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The Outlook For Consumption in 2005: Average Growth Eclipsed by High Performance Standards

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Introduction

This presentation has two interrelated themes. The first focuses on consumer confidence and why it has remained remarkably stable at high levels during the past year, despite a long series of economic, political and global uncertainties as well as natural disasters. Consumer spending can be expected to be nearly as strong in 2005 as in 2004, with the key difference being that consumers will save more in 2005 whereas in 2004 they saved less. Importantly, the year-to-year differences are expected to be small.

The second theme relates to longer term developments in the criteria that consumers use to assess ongoing economic developments. Consumers adopted a new criteria following the long robust expansion of the 1990s that incorporates much higher performance standards than anytime since the 1960s. This transformation persisted despite the fact that the economic boom was widely described as unsustainable as it occurred. The 1960s exhibited the same blind optimism, although economists as well as consumers bought into that bout of irrational exuberance.

Without the use of some criteria or comparison standard, assessments of economic conditions are not possible. These standards reflect longer term expectations about the performance of the economy (Curtin, 2003a). Clearly, these criteria can not be solely based on current economic conditions since the very function of these standards is to evaluate current condition. These reference standards are adaptive and change slowly, typically following the actual performance of the economy with a considerable lag. There are, to be sure, extraordinary circumstance that produce a rapid transformation in these standards, but such circumstances are the rare exception.

Economists use similar criteria to judge ongoing economic developments. The term NAIRU, the non-accelerating inflation rate of unemployment, signifies one set of standards to judge the performance of the economy. Just like consumers, economists don't simply equate their definition of NAIRU to conform to current conditions, but change the definition over time along with the performance of the economy. Rather than explicit numerical targets, consumers typically use thresholds that are not precisely defined and are not based on a fixed information set. Moreover, the process that consumers use to raise their standards is quite different from the process associated with declines.

Evaluative reference standards have three primary characteristics. First, the frames of reference are not neutral, but directly influence how economic events are interpreted. A shift in reference standards thus influences behavior since it changes the interpretation of the quantitative information. This is not a problem of cognition or misperception of economic facts, but solely an issue of interpretation.

A second characteristic is that the weight attached to inconsistent information varies by the frame of reference. High performance standards are typically accompanied by a sense of optimism and confidence, whereas low performance expectations are accompanied by pessimism and uncertainty. As a result, an isolated bit of inconsistent information is more likely to be viewed as a temporary aberration in one context, and as a signal of impending harm in the other. These contextual effects are powerful. Only when these inconsistencies persist and extend across a number of areas will the old frame of reference be replaced.

The final characteristic is that changes in performance standards follow a long term cyclical pattern. Indeed, the most important implication of reaching a new peak in performance standards is that declines are sure to follow. While the timing and speed of change varies and is difficult to forecast, the central characteristics of the process of decline are well known: the decline will be slow and accompanied by uncertainty, distrust, and divisions across population subgroups. Indeed, the process follows a familiar process, from disbelief, to blame, then anger, and finally acceptance.

While the recent election campaign may suggest that this process is well underway, it was only the preliminary skirmish, as the real battle is still ahead. This is so because few people have as yet accepted the need for a downward revision in their expectations. Rather than readily accepting the truth that the economy can't be sustained at peak levels, many consumers believe the recent declines have been entirely due to special and temporary circumstances, such as terrorism, the war, global off-shoring, or the mismanagement of the economy.

Presidential Election

Before I begin my discussion of these interrelated themes, I would like to briefly comment on the Presidential election. At last year's conference I suggested that 2004 would be characterized as the best and the worst of times, a division now known as red versus blue. As last year's presentation suggested, the election was indeed based on "...widespread claims of wisdom and foolishness in economic policy..." with one side arguing "...that without a radical change in policy, the economy is sure to go to hell..." and the other countering that "...a place in heaven requires an even greater commitment to the current course..." (Curtin, 2004).

While factors other than the economy played a greater role in this election, in the last fifty years an incumbent President has never lost his reelection bid when the Index of Consumer Sentiment was above 90.0 in the third quarter of the election year (see Chart 1). Eisenhower, Nixon, Reagan, Clinton, and Bush all won reelection. In contrast, Carter and Bush the elder lost their reelection bids with Index values that averaged about 70.

What made this election so close was not the level of consumer confidence but how confidence had changed since President Bush first entered office (see Chart 2). The change in confidence is measured as the difference between the Sentiment Index values in the 3rd quarters of the two election years. For the first time in fifty years, the level of confidence was high enough to warrant the reelection of the President but the change in confidence during his first term falsely indicated he would lose.

Sentiment Index
Remains at Positive Levels

There is no better example of the stabilizing impact of the current frame of reference than the trends in the Index of Consumer Sentiment during the past year (see Chart 3). From January to mid November of 2004, the Sentiment has averaged 95.2 (nearly identical to the mid November reading of 95.5), and has remained in the narrow range of 94 to 96 in eight of the eleven months. Overall, the Sentiment Index has been above 90 for twelve consecutive months for the first time since the month prior to 9/11. It is worth noting, however, that the Sentiment Index remains more than ten points below the levels recorded from 1997 to 2000.

Neither the presidential campaign nor the result of the election had much of an impact on consumer confidence, although this has been a common media interpretation of the early November increase. In the four months prior to October, and from mid October to early November, the Sentiment Index was essentially unchanged. The only outlier was in early October, when confidence fell due to the surge in gas prices. The same temporary decline in the Sentiment Index was recorded in the May survey also in response to a sharp increase in oil prices.

Many observers would have predicted sharper and more sustained declines in confidence not only in response to the oil shocks, but as a response to a host of other issues such as lagging job growth, rising interest rates, corporate malfeasance, terrorist threats, and an unending war. In past decades, any of these issues could have caused prolonged decline in confidence. In 2004, in contrast, consumers hardly blinked. To be sure, these issues could have prevented gains in confidence, but what would have happened in the absence of these problems can never be known.

