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## Dollar's fall forces new standard of frugality

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It's a global shift that some are calling the Great Reckoning.

For a generation, economists warned that Americans were living too large. With wallets crammed with credit cards and home-equity loans available to any homeowner who could sign his or her name, consumers went on a debt-fueled buying binge. Living rooms bulged with the latest in snazzy electronics and garages filled with shiny new cars and trucks. Restaurants were fully booked, and airlines whisked happy passengers to dream vacations around the world.

Now, that shop-till-you-drop, I-want-it-all-and-I-want-it-now era may be coming to an end. It couldn't last because it was built on a mountain of money borrowed from overseas.

Year after year, the United States bought more from the rest of the world than it sold as foreign nations cranked out shipload after shipload of goods destined for American consumers. By 2006, the U.S. international deficit in trade and related payments exceeded \$800 billion, about 7 percent of the entire economy.

It was only thanks to the kindness of strangers that such a drain of dollars was able to continue. Every year, overseas investors poured hundreds of billions of dollars into U.S. stocks, bonds, real estate and other assets, largely offsetting our taste for imported goods.

But the housing crash, a severe credit crunch and a dizzying fall of the dollar are depriving the nation of the means to keep on borrowing and spending. Foreigners have become wary of underwriting the U.S. standard of living. The flow of outside investment is slowing.

In effect, the United States has maxed out on its national credit card. Like it or not, that's one of the most important things now forcing a new standard of frugality on free-spending Americans.

"We're going back to the good old days of living within our means," said David Rosenberg, chief North American economist for securities giant Merrill Lynch.

Because household spending represents 70 percent of all economic activity in the United States, a prolonged consumer slump could weigh heavily on the nation, fostering recession or weak growth for some time to come.

### **A long boom**

The years from the early 1980s until recently were a long boom for American consumers, even though their incomes grew slowly if at all during much of that period.

"There was a lot of air under this economic expansion," Rosenberg said. "It was engineered by an unprecedented increase in (borrowing) that involved practically every area of consumer credit."

Consumer debt reached levels never seen before and, by the end of 2007, the household savings rate fell below zero.

The United States is now in the early stages of a prolonged period of belt tightening, a contraction not seen in decades.

Consumer purchases of items other than food and gas have fallen this year, according to the Commerce Department. Sales of a broad range of products - including clothing, home furnishings and motor vehicles - were lower last month than they were in March 2007. The slump extends to services too, such as air travel, restaurants, hotels and casinos.

The International Monetary Fund forecasts that in 2008 and 2009, household consumption will decline further.

"We're seeing the birth pangs of a new economic structure," said Neal Soss, chief economist for the securities firm Credit Suisse First Boston. "The next year or two or three will be about the transition to a new equilibrium. Consumption by households will grow more slowly than their incomes, which is the exact opposite of the last 25 years when consumption grew faster than incomes."

### **Time to cut back**

The adjustment is painful. Few people voluntarily cut back their standards of living. In most cases, families are doing so because their incomes aren't keeping up with soaring prices, especially for such necessities as food and fuel. Their homes and investments are falling in value and can't be tapped as readily for consumer purchases. With credit standards tightening, people can no longer borrow easily to make up the shortfall.

"Standards of consumption have to fall," said Stanford University economist Ronald McKinnon. "The burden really falls on households."

The changes in middle-class family budgets are likely to be significant but not necessarily devastating, economists say.

"This is not the end of the world. It's not Armageddon," Rosenberg said. "It doesn't mean we're going to have to live in a cave or a hut or an RV. The areas of retrenchment are in things we can do without, such as cutting out that extra vacation."

The current period marks the finale of the post-World War II era when the United States stood

unchallenged atop the world's economic pyramid and the dollar reigned as the one truly global currency, many observers say. Now the nation must deal on more equal terms with a rising China and India, a united Europe and a powerful bloc of Asian manufacturing nations. Even Latin America, the long-time underperformer in the global economy, is flexing its muscles.

"The world has become multipolar," said UC Berkeley international economics expert Barry Eichengreen. "Our dominance will decline."

In places such as Asia, where Uncle Sam long wagged his finger at nations that mismanaged their economies, "there is a peculiar sense of satisfaction that the United States has received its comeuppance," Eichengreen said.

The catalyst for this transformation has been the traumatic collapse of the nation's housing market. The abrupt U-turn in home prices in the United States beginning a little more than a year ago set off a chain of events that dramatically altered the nation's position in the world economy, creating a set of circumstances that made a consumer retreat inevitable.

### **Reasons for downtrend**

The strands of this story are complex. Several important trends are interacting to change the global balance of economic power and bring U.S. consumers down to earth. Put the pieces together, and you have a recipe for consumer cutbacks in the United States.

-- The U.S. housing bubble - especially the shaky subprime mortgage market - was inflated not only by U.S. lenders, but by foreign ones too. As mortgages were repackaged in the form of exotic securities, banks and investment funds in Europe and elsewhere snapped them up. When the market crumbled, those investors were left with hundreds of billions of dollars in losses.

