
CONSUMER AMBIGUITY IS LIKELY TO BE A FEATURE OF THE U.S. ECONOMY FOR SOME TIME TO COME.

By Richard Curtin

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Consumer confidence is a fairly accurate predictor of macroeconomic change. Recently, measures of consumer confidence have been giving ambiguous signals about consumer confidence and future economic growth. The factors behind the levels of consumer confidence as of the end of September 2002 are explored and provide insight into the determinants of consumer confidence and its importance as a predictor of the economy in the future. Also, the paper illustrates how the various aspects of consumer confidence can be used to interpret different facets of the economy, now and in the future.

It is alleged that Winston Churchill once said that if you put two economists in a room, you would get two opinions, unless one of the two was Lord Keynes, in which case you would get three opinions. As Milton Friedman and Richard Nixon said (with different meanings), “We’re all Keynesians now.” The economic situation as of the end of 2002, and perhaps for some time to come, is perfectly suited to the economist who wants to extend the forecast with “...on the other hand.” Perhaps more importantly, consumers, who account for two-thirds of all spending, now frame their own forecasts in that same way. A broad range of offsetting changes in economic expectations has been recorded in the Surveys of Consumers conducted by the University of Michigan. Consumer expectations for jobs, incomes, interest rates, inflation, stock prices, home values, and taxes, to name just a few, have moved independently, and often in opposite directions during the past few years.

Given these divergent changes, it should be no surprise that the summary measure of trends in consumer confidence has hovered around its fifty-year average. While this middling position is hardly a positive development, the cross-currents that now exist among economic expectations do not make it unambiguously negative. Indeed, no headline-sized summary of the current state of consumer confidence is now possible as the more nuanced judgments made by consumers defy easy char-
acterization. Consumers think it’s a good time to buy vehicles but not PCs, a good time to buy homes but not household durables; consumers are pessimistic about wage growth but are optimistic about their future finances; they are more willing to incur debt, yet they have also increased their savings.

Perhaps the most surprising result has been stability in consumer confidence amid the steep falloff in business investment spending, plunging stock prices, the financial and accounting scandals, and the terrorist attacks. Who would have thought that businesses would be most susceptible to the irrational exuberance generated by the dot-com craze? More importantly, who would have thought that we would depend on consumers to provide stability to the macro economy? For the last seven consecutive quarters it has been business investment that has contracted and consumer spending that has continuously expanded. How long can that last? More importantly, will it be business or consumer spending that changes course?

An answer to this question requires an analysis of both recent developments in consumer expectations as well as the more fundamental criteria that consumers use to judge the performance of the economy. Both types of expectations have recently changed, and both types of changes will have pervasive impact on developments in the economy during the years ahead.

Index of Consumer Sentiment

While the overall level of the Index of Consumer Sentiment is middling, it has not lost its power as a predictor of GDP (see Figure 1, both series are shown as year-to-year changes). Even after controlling for other variables typically used to predict GDP, the Index of Consumer Sentiment is a statistically significant predictor of future trends (Howrey, 2001). The survey indicated that the Sentiment Index posted its fourth consecutive small decline in September 2002. At 86.1, the Sentiment Index was just 4.3 Index points above the September 2001 low and 10.8 Index points below the year-to-date high. While the data continued to indicate that consumer confidence remained in the middling range, the recent decline indicated an even slower, but still positive, pace of growth in 2003.

Given the terrorist attacks of September 11, 2001 and the growing winds of war, these are hardly normal times. The September 2002 data provided no evidence that the prospective war with Iraq had yet had much impact. Nonetheless, consumer confidence is vulnerable to the same factors that surrounded the Gulf war a decade ago. Indeed, the September 2002 level of the Sentiment Index was nearly identical to its level in the month prior to the invasion of Kuwait by Iraq. The sharp increase in gasoline prices in August 1990 caused an immediate plunge in consumer confidence, with the Sentiment Index falling by twenty-five percent in just three months.

To be sure, there have been significant developments since 1990 that could fundamentally alter consumers’ responses to the same set of factors. Consumers have experienced repeated and temporary surges in gasoline prices as well as repeated and successful military campaigns. While it is impossible at this early stage to know how consumers will respond, I do not think the reaction of consumers will be as extreme as in 1990.