The Sentiment Index can be compared with other data to determine if it has exhibited some unusual patterns during the past year. The well-known relationship between changes in the Sentiment Index and the annual growth rate in GDP has persisted unchanged throughout the past fifty years (see Chart 4). Interesting, as economic cycles have become less volatile in the past decades, the prediction lead time of the Sentiment Index has declined but the correspondence has remained very close.

Interest Rates

Changes in consumer sentiment have revolved around several key economic expectations—interest rates, inflation, wages, and employment. There is the widespread agreement among consumers on expected trends in interest rates, less on expected inflation, and the least consensus on employment prospects.

Increases in interest rates were universally expected by consumers, well in advance of the first rate hike by the Fed at the end of June. By the start of 2004, the majority of consumers anticipated that the Fed would raise interest rates, and by the May 2004 survey, the month before the Fed's first hike, 85 percent of all consumers anticipated increases in interest rates, the highest proportion ever recorded in the history of the surveys (see Chart 5). It is hard to imagine another economic policy initiative that was expected by such an overwhelming majority of consumers. Moreover, consumers still expect additional increases. In the early November survey, 70 percent expected additional hikes compared with just 4% who expected any declines during the year ahead. It would appear that consumers expect continued gradual increases in interest rates through the next year, just as the Fed had intended to communicate.

Home Buying Conditions

Views on home buying conditions are perhaps the best indication of how consumers evaluate trends in interest rates. Consumers had to sort out conflicting signals during the past six months from the Fed and mortgage lenders. In the months prior to the Fed's first hike in June, market mortgage rates rose, but then immediately following the Fed's first hike, mortgage rates fell, and were about half a percentage point lower in October than in June. The unexpected declines in mortgage rates were considered by consumers as a second chance to obtain low mortgage rates. As a result, home purchases have reached record numbers in recent months. (There have been other factors that have had a significant impact, including speculation that real estate would outperform other investments.)

Even after the recent declines, mortgage rates in October were still half a percentage point above the lows recorded in mid 2003. Just as importantly, consumers' perceptions of home prices have grown more negative during the past year, with homes now more frequently viewed as too expensive. Indeed, consumers now hold the least favorable assessments of home prices in twenty years. The combined impact of higher prices and mortgage rates have caused an overall decline in favorable buying attitudes during the past year (see Chart 6).

Given that interest rates are expected to increase during the year ahead, additional declines in home buying attitudes can also be expected. The extent of the declines in sales will be a relatively small reduction from an all-time peak level. Importantly, the Fed would not have to raise rates by very much to trim housing demand. The change in reference criteria now means an 8% mortgage would seem impossibly expensive when a decade ago it would have seemed irresistibly low! Overall, the small declines in home sales forecasted for 2005 represent the weakest area of consumer spending.

Vehicle Buying Attitudes

New vehicle buyers have learned to look toward manufacturers for information on interest rates as well as prices. It should be no surprise that the size of the discounts have gradually increased so as to maintain the same response from consumers. Both the consumer and the manufacturer have mastered the game of hide-and-seek. Now, when discounts are judged too small by consumers, they hide until manufacturers seek them out with larger discounts. At other times, manufacturers hid discounts on popular models until enough consumers sought out other manufacturers. Overall, competition for market share has never been so fierce, nor have the costs in terms of foregone profits been so expensive.

In the early November survey, the proportion of consumers holding favorable vehicle buying attitudes fell to 63 percent, the lowest level in three years. In explaining their views, fewer consumers mentioned the attractiveness of discounts than anytime since the zero rates were first offered following 9/11. In early November, just 25 percent mentioned the availability of discounted interest rates on vehicle purchases, down from 32 percent one month earlier and 44 percent one year earlier.

Given these declines, the introduction of what might be termed the “double zero” incentive is not surprising. Three years ago, zero rate financing set the new standard for discounts; now it’s a zero rate on both your current and your next replacement purchase. (Essentially a lease type arrangement with the risk of the vehicle’s resale value shifted from the manufacturer to the consumer.)

The overall data indicate a weakening of demand (see Chart 7). Vehicle manufacturers can be expected to continue offering discounts of sufficient size to offset much of what would otherwise be more significant declines. Overall, I expect vehicle sales to be close to this year’s 17.1 million units in total sales of cars and all trucks during 2005.

Rising gas prices have a direct and indirect impact on vehicle demand. First, insofar as higher gas prices lessen discretionary incomes and heighten uncertainty, vehicle demand would be somewhat weaker. Second, if gas prices are expected to be permanently higher, vehicle preference can be expected to change toward more fuel efficient vehicles. It was the combination of both the indirect and direct impacts that had such a devastating impact on vehicle sales in the 1970s.

Some consumers have recently mentioned gas prices when asked to assess current vehicle buying conditions, but the number has remained quite low. In early November just 9 percent of all consumers mentioned gas prices, below the 15 percent recorded in June, and much less than the 26 percent peak recorded in the 1970's. Importantly, consumers do not anticipate that gas prices will be permanently higher. Moreover, in historical perspective, current gas prices are well below the peak levels recorded in 1980.

Inflation Expectations

As of mid November, consumers expected the surge in oil prices to have a temporary impact on the overall inflation rate. Following the May surge in oil prices, consumers expected an inflation rate of 3.3% in the May and June surveys, which then subsided to 2.8% in August and September. The October surge prompted consumers to anticipate an annual inflation rate of 3.1%, but that quickly fell back to 2.8% by early November.

More importantly, throughout the past year consumers have not changed the inflation rate they expected over the next five years, indicating that they expected only a temporary impact from higher gas prices. The annual rate of inflation expected by consumers over the next five years has remained about 2.8% during the past year (see Chart 8).

