket the leftover cash.

New Mortgage

In October, Matthew Pallatto, a mechanical engineer in Southbury, Conn., went onto **Priceline.com** and quickly found a deal to cut a full percentage point from his mortgage rate. He knocked $50 a month from his monthly payments, even though he borrowed an additional $13,000, which he is using to remodel his basement. He hasn't been happy to see the losses in his mutual funds, but they are for his retirement. "I'm not that worried -- I can't touch them for 30 years anyway," says Mr. Pallatto, 32.

After Sept. 11, U.S. businesses put on a fire sale. Not only did they mark down prices, but they offered imaginative promotions that many consumers couldn't pass up.

Steve Ward, an assistant district attorney in Charlotte, N.C., cut back in small ways. Instead of ordering drinks with dinner, he and his wife now have one at home before leaving. They no longer take their 10-year-old daughter and her friends to expensive amusement parks, figuring a movie will do just as well.

Mr. Ward could have held off on a new car, too. But his local Volvo dealer offered two free airline tickets if he picked up the car in Europe. By dealing directly with the factory, he saved about $3,000 in markups that normally would have been charged for importing that vehicle. "They dangled that carrot out there and I bit on it," says Mr. Ward, who used the money he saved for a two-week European vacation. To prepare for the trip, he spent more than $300 here at home, including $120 for a new suitcase.

Even rising unemployment didn't shake consumers as much as in past recessions. The unemployment rate has climbed from a 30-year low of 3.6% in 2000 to 6% now, but it's still lower than it was during the growth years of the 1980s and early part of the 1990s.

For those who lose their jobs, the prospects for being rehired elsewhere are strong. Although a net average 105,000 jobs a month have been lost since March 2001, Labor Department data released Friday suggest that more than four million people change jobs every month through the normal process of hiring, firing and quitting. "Even in tough times, the U.S. labor market is enormously fluid," says Robert Mellman, an economist with J.P. Morgan Chase & Co.

After surviving four rounds of layoffs at ICG Communications Inc., a telecommunications company, Stacy Ferrell lost her job in June as a repair coordinator. Undaunted, she used her severance package to pay off several medical bills and move from Irvine, Calif., to Carson City, Nev. There, her husband landed a job as an auto mechanic, and she quickly turned up five openings for telephone repairers. The Ferrells plan to buy a house by the end of the year. "People always will need to get their cars and their phones repaired," Ms. Ferrell says.

The two-worker family provides an important cushion. In 2000, both husbands and wives worked in 56% of married couples, up from 50% in 1986. If one spouse gets laid off, the other may still be working. Charles Chandler lost his job as a computer-programming consultant at **Sprint** Corp. in Overland Park, Kan., a few weeks before Sept. 11, but his wife, Pam, kept working as a teacher.

The couple cut back on dining out. But he didn't try to get back a $500 deposit he had put down for a new BMW Mini Cooper before being laid off, even though the $19,000 car was so much in demand the dealer was charging full retail price. "I had my heart set on this car since 1968," says Mr. Chandler, who took delivery a month before getting a new job as an information-technology manager at a bank. "It's not like we were destitute."

Many economists had predicted that the loss of wealth from the fall in stock prices -- which began in 2000, gathered steam after Sept. 11 and resumed amid corporate scandals this summer -- would prompt sharp spending cutbacks. But that hasn't been the case. While many people have seen their late-1990s winnings erased, the market gyrations so far haven't inhibited spending nearly as much as anticipated. Many consumers hold their stocks in retirement accounts and haven't factored the fallen value into day-to-day spending.

Counting both stock losses and housing gains, the less affluent 80% of households saw their net worth rise from 2.8 times their annual income in 1995 to 3 times in 1999, and then fall back to 2.8 times by early 2002 -- hardly much of a change in either direction, according to Fed data. For the wealthiest 20%, net wealth shot from 5.6 times income in 1995 to 7.6 times in 1999, then slipped to 6.1 times.

Less affluent buyers have continued spending at their usual rates despite the stock market's drop, according to Vadim Zlotnikov, equity strategist at Sanford C. Bernstein & Co. It has been the affluent who have socked away more money than usual in savings. Their spending also has risen, but at a slower clip than that of the larger middle class. So discount chains, such as **Dollar General** Corp., are reaping double-digit annual gains in sales, while tony department stores, such as **Neiman Marcus Group** Inc. and **Saks** Inc., are reporting declines.

-- *Ken Gepfert contributed to this article.*

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