How a war would affect the price and availability of heating oil and gasoline is a crucial factor. In the event of war, it could be expected that reducing the risks of sharp hikes in energy prices and insuring adequate supplies will be an objective of the U.S. administration, and raising those risks will be an objective of Iraq. As long as the military conflict is resolved quickly, consumers are unlikely to view the war as having a negative impact on the domestic economy. To be sure, any military setbacks in Iraq or concurrent terrorist attacks in the United States could significantly raise consumer apprehensions and disrupt spending. Most consumers, however, expected no such adverse consequences as of September 2002. Needless to say, these assessments by consumers can change quickly and, thus, should be carefully monitored.

It will be consumers’ expectations for income and job prospects, interest rates and inflation, their debt burdens and changes in

![Figure 1: Change in the Index of Consumer Sentiment and Annual Growth Rate of GDP](image-url)
their household wealth that will have the most lasting impact on consumer spending during the year ahead. I discuss these factors first and then broaden the presentation to include how consumers have changed the criteria they use to judge the performance of the economy and, in so doing, have changed the underlying dynamic of the economy.

Unemployment

It is only fitting that I start with job prospects since it was a sudden change in consumers’ expectations about jobs that initially tilted the economy toward recession. It started on Thanksgiving weekend in 2000. At that time, there was little discussion about the economy: it was the undecided Presidential election that dominated the media headlines. Nonetheless, between Thanksgiving and the middle of December, consumers came to the conclusion that unemployment would significantly increase during 2001 because they thought that businesses were beginning to scale back their investment spending plans. The shift in consumer expectations was as dramatic as the subsequent increase in the unemployment rate, which rose from just under four percent to nearly six percent.

Consumers initially thought the worst was over by the start of 2002, and unemployment expectations began to improve. These gains were ultimately reversed by how consumers interpreted the spreading financial and accounting scandals. To be sure, most of their attention was initially focused on its impact on stock prices and the evaporation of their wealth. Nonetheless, consumers also came to the conclusion that the accounting scandals would mean that firms would be less willing to invest in expansion and new job creation. For consumers, this meant that they now anticipated a prolonged period of slower job growth. While the loss of stock market wealth was mainly a concern about retirement, the loss of job prospects was a much more immediate concern.

Some may doubt the ability of consumers to anticipate actual changes in the national unemployment rate, and some may be skeptical about whether consumers would actually base their spending decisions on their unemployment expectations. How well can consumers anticipate actual changes in the unemployment rate? Figure 2 indicates a close relationship between trends in consumers’ expectations and the annual change in the national unemployment rate. Statistical analysis has documented that consumer expectations have a significant predictive relationship with the actual subsequent changes in the unemployment rate even after controlling for other relevant variables.

Unemployment expectations have an important impact on spending decisions as well. The Michigan series on unemployment expectations was found to be a significant predictor of personal consumption expenditures even after controlling for the variables typically part of consumption models, including measures of permanent income (Carroll and Dunn, 1997). This correspondence is shown in Figure 3, which shows the correspondence between changes in

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the consumers' unemployment expectations and the annual growth rate in total personal consumption expenditures.

The September 2002 data indicated that consumers were somewhat more optimistic about job prospects, but on balance consumers were still more likely to expect the unemployment rate to edge upward during the year ahead. This would be consistent with a slight slowdown in the pace of total personal consumer expenditures in 2003.

**Interest Rates**

Immediately following the December 2000 increase in consumers' unemployment expectations, the Fed began to lower interest rates. Eleven rate cuts were implemented during 2001. The repeated cuts in interest rates, however, did not have much impact on consumers' unemployment expectations because consumers did not expect that business investment spending would quickly respond. Cuts in interest rates, however, did have a substantial impact on consumers' willingness to purchase homes and vehicles. Indeed, even as consumers became progressively more pessimistic about overall economic prospects, their views of buying conditions for homes and vehicles became even more favorable. Trends in these buying attitudes have demonstrated a very close correspondence with actual sales (see Figures 4 and 5). More importantly, the recent data indicate that sales of homes and vehicles will remain strong in 2003, although they will be marginally lower than in 2002.