How would consumers react to substantially higher inflation rates? The rate of inflation consumers view as acceptable has varied considerably over the past fifty years. A 5% inflation rate sparked enough fear to prompt the imposition of a price freeze in the 1970s and sparked enough optimism to herald the return of good times in the 1980s. The context was crucial to these evaluations: in the former case, inflation had been low and stable, and then rose sharply from 1.6% in 1965 to 5.5% in 1969; in the latter case, inflation was high and variable, and then dramatically fell from 13.5% in 1981 to 3.2% in 1983. During the past decade the annual inflation rate has ranged from 1½% to 3½%, not quite as low as in the early 1960s but low enough for consumers to consider inflation a non-issue. Any sustained increase, even if it remains well below 5%, will now arouse great concerns among consumers.

Consumers' reactions to inflation have also varied over the years, shifting between precautionary saving and advance buying. Which reaction inflation prompted depended on longer term inflation expectations as well as on future job and wage prospects. Obviously, purchase postponement is the more likely reaction to temporary price increases, and advance buying is more probable for goods that are expected to post repeated and permanent price increases. The boom in spending that occurred in the 1970's required both the expectation of rising prices over the longer term as well as the expectation of a secure job. In contrast, the more cautious response in the late 1950's was predicated on the expectation that price hikes would be temporary and job security was not guaranteed. While I do not expected the reincarnation of the 1950s consumer a half century later, rising inflation is more likely to heighten precautionary motives.

Personal Finances

When asked to explain how their financial situation had recently changed, consumers were more likely to cite the corrosive impact of higher inflation in early November. Overall, one-in-four households reported that their finances had worsened. Whereas last year's top concern was meager wage growth, this year's primary concern was that a higher inflation rate could erase any wage gains. Wage growth has improved during the past year, although it still remains quite low by historical standards (see Chart 9).

Unfortunately, just as consumers anticipated somewhat stronger growth in their nominal wages, a higher inflation rate has convinced consumers that real income growth would be meager during the year ahead. Indeed, the majority of households anticipated that the gains they expected in their wages would be entirely offset by higher prices, leaving their net financial situation unchanged. This stands in sharp contrast to four years ago, when nearly half of all consumers expected a net gain in their financial situation. Indeed, the data make it quite clear that consumers based their future financial prospects on real gains in income, not simply on nominal changes (see Chart 10).

Given that consumers initially anticipated the price increases to be temporary, rather than cutting back on spending, they have reduced their saving. The rate of savings out of disposable income fell to an all-time low of just 0.4% in the third quarter of 2004. During the year ahead, the savings rate can be expected to double or triple! In the past consumers had a difficult time balancing the need for more savings against what they considered a once in a lifetime opportunity for low fixed mortgage rates and zero rate financing. Precautionary motives are likely to dominate in the year ahead, but not so completely that the savings rate even reaches 2%.

Unemployment

Rather than interest rates or inflation, employment has been the key factor in determining overall trends in consumer sentiment. New reference standards for unemployment were first expressed by consumers four years ago, in the time period between the November Presidential vote and the December Supreme Court decision. The unemployment was 3.9% from October to December of 2000, the best three months in thirty years. Nonetheless, by early December consumers expressed heightened concerns about potential increases in unemployment. Unemployment did indeed rise as consumers had anticipated, reaching a four-year high of 4.9% in August, the month prior to 9/11.

It should be no surprise that these heightened concerns have persisted despite the fact that the current 5.5% unemployment rate is well below the recent peak of 6.3% and is lower than its average level during the past fifty years. What matters now for consumers is that the unemployment rate is above the lows recorded in 2000. While it may sound incredible, it is nonetheless true that consumers now believe a 4% unemployment rate is a reasonable expectation. That same high performance standard was last recorded in the late 1960s, following what is now the second longest expansion on record. It was not until the 1980s, following more than a decade of economic and political turbulence, that consumers finally adopted lower performance standards for the economy.

The recent experiences of consumers have challenged these new performance standards. It is a tenet of conventional wisdom that younger and lower skilled workers suffer the most in economic downturns. This meant that the extent of the recent cutbacks among older and more educated workers came as a disturbing surprise to consumers. To be sure, younger and less educated workers still experienced the highest levels of unemployment, but they did not suffer the greatest relative increases in unemployment. In the last four years the change in unemployment rates was much steeper among older and higher educated workers (see Chart 13). Compared with an increase of 28% among the youngest workers, among those aged 55 to 64 the unemployment rate increased by 90%. The same was true for education: among those with less than a high school degree, the unemployment rate increased by 36% compared with an 80% increase among those with college degrees. It has been the combination of large absolute increases among the younger and less educated workers coupled with extremely large relative increases in the unemployment rates among the older and highest educated workers that has made the 5.4% unemployment rate a cause for alarm rather than the cause for celebration it was in the 1980s.

Where do consumers obtain the information on which they base their future employment expectations? Consumers base their economic expectations on information from a variety of sources. Economic news carried by the media is certainly an important source, but it is not the most important source for the formation of unemployment expectations. Over the past half century, expectations have consistently led media reports, and not, as many have hypothesized, that news reports have led expectations.

The Surveys of Consumers has regularly asked respondents to describe in their own words what economic developments they had recently heard. Out of the more than 100 different responses that are consistently followed, this analysis highlights just two: news reports of increases in employment, and reports of job losses. An index was formed by taking the difference between increases and decreases in employment to represent the news environment. These data are compared with another question which asks respondents how they expect the national unemployment rate to change during the year ahead. The time-series comparison of the questions on unemployment news and expectations indicate that it is expectations that change in advance of news (see Chart 14). This suggest that news reports act more to confirm prior expectations than create expectations.