Not surprisingly, many foreign investors lost their taste for U.S. securities. When the Federal Reserve pushed down interest rates in response to the housing crisis, overseas investors had another reason to yank their money and put it to work in markets where returns were higher. In the second half of 2007, foreign investment flows into the United States fell to about \$623 billion, about half what they were in the first six months of the year, according to the U.S. Commerce Department.

-- As foreign investors lost interest in U.S. markets, the dollar tumbled. Since the beginning of 2007, the greenback has fallen 17 percent against the euro, the currency of 15 European nations, and 13 percent against the Japanese yen. That's made imported goods and services more expensive, putting such products as French wines and Japanese autos out of reach for some consumers.

-- The fall in the dollar coincided with a big run-up in the prices of oil, foodstuffs such as wheat and corn, and other commodities. That raised the cost of such necessities as gas and food, leaving less

available for discretionary items such as restaurant meals and new cars.

-- Lenders in the United States responded to housing losses by imposing more stringent credit standards, tightening qualifications for home loans, car loans, student loans and credit cards. The volume of home mortgages and equity loans dropped and was only partly offset by increases in credit card debt.

-- The downturn in the U.S. economy took big bites out of the value of consumers' two most important assets: their homes and their stock portfolios. That left fewer resources that could be drawn on to buy goods and services. It also robbed people of confidence in the security of their nest eggs, leaving them more reluctant to spend.

-- Rising unemployment, slow wage growth and higher inflation squeezed family budgets, forcing many households to cut back.

Meanwhile, even as consumers retreat, U.S. exporters are having a field day with the weak dollar, stepping up overseas sales of products ranging from soybeans to technology equipment.

Add it all up, and you get a downturn in retail spending, a drop in nonenergy imports, and a notable improvement in the U.S. trade balance with the rest of the world. In the second half of 2007, the current account deficit - the broadest measure of trade and other international payments - was \$350 billion, down 13 percent from the second half of 2006.

### **Important medicine**

As difficult as the adjustment may be, experts say the change is important medicine. To take one example, we're moving into a period when loan standards are more realistic. Home buyers now have to put money down and pay interest appropriate for their level of creditworthiness.

"We should not look at today's raising of credit standards as being bad," said Catherine Mann, professor of international economics and finance at Brandeis International Business School in Massachusetts. "We're returning to a more realistic credit paradigm after a period of excess. What people are comparing it to is something that was outlandishly unrealistic."

As for the nation, being humbled isn't the same as being bankrupted. The United States can still thrive in a world in which the dollar is no longer king and where economic power is centered in Shanghai and London as much as in New York.

"I see no reason that we can't continue to enjoy productivity gains and double the standard of living in the next 30 or 40 years," said John Shoven, director of the Stanford Institute for Economic Policy Research. "I still sense that there's lots of excitement for things like solving our clean technology problem. I don't see a country that's down on its luck and out of ideas."

## Dollar falls, prices rise, credit evaporates as foreign investors cut off funds to u.s.

How do the weak dollar and the declining fortunes of the United States in the global economic arena add to the pressure on consumers? The answer isn't obvious, but it's an important part of the squeeze on household finances. For years, the United States imported far more goods from overseas than the nation sold abroad, creating a trade deficit that topped \$800 billion annually. The only reason the United States could afford to buy all that foreign stuff was that overseas investors put hundreds of billions of dollars into the U.S. economy by buying our stocks, bonds and real estate. Now, spooked by the housing crisis, foreigners have cut by about half the money they invest in the United States. That's had a dramatic effect on consumers. First, it's pushed the dollar down. The lower dollar is one of the key reasons prices of food, gas and other products have shot up. For example, oil exporting countries are getting paid with less-valuable dollars, so they raise the price of crude to offset the greenback's fall. U.S. motorists in turn get walloped at the gas pump. The same holds for a wide range of other imported products. Second, the reluctance of foreigners to invest in the United States is one of the reasons credit is scarce and loans are harder to get in this country. If U.S. banks can't sell mortgages to investors in Europe and Asia, they are less willing to lend, intensifying the credit crunch.

### Ins and outs

Squeezed by food and energy prices, tight credit, stagnant incomes and falling home and stock values, many consumers are throttling back. Here's what's in and what's out in the new economic order.

IN	OUT
Saving	Borrowing
Cooking at home	Eating out
Fixing the old car	New car
Staying at home	Foreign vacations
20 percent down	No down payment
Debit cards	Credit cards
Working past 65	Early retirement
Library	Bookstore
Tap water	Bottled water
BART	Bay Bridge
Patching	Remodeling
Public park	Theme park

Eyeglasses	Lasik surgery
Poker night	Weekend in Vegas

Source: Chronicle research, BudgetSavvyMag.com

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