The prompt action by the Fed has made the downturn as well as the upturn quite unique. Whereas in prior recessions the housing and vehicle industries were the first and hardest hit, these industries have done quite well during the past two years. Correspondingly, as the recovery gains strength and interest rates rise, the housing and vehicle industries will contribute less than usual to the pace of the expansion. While the improved job and income prospects that accompany the renewed economic strength will offset the negative impact of the initial increases in interest rates, those gains will not be sufficient to propel home and vehicle sales to ever higher levels.

It is worth emphasizing that the repeated cuts in interest rates did not have an immediate positive impact on the overall level of consumer confidence. The Sentiment Index in the two weeks before September 9th was at the lowest level recorded in ten years. In contrast, the terrorist attacks had much less impact, as consumer confidence was only marginally lower in the two weeks after September 9th than in the prior two weeks. In the following months, rather than being immobilized in fear, consumers were busy heading out to the dealerships to purchase new vehicles at zero interest rates. New vehicle sales set an all-time sales record just one month after the terrorist attack. This was a remarkable confirmation of a newfound resilience among consumers. It was not simply a deal too good to miss, but also reflected a more fundamental change among consumers in how they viewed longer term economic prospects.

**Inflation**

Low inflation has been the mainstay of consumer confidence. To be sure, few consumers specifically cite the absence of inflation as a positive factor in their financial assessments. Inflation has been too low for too long for consumers to still cite its demise as a favorable fac-

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has been recorded during the past quarter century. This expectation of a permanently lower inflation rate has important implications for consumers' assessments of buying conditions as well as their personal finances. A few decades ago the term "sticker shock" was meant to convey the feelings consumers had when they realized how much new vehicles cost; today that same term could be aptly used to describe the reaction of vehicle manufacturers to how much they can now charge. Deep discounts have become a part of normal business, not just for vehicle manufacturers but across a wide array of industries.

There was a time when the situation was quite different. In that earlier era, manufacturers could not only pass on cost increases but anticipated cost increases as well. In that era of inflationary psychology, consumers tried to maximize their advantage by buying-in-advance. As a strategy, consumers anticipated inflation quite well (see Figure 8), but their actions nonetheless added to the instability of the economy. While in recent times, consumers' reactions to price changes have muted the boom-bust cycles, there is a growing concern that their actions could help push the economy into a deflationary mode. While I judge this to be an unlikely outcome, the current behavior of consumers would be consistent with creating a dynamic that supports disinflationary trends in the economy.

Performance Criteria
I rarely talk about the more fundamental changes observed in how consumers judge the performance of the economy. These views infrequently change and thus do not usually play a role in near-term forecasts of consumer spending. Without the use of some criteria or standard of comparison, consumers could not assess current economic developments. These standards reflect more fundamental and longer term views about the economy. These views
are not easily changed by current experience; indeed, these views act as a frame of reference that people use to interpret current developments. Nonetheless, the criteria do change over time along with the performance of the economy. These evaluative frames of reference are not neutral, but directly influence how economic events are interpreted as well as influence the behavior of consumers.

There have been four distinct periods in the last fifty years. The first was an era of optimism and confidence, lasting from the end of World War II through the 1960s; the second was a period of uncertainty and discontent, which dominated the decade of the 1970s and early 1980s. The third period, starting in the mid 1980s and lasting to the mid 1990s, was characterized by diminished economic expectations. Finally, in the current period, which started in the mid 1990s, consumers have again adopted optimistic economic expectations. While the repetitive cycle from optimism to pessimism is a characteristic of these longer waves, like the shorter term cycles, there is no fixed timing to the individual stages. More importantly, like the shorter term cycles, these repeated long waves provide information about what can be expected over the years ahead.

Optimism and Confidence. The decades of the 1950s and 1960s were characterized by consumer optimism and confidence. Rapid and sustained economic growth was translated into rising affluence for most American families. To be sure, the economy did occasionally experience recessions during those decades, but they were few in number. More importantly, recessions were increasingly viewed as preventable. By the mid 1960s, confidence in the government’s ability to utilize fiscal and monetary policy tools led many to believe that cyclical downturns in the economy were a thing of the past. Economic growth came to be seen as the inevitable course.