There are also some other interesting facets of consumers' responses to the news question. The series is mostly negative, meaning that consumers typically report more news about declines than increases. It should be no surprise to a behavioral economist that consumers are more responsive to potential risks. Indeed, risk averse information processing dominates how consumers process news about unemployment. It is a rare situation where news of increases in employment is reported more frequently than job losses. Favorable job news predominates only in the early stages of a recovery, and only for a brief period of time. The second striking finding is that news about rising unemployment was as frequently reported in the recent surveys as in earlier periods when the unemployment rate was much higher: the peak unemployment rate was 10.8% in 1982, 7.8% in 1992, and 6.3% in 2003. This in part reflects the higher performance standards that consumers have adopted.

The changing employment standards, however, have not affected the forecasting ability of consumers' expectations (see Chart 15). Elsewhere I have shown that SRC's unemployment expectations series to be an unbiased predictor of future changes in the unemployment rate, and that ability is based on information independent of past trends in unemployment and other economic variables (Curtin, 2003b). Rather than responding to the official announcements, unemployment expectations were more responsive to private information about future unemployment and the outlook for the economy. Uncertainty about job prospects is an important component of precautionary motives and is associated with lower rates of growth in consumption (see Chart 16). Indeed, SRC's unemployment expectations have been shown to be a significant predictor of future changes in consumption spending even after controlling for other economic variables.

Summary Outlook

It is now time to summarize the implications for spending and saving in 2005 from the perspective of the two interrelated themes that I have discussed.

The primary finding from the Surveys of Consumers is that consumer spending will remain quite healthy. The survey data indicate that total consumer expenditures will grow by 3 ¼ % during 2005. Rising interest rates will have the most impact on housing, and to a lesser extend on vehicle demand. While energy prices are expected to slowly decline during the year ahead, they will remain high, including the cost of home heating. Inflationary problems are not limited to energy prices, and consumers now have a reduced tolerance for rising inflation. Consumers expected the pace of growth in employment and wages to offset higher inflation rates during the year ahead, and thus help to improve their personal financial situation.

Importantly, the personal savings rate will begin to increase, although the small gains expected during 2005 pale in comparison to the decade long slide in the savings rate. Returning to the higher savings rates recorded in the past will be helped by the downward revision in long term performance standards. These declines will generate a good deal of angst and uncertainty. The resulting rise in precautionary motives will act to increase savings. The carrot of future economic security may not be as effective as the stick of financial distress. In any event, it is likely that the personal savings rate will rise over the longer term.

There are several risks to this forecast. The non-economic risks mainly involve terrorism and disruptions in the supply of oil. It is difficult for consumers to sort out how much of the recent increase in oil prices was due to rising worldwide demand or a risk premium against potential disruption. It is likely that consumers have placed greater emphasis on the risk premium rather than higher demand. This follows from the fact that they anticipate the price increase to be temporary. If that is true, consumers have simply postponed the ultimate adjustments that they will need to make to accommodate permanently higher prices. A sudden recognition of this mistaken judgement by consumers would mean somewhat higher savings in 2005.

The more likely risks primarily involve the pace of growth in employment. While it is not impossible, it is nonetheless unlikely that employment would grow by the amount needed to achieve an average unemployment rate less than 5% in 2005. It is more likely that unemployment will remain at about the same level as now, with the growth in jobs largely offset by greater labor force participation rates as well as the natural growth in the labor force. As a result, the risk of a higher unemployment rate can not be entirely dismissed, especially if a burst in inflation is countered by higher interest rates.

Finally, consumers now used extraordinarily high performance standards to judge ongoing economic developments. The key issue will be the size of the gap between the performance standards and the actual performance of the economy. Consumers will have no other choice but to gradually lower the performance standards given that inflation and interest rates as well as unemployment cannot be expected to permanently remain near three-decade lows. As long as both the evaluative standards and economic performance slowly change, the size of the gap will remain manageable. An abrupt change in inflation and interest rates—even if they remained at comparatively low levels—would significantly widen the gap and prompt a widespread increase in economic pessimism.

References

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Curtin, Richard. (2003b) “Unemployment Expectations: The Impact of Private Information on Income Uncertainty,” *Review of Income and Wealth*, 49:4, December 2003.

Curtin, Richard (2004) “A Tale of Two Economies: The Outlook for Consumption in 2004,” in *The Economic Outlook for 2004*, Department of Economics, University of Michigan.

