CRISIS IN CONSUMER CONFIDENCE: TEMPORARY PLUNGE OR PRELUDE TO FURTHER DECLINES?

Sharp Decline In Confidence

The Middle East crisis has brought about a crisis in U.S. consumer confidence. The Index of Consumer Sentiment fell sharply to 76.4 in the August 1990 survey from 88.2 one month earlier. Overall, most results in the August survey were at the lowest level recorded since the end of the last recession in 1982.

The one-month decline of 11.8 Index-points was larger than the one following the 1987 stock market crash, and just slightly less than the record one-month decline of 12.2 Index-point recorded in 1980. Prior to the start of monthly surveys, the largest quarterly decline was recorded following the 1973 oil embargo, when the Index fell 14.7 Index-points.

If the current depressed levels of consumer confidence are sustained or further weaken in the months ahead, these data certainly point toward recessionary cutbacks in consumer spending.

While it has often been true that sharp declines have been followed by rebounds, it has been rare that the rebound fully restores consumer confidence to its prior level--with the 1987 stock market crash being the exception. More typically, the rebound has proven temporary, only to yield to further declines, especially when attitude trends were already weakening prior to the sharp loss in confidence.

While the risk of a recession is now undoubtedly greater than before, it is not a foregone conclusion that a full scale recession will develop before year-end. Throughout this long expansion, consumers have shown a good deal of resilience, not allowing adverse developments in one region or sector of the economy to dominate their views.

The crucial issue is whether a sufficient number of favorable economic developments occur in the coming months to sustain an improving trend in confidence beyond any initial rebound. Unlike the situation prior to the Middle East crisis, when unchanged attitudes meant the continuation of the expansion, at the present time improvement is needed to avoid cumulative spending cutbacks.

Widespread August Decline

Declines in consumer confidence were recorded among all regions and population subgroups. Among families with incomes of $40,000 or more, the Index of Consumer Sentiment fell to 78.9 in August from 94.4 in July.

The largest declines in consumer confidence were recorded among residents of the Northeast (67.2 in August, down from 82.6 in July) and North Central (78.0, down from 93.3) regions, followed by residents of the West (80.1, down from 90.1) and the South (78.7, down from 85.3).

Leading Indicator Component Posts Sharp Decline

The Index of Consumer Expectations fell to 62.9 in the August 1990 survey from 77.3 one month earlier and 85.5 one year earlier. The decline reflected sharply lower assessments of prospects for the general economy. The 14.4 index-point decline (18.6% of its July level) will have a significant negative impact on the Index of Leading Indicators.

The Index of Current Economic Conditions fell by a more modest amount, declining to 97.5 in August from 105.1 in July.

Outlook for Economy Abruptly Turns Negative

The proportion of families with unfavorable views about prospects for business conditions during the year ahead jumped to 63 percent in August from 43 percent in July and 33 percent at the start of the year. Just 25 percent of all families in the August survey expected good times financially in the economy as a whole during the year ahead, down from 40 percent in July and 52 percent at the start of the year. Overall, the August decline was the steepest one-month decline since the monthly survey began in 1978--only smaller than the record *quarterly* decline following the oil embargo in 1973.

Consumers also viewed prospects for the economy over the longer term less favorably, but the August decline was not as sharp as for the one year prospects. Among all families in the August 1990 survey, 56 percent expected bad times financially during the next 5 years, up from 50 percent in July.

Sharp Increase in Inflation Expected

The rate of inflation was expected to average 6.1% during the next 12 months in the August 1990 survey, up substantially from the 4.7% recorded both one month and one year earlier. The August reading was the highest recorded since 1982.

Unemployment Rate Expected to Increase

The national unemployment rate was expected to increase by 46 percent of all families in the August 1990 survey, up from 37 percent one month earlier. This is the most negative reading recorded since the last recession period.

Interest Rates Expected to Increase

Interest rates were expected to rise during the year ahead by 59 percent of all families in the August 1990 survey, up from 50 in July, reversing the improvement from the June survey when 56 percent expected increases. The proportion that expected declines in interest rates, however, also edged upward, to 19 percent in the August survey from 18 percent in both the June and July surveys. Overall, the Middle East crisis has had the least impact on interest rate expectations, with expectation in August comparable to the levels recorded in June 1990.

Confidence in Government Economic Policies Continues to Sag

Confidence in government economic policies to combat inflation and unemployment fell in the August 1990 survey. Among all families, 31 percent gave unfavorable ratings in the August survey, up from 27 percent in July and 17 percent at the start of the year. The August reading was the least favorable assessment of government economic policies in more than seven years.

Personal Finances Strained But Remain Favorable

Consumers' assessments of their personal financial situation worsened in the August survey in reaction to rising gasoline prices. Although the decline left these personal financial evaluations at the lowest levels since the start of the expansion, their overall level still remained relatively favorable.

Consumers' assessments of their current financial situation worsened due to rising gasoline prices. Among all families in the August 1990 survey, 36 percent reported that their financial situation had improved during the past year, down from the 43 percent recorded in each of the prior three months. The proportion of families that cited higher prices as making them worse off rose to 18 percent, the highest proportion since the start of the expansion.

Financial prospects for the year ahead were viewed favorably by 32 percent of all families in the August 1990 survey, down from the 37 percent recorded both one month and one year earlier. Most families (52 percent) expected their financial situation to remain largely unchanged during the year ahead. Importantly, just 13 percent expected that their financial situation would worsen during the year ahead in the August survey.

Buying Attitudes Weaken

Favorable buying attitudes toward vehicles, homes, and large household durables each declined in the August 1990 survey.

<u>Vehicles</u>. Attitudes toward buying conditions for vehicles weakened significantly in the August 1990 survey. Among all families, the proportion that thought it was a bad time to buy rose to 38 percent in August from 26 percent in July. Overall, car buying attitudes were at their lowest level in the August survey since the start of the expansion.

The proportion of families that mentioned the availability of price discount fell to 32 percent in August from 41 percent in July and the all-time peak of 48 percent recorded six months earlier. At the same time complaints about high vehicle prices rose to 21 percent in August from 16 percent in July.

Uncertainty about future gasoline prices was also cited by families as a reason for making it a bad time to consider a vehicle purchase. In the August survey, 5 percent mentioned this factor in explaining why they had negative views on vehicle buying conditions.

<u>Homes</u>. The proportion of families holding favorable attitudes toward buying conditions for homes fell to 59 percent in August from 66 percent in July. Unfavorable assessments of home buying conditions rose to 37 percent in August from 30 percent in July. Overall, the August data was at the weakest levels recorded during the past five years.

The recent decline was partly due to trends in mortgage rates, but mainly due to rising concerns about the current and future state of the economy. In the August survey, 8 percent mentioned that current economic conditions made it a bad time to buy a home, up from 4 percent in July, and 6 percent mentioned that the depressed prospects for the year ahead made it a bad time to buy a home, up from 1 percent in July.

Fewer families mentioned the availability of low mortgage rates (21 percent in August, down from 24 percent in July), and more families registered complaints about high mortgage rates (20, up from 19 percent).

<u>Durables</u>. Attitudes toward buying conditions for furniture, appliances, and home electronic goods posted the smallest August decline of the markets studied. Among all families in the August survey, 69 percent held favorable attitudes toward buying conditions for large household durables, down from 73 percent in July. The decline in favorable buying attitudes was due to fewer families citing the availability of price discounts--falling to 30 percent in August from 37 percent in July.

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The August 1990 survey included 500 completed interviews conducted between August 1 and August 29, 1990.