The psychology of prosperity that evolved became deeply ingrained. When recessions did occur, they were viewed as only a temporary pause in the otherwise rising tide of affluence. To cope with the downturns, some spending plans had to be put on hold, but the postponement was expected to be brief. Consumers’ aspirations remained unchanged since they saw little reason to revise them because of what was viewed as a temporary aberration in the economy.

Uncertainty and Discontent. In the decades of the 1970s and early 1980s, rather than a source of satisfaction and confidence, the economy became a source of uncertainty and discontent. Economic instability was the dominant characteristic of this time period, as the economy moved rapidly from boom to bust, and back again. The high levels of economic aspirations that were built in the earlier decades were not quickly abandoned. In part, the persistence reflected what was thought to be the special, and transitory, impacts from the initial oil shocks to the economy.

Economic aspirations are not easily modified by the twists and turns of current economic conditions. When accomplishment meets or exceeds aspirations, a sense of satisfaction results; when accomplishment falls short, dissatisfaction results. It was only after prolonged frustration and non-fulfillment that aspirations were reduced. Thus, for much of the decade of the 1970s, the American public expressed widespread discontent as they still held the economy to the high performance criteria of the earlier decades.

Diminished Expectations. Ultimately, however, high aspirations gave way to persistent economic adversities. By the mid 1980s, the standards consumers used to judge economic performance had changed. Consumer assessments did not depend so much on whether the economy was meeting its potential for growth, but whether the economy could avoid the catastrophes of the prior decade. The focus of consumers was not the restoration of the American Dream but to simply reduce the Misery Index (the sum of the inflation and unemployment rates). These changed standards affected performance evaluations across a broad range of economic measures.

What was considered an achievable rate of economic growth was lowered and was accompanied by widespread accommodation to higher inflation and higher unemploy-
ment rates. By the early 1990s real median family income was not appreciably higher than the level recorded twenty years earlier. Moreover, a new sense of job insecurity spread among workers at all skill levels and across all occupations in the early 1990s. The problem was then blamed on a failure of government economic policy to prevent any further erosion of already diminished expectations.

Optimism Renewed. The persistence of these negative developments made the eventual resurgence of optimism more likely. Economic aspirations had been drastically lowered, and consumers were more willing to accept fundamental changes in government policies. The shift from diminished expectations to widespread optimism was not easily or quickly accomplished. Indeed, it required the longest economic expansion in more than 150 years. As long as accomplishment went beyond what consumers had anticipated, aspirations continued to rise, and a new peak in optimism was reached in 2000.

Perhaps the most telling characteristic of the renewed optimism was that it spawned the view that the business cycle was finally conquered, just as it had in the heady 1960s. While in both periods this view was caused by an irrational exuberance, it is nonetheless a hallmark of the establishment of a new peak in optimism. The recent recession has only erased the irrational aspect of this unfounded view, not the underlying exuberance. Once established, the prevailing sense of optimism does not vanish at the first setback. Even war or political crisis will not immediately erase optimism, as was demonstrated by the inability of the Vietnam War and Watergate to end the optimism of the 1960s. To abandon optimism it would take repeated, persistent, and widespread failures in the economy over a prolonged period of time. To be sure, the current mixed performance of the economy is not likely to change consumers’ underlying views. The weakness in the economy is seen more as an anomaly rather than as a systemic problem.

Just as the rebuilding of confidence was aided by lower performance expectations, the shift away from optimism will be facilitated by the higher standard of performance recently achieved. In the former case, it was the pleasant surprise of unexpected gains; in the current situation it will be the unpleasant realization that expectations were too high. Indeed, expectations for the performance of the economy are now very high. There is widespread agreement among consumers that the sustainable rate of economic growth is now higher than anytime since the 1960s, and what consumers view as an acceptable inflation rate and unemployment rate is now much lower.

This has been convincingly demonstrated by consumers’ reactions to the recent increases in the unemployment rate. Although it is still under six percent, more consumers than ever before cited high unemployment in recent surveys—more consumers than when the unemployment rate was twice as high in the early 1980s. Even what would have been considered a modest inflation rate in past years could now prompt very unfavorable reactions among consumers. While the same can be said for higher interest rates, it will also mean that the Fed will find consumers’ spending plans even more responsive to smaller changes in interest rates.

Lower performance expectations are never accepted without complaint. They are fiercely resisted. Indeed, consumers can be expected to be more willing to express their political disfavor as the performance of the economy falls short of their expectations. Importantly, the process of change is slow and could take a decade to complete even if the economy fails as miserably as it did in the 1970s and early 1980s. While this process of change has begun, the most important impact during the next few years will be the continued influence of the very favorable long-term expectations for the economy, even if they are now slightly reduced from the prior peak.

Indeed, the continued willingness of consumers to spend and incur debt is largely due to the expectation that the downturn will be only a brief interruption in an otherwise rising tide of economic growth. This does not mean that consumers will not temporarily lower the pace of growth in their spending, nor that consumers will not increase their rate of savings. The implication of these favorable long-term expectations is that they will not cut spending as much, nor increase saving as much as they would have otherwise done. This will make recessionary declines less severe and shorter, but it will not prevent economic downturns completely.

The prevailing level of optimism, however, makes the economy more vulnerable to excesses. Consumers have accumulated a substantial amount of debt that would become burdensome in the event of income declines.
While refinanced mortgages have added to consumers’ discretionary incomes, the higher levels of outstanding mortgage debt is now more vulnerable to declines in home prices. While there is no reason to expect falling incomes, falling home prices, or further plunges in stock prices, consumers are now more vulnerable to each of these reversals, and these risks cannot be easily dismissed.

Perhaps the most serious threat, but the least likely, is deflation. Just as consumer optimism played a key role in the development of inflationary psychology in an earlier era, so too could optimism help in the development of a deflationary psychology. Consumers ultimately made inflation worse by trying to beat inflation by buying-in-advance, and consumers could ultimately make deflation worse by insisting on deep discounts before buying. Optimism is crucial since only consumers who are optimistic enough to expect their financial situation to remain unsathed will actually confirm those price changes by their buying behavior. Of course, the actions of consumers would be self-defeating, as real incomes fell due to the price increases in the prior inflationary era, and real incomes would fall due to wage decreases in an era of deflation. Thus, the new wave of optimism makes it possible, however unlikely, that deflation could become a driver of economic change just as inflation did a few decades ago.

Summary Outlook

What do the data indicate about the near-term outlook for consumer demand? The short answer is that consumers will increase their spending and increase their saving during the year ahead. The problem is that the increase in spending will be smaller and the increase in saving will be larger than last year. Whether the economy continues to stumble forward will depend on whether the weakened strength in consumer spending will be sufficient to offset any continued declines in investment spending. Clearly, the impact of the war with Iraq will have a significant impact on the economy. Unknown risks increase uncertainty, but do not necessarily lower the forecast level. Until more is known about the war’s ultimate cost, the risks have widened the range but not lowered the forecast.

Even without a war there would be ample cause for angst. Slow economic growth will mean fewer jobs and smaller income gains. Unlike the usual recovery period, characterized by strong increases in sales of homes and vehicles, 2003’s sales levels are unlikely to show a gain over 2002. Just as consumer spending has tempered the recent economic downturn, trends in consumer spending will also temper the upturn during the year ahead. As a result, the strength of the recovery, as the depth of the downturn, will depend on the pace of investment spending by business.

The shifts in the evaluative criteria consumers use to judge the performance of the economy indicate that consumer spending will continue to support economic growth. Whereas business investment fell victim to the irrational exuberance of the dot-com craze and caused the recessionary decline, the continued optimism of consumers has added strength and provided stability to the national economy. The maintenance of an underlying sense of optimism in long-term economic prospects does entail risks, the primary one being high levels of indebtedness. Another more speculative concern is that the uncertainty could increase the vulnerability of the economy to deflationary forces. Overall, the data indicate that we have just begun the process by which people lower their performance expectations to more manageable levels.

Overall, the data indicate neither a robust recovery nor a renewed recession. It is more likely that the overall pace of economic growth will be slow enough, and the divergences across industries wide enough, to keep two-handed forecasts in vogue.

REFERENCES