Chart 1

Level of Consumer Sentiment and Presidential Reelections

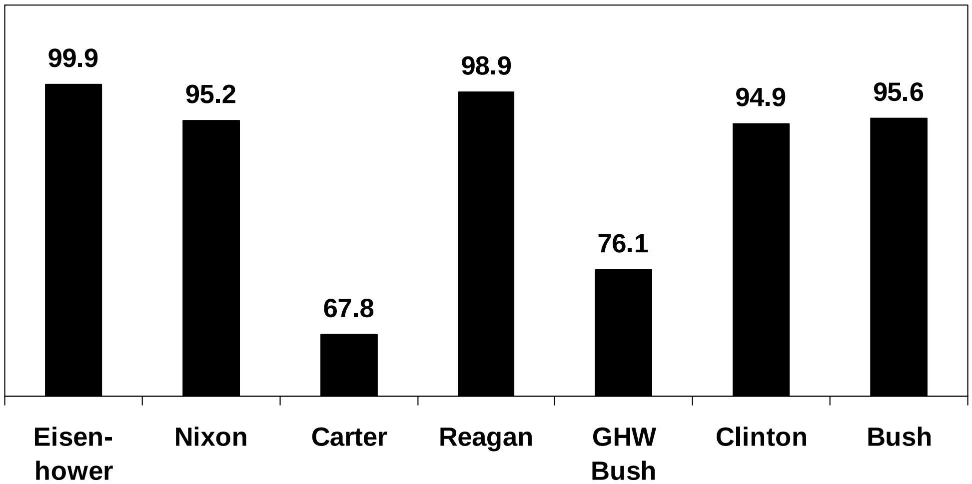

Chart 2

Change in Consumer Sentiment and Presidential Reelections

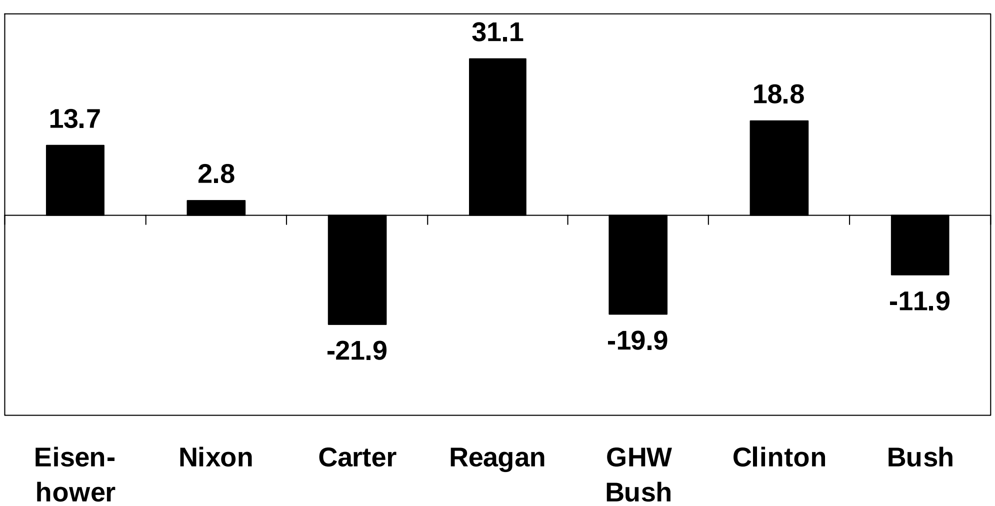

Chart 3

Index of Consumer Sentiment

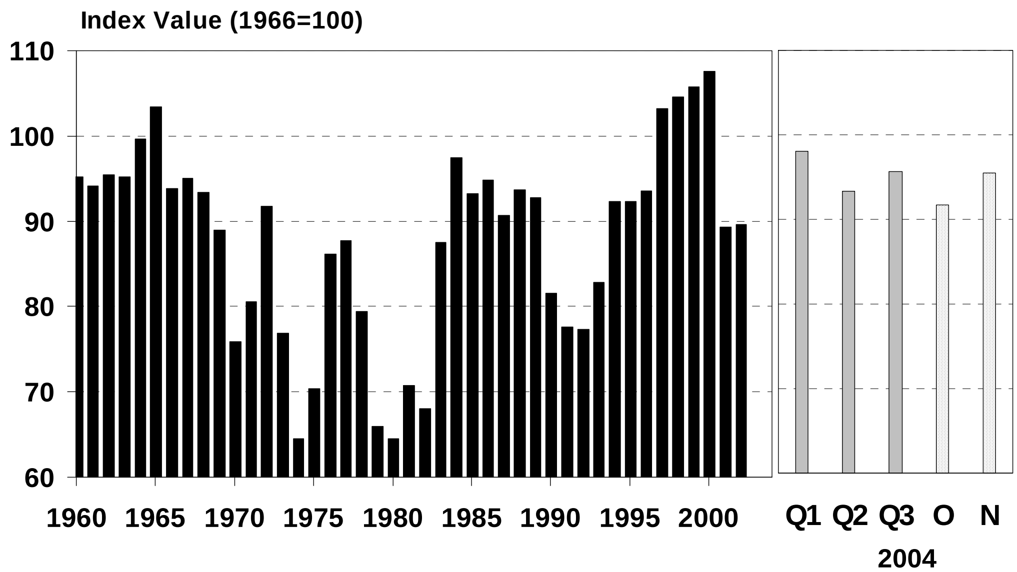

Chart 4

Change in Sentiment Index and Annual Growth in GDP

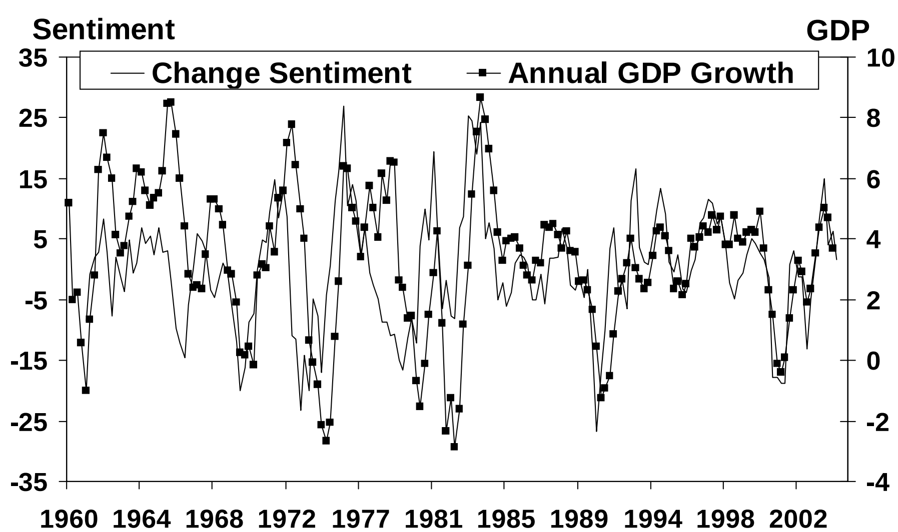

Chart 5

Expected Change in Interest Rates During the Year Ahead

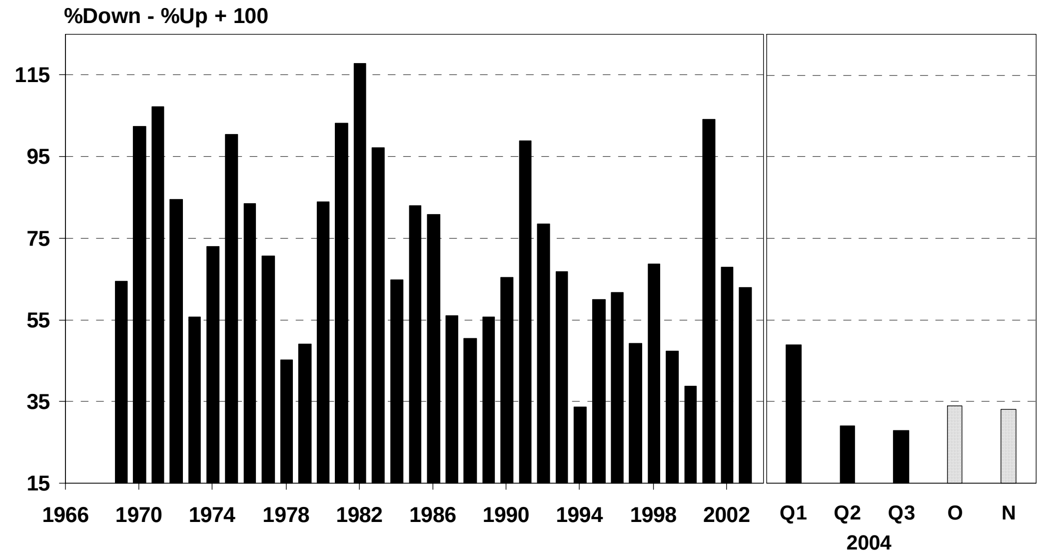

Chart 6

Home Sales and Home Buying Attitudes

(Year-to-Year Change in Series)

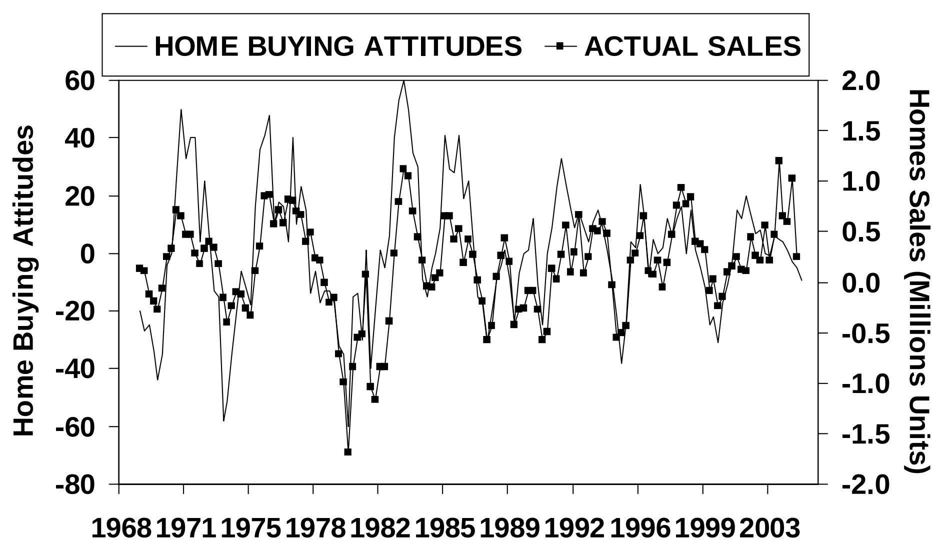

Chart 7

Vehicle Sales & Vehicle Buying Attitudes

(Year-to-Year Change in Series)

