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Three Strikes Against Consumers

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ONE of the spookiest features of the current economic crisis is the way everything seemed to go wrong at the same time. In 2007, as if some kind of secret signal went out among them, housing prices accelerated their decline while the prices of oil and food rocketed higher. These changes were abrupt, as they slammed into the economy with little forewarning of even bigger price shocks just ahead.

The pain from any one of these price increases would have been bad enough. But experiencing all three simultaneously doomed the business expansion under way since the end of 2001. That the housing crisis also served to ignite the calamities in the world of credit made the problems only harder to overcome.

The numbers are striking. From May 2007 to May 2008, the price of food jumped by 5.1 percent, double the annual rate from 1991 to 2006. Home prices show a similar disconnect. During the two years ended in December 2006, home prices jumped 43 percent. But in 2007, home prices fell 10 percent, and the pace of decline has accelerated this year. In the case of oil, the price at the end of 2006, at $62 a barrel, was only $3 more than it was a year earlier. Over the course of 2007, however, oil zoomed to $92 from $62; by mid-2008, it was up an additional $40.

These extraordinary shifts in tempo were, for the most part, unanticipated. Yes, the explanation for the explosion in food and oil prices — global demand exceeding the growth in global supplies — was apparent in the three or four years that preceded this crisis. Yet why were there no price shocks then?

At least the moves in oil and food prices share a common explanation, but what in the world do they have to do with the end of the boom in home prices? One could contend that increases in gasoline prices caused the demand for homes to weaken, but the argument is not very compelling, and I do not recall a single mention of that possibility during 2007.

In fact, the timing among these price movements seems a weird coincidence, not a development linked by cause and effect. And this suggests the most unusual feature of our current problems: the primary impact of all of them has been on consumers, not on businesses. Even the credit crisis centers on the home mortgage problem — though the jolly time investors had in risk-taking en route to the edge of this abyss made a significant contribution to the distress in the banking system and other financial markets.

This combination of events explains why it is so hard to find solutions that can bring the economy back into the light. Past recessions and economic crises typically developed in the business sector, where companies have a habit during good times of running to excess in inventory accumulation or in expanding employment and capacity. This time, businesses generally have been well financed and conservative in their decision-making. Even the stock market, although at high levels in 2007, has not been in the kind of speculative fever that has led to past crashes.

As a result of these exceptional conditions, we have no guidelines to follow. We are in uncharted territory.

Most of the attention has focused on the cracks and groans from the financial sector, as banks totter at the edge of failure and where credit has been so hard to come by. Some banks are even uneasy about lending to one another — an astonishing rupture of normal conditions.

Nevertheless, the therapy must focus on the household sector, wrestling with the triple blows of high home prices, oil prices and food prices. Nothing will turn the economy around until we can restore some sense of hope and security among consumers — perhaps even as food and oil remain painfully expensive.

Today, a halt in the decline of home prices seems the necessary condition to transform the system from despair to hope and to turn the financial sector, now embattled and disorganized, back into the functioning organism the economy needs so badly. Indeed, here is where economic policy can have some influence on the outcome. (In the case of food and oil, the forces are too strong for government to intervene with any success.)

These steps would involve more effort by Washington — including financial incentives —to persuade mortgage lenders to be patient about repayments instead of foreclosing and making matters worse. After all, every participant in the mortgage business will breathe more easily when the decline in home prices comes to an end.

ASSISTANCE to individuals and institutions in trouble always raises concerns about the moral hazards of bailouts, especially when a case can be made that people underrated risks or were blindsided in their decision-making. But we have no choice here. The economy teeters on the edge of not just a recession, but also a more profound decline where trouble in any single sector can spread breakdowns throughout the system, driving unemployment to intolerable levels. To sit back and let nature take its course is to risk the end of a civil society.

Until we move more decisively in this direction, other efforts are likely to be frustrating at best and counterproductive at worst. The household is the key to the puzzle.

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