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Monitoring trends for over 70 years

Subject: Impact of Interest Rates on Home and Vehicle Purchases November 30, 2018
From: Richard Curtin, Director

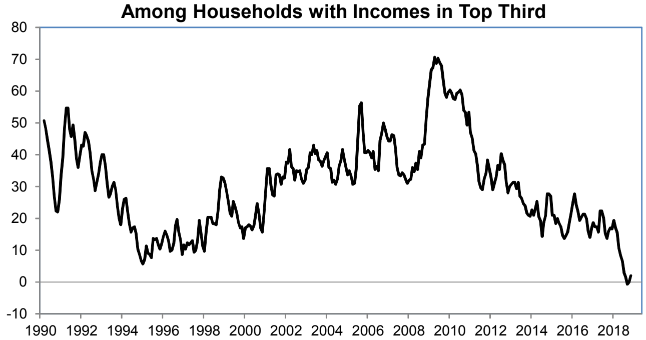
Households with incomes in the top third account for more than half of all consumer spending. The largest purchases are vehicles and homes. These purchases usually involve the use of debt, and their timing is typically discretionary. Past reports have emphasized that recent declines in overall buying attitudes were due to less favorable perceptions of prices and interest rates. Importantly, these declines have been led by changes among upper income households. As shown in the charts below, the declines have left consumers' perceptions of prices and interest rates near the lowest levels recorded in the past quarter century—the all-time lows recorded in the 1970's and early 1980's were due to double-digit inflation and interest rates. The data represent spontaneous mentions of prices and interest rates when consumers were asked to explain their views; the data are shown as three-month moving averages of positive minus negative mentions for those with incomes in the top third.

Prices and interest rates are the primary economic factors determining the strength of demand. As has occurred in the later stages of past expansions, confidence in future job and income prospects has continued to support vehicle and home sales, allowing interest rates to increase without threatening sales. Beyond some threshold, however, interest rate increases cause sharp and sustained declines in sales, often resulting in an economy-wide recession. Unfortunately, that threshold has often been breached in the past, at some times intentionally to reduce high and stubborn inflationary expectations. While it is not impossible for consumers to become more positive about prospective trends in market prices and interest rates, it is unlikely as long as wage and job growth remain strong and the aim of policy is to temper the rate of change in economic growth.

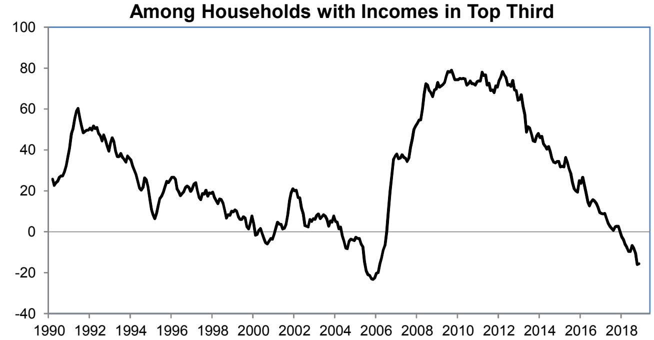
Some observers may be surprised by the reactions of consumers to the relatively low levels of current inflation and interest rates. Consumers do not use an absolute standard, but utilize a relative standard to make their judgements. Those standards have been shaped by the aftermath of the Great Recession. While credit risks in the past were reflected in the level of interest rates, consumers now anticipate that lenders will vary credit standards, not solely interest rates, to control the flow of credit—a practice that was common in the 1950's. The survey data on "interest rates" have always included favorable and unfavorable references to credit standards, and this is the reason the recent peaks are not as high as in the past. Importantly, varying credit standards, rather than interest rates, will have less impact on sales among those with incomes in the top third.

Economists have followed the same practice of making policy judgements dependent on relative standards. The prime relative judgements for monetary policy involve the neutral rate of interest and the non-inflationary rate of unemployment. Current practice is to estimate these guidelines based on past data, with the basic view that they reflect a slow process of change. It would be more appropriate to hypothesize an expectations model that allows sharp and discrete changes in these guidelines.

**Vehicles: Net References to Prices
Among Households with Incomes in Top Third**



**Homes: Net References to Prices
Among Households with Incomes in Top Third**



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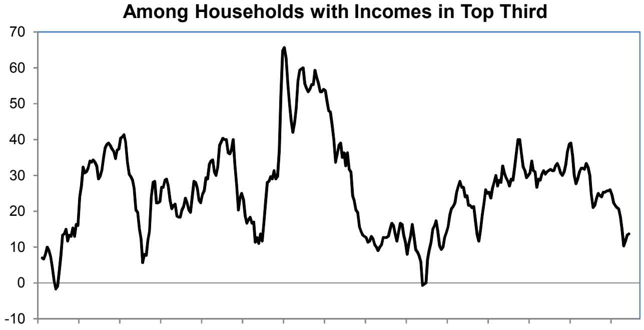

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