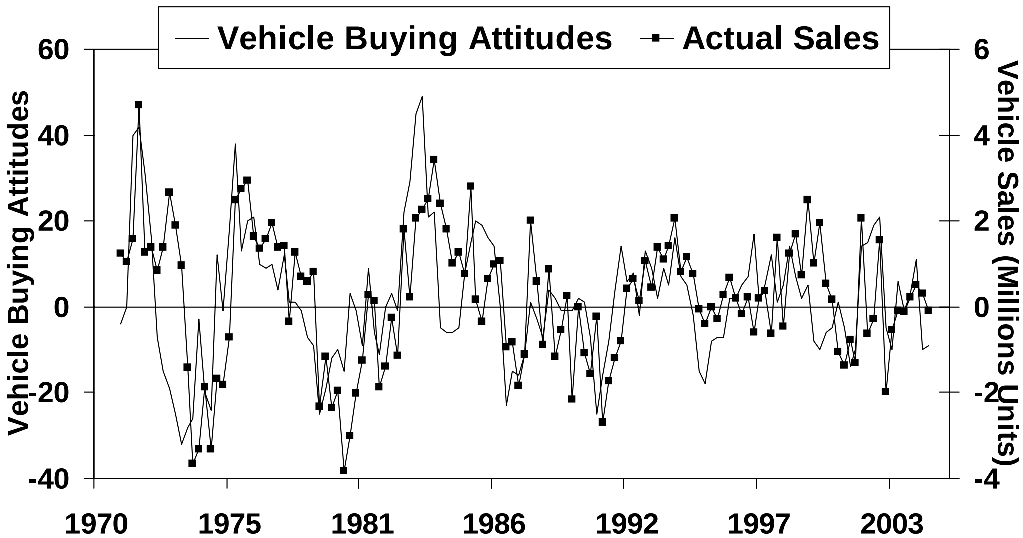

Chart 8

Expected Near and Long Term Inflation Rates

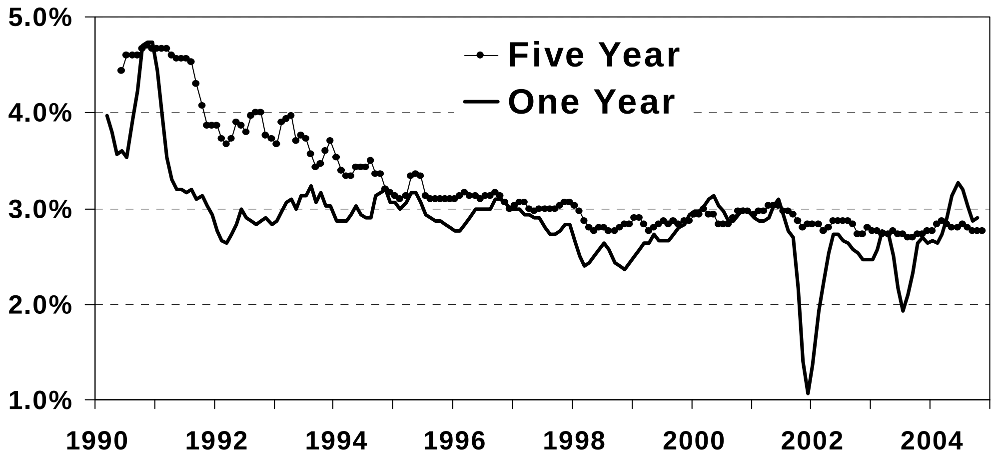

Chart 9

References to Income Growth and Annual Change in Real Wages

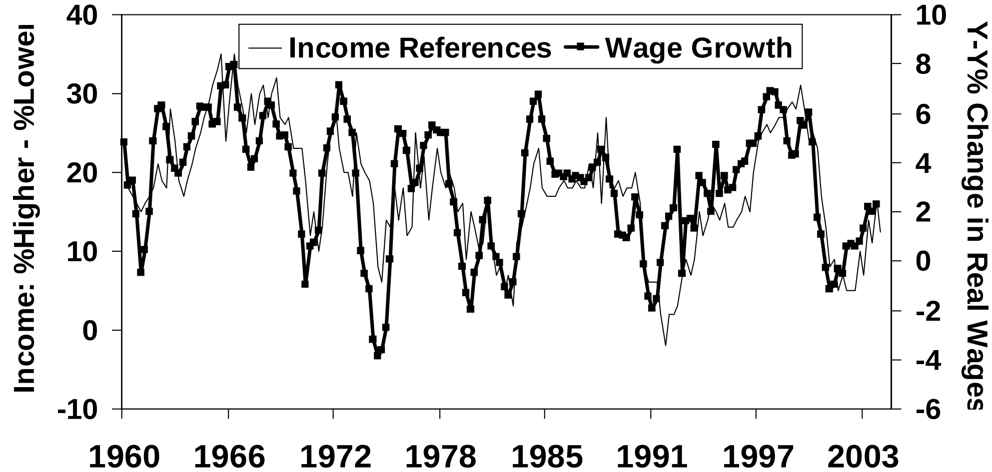

Chart 10

Personal Financial Prospects and Real Income Expectations

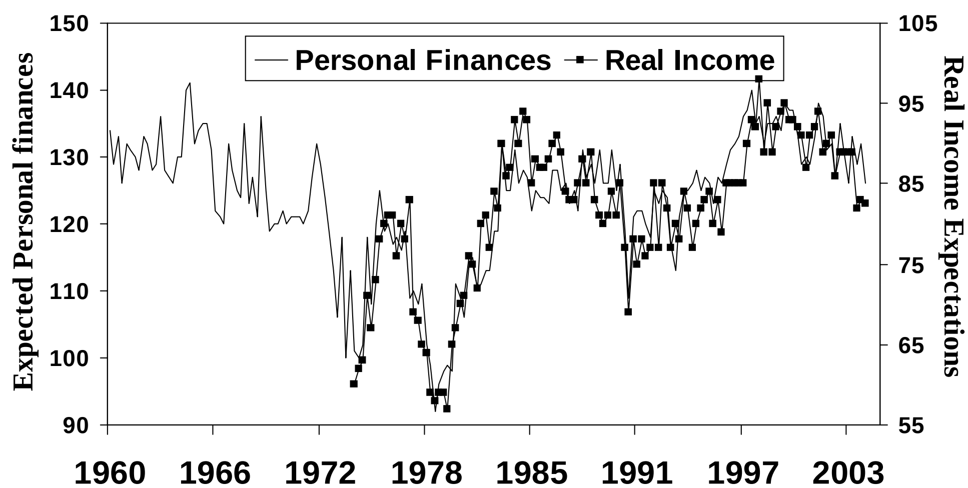

Chart 11

Debt Service & Financial Obligations as a Percent of Disposable Income

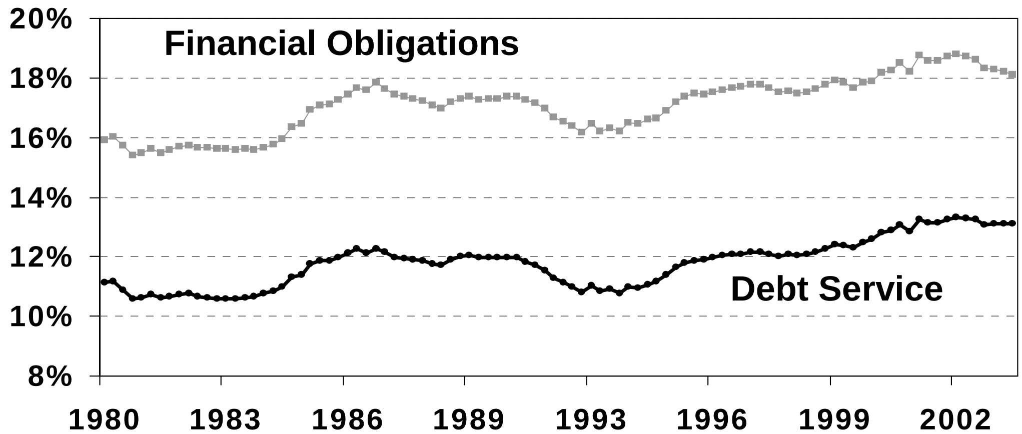

Chart 12

Change in Likelihood of a Comfortable Retirement Income

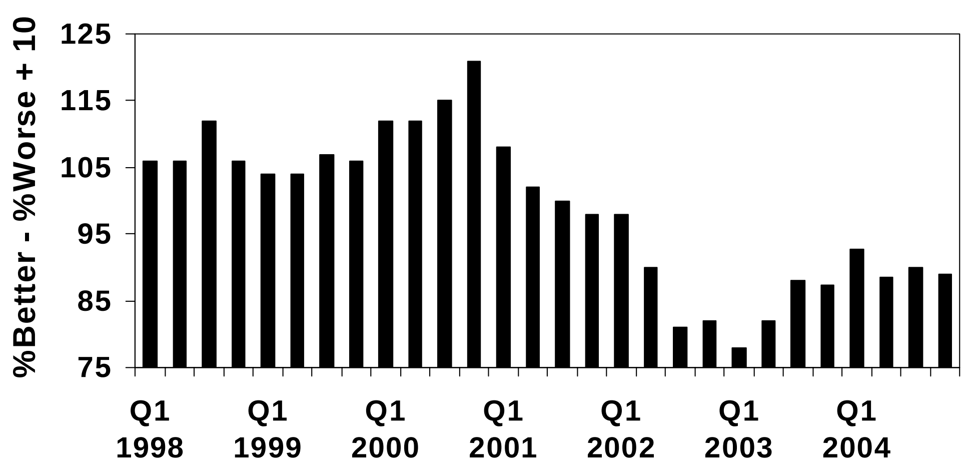

Chart 13

Change in Unemployment Rate By Age and Education

