Subject: The Impact of Emotions on Expectations January 22, 2021
From: Richard Curtin, Director

Economic expectations are formed to make optimal self-interested decisions. People use all of their mental faculties to form expectations. While conscious deliberation is important, most expectations are usually formed by nonconscious information processing and learning. Emotions also play a central role in forming expectations. Economics has long recognized that "irrational" emotions cause spending booms and extend spending busts. What has not been fully appreciated is that emotions play an integral role in the formation of economic expectations between the extremes of booms and busts. Indeed, the nation is now experiencing the impact of two dominant emotional influences on economic expectations: the Trump presidency and the coronavirus