Age	Chg Unemployment Rate 2000:2 to 2004:2		Education	Chg Unemployment Rate 2000:2 to 2004:2	
	Pt Chg	% Chg		Pt Chg	% Chg
18 – 24	2.7	28%	Less High School	2.1	36%
25 - 34	1.7	49%	High School	1.7	49%
35 - 44	1.3	45%	Some College	1.6	62%
45 - 54	1.6	73%	College Degree	1.2	80%
55 - 64	1.8	90%			
65 +	0.5	17%	Labor Force	1.6	41%

Chart 14

News Heard About Unemployment and Unemployment Expectations

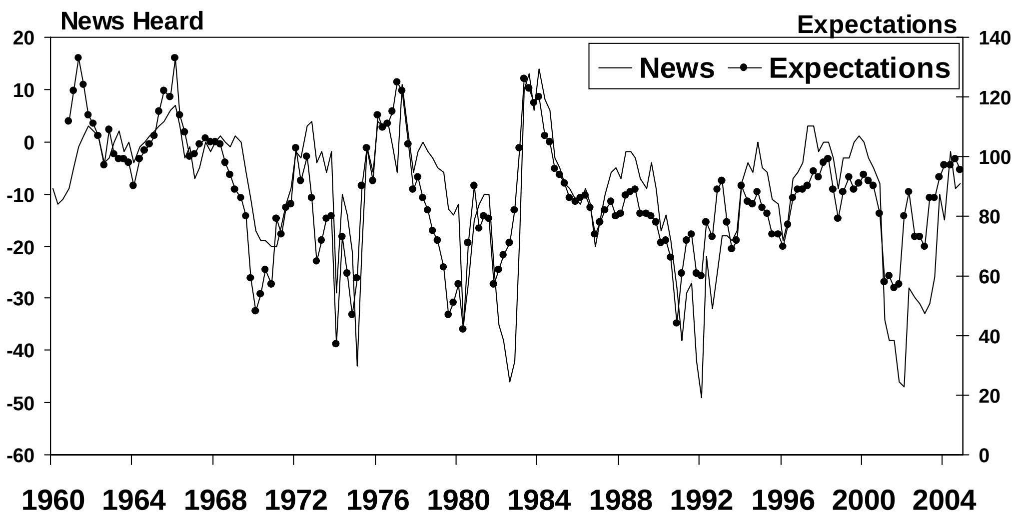

Chart 15

Unemployment Expectations & Change in Actual Unemployment Rate

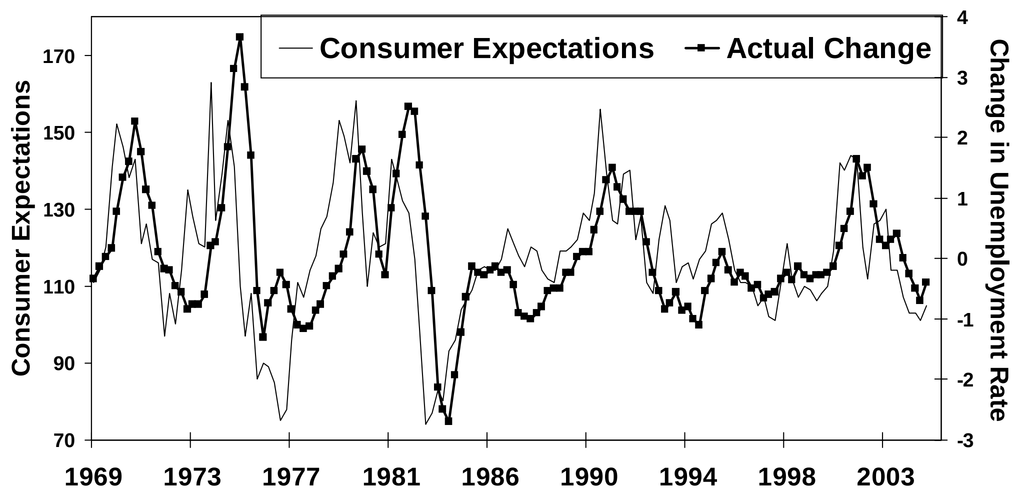

Chart 16

Unemployment Expectations & Growth in Personal Consumption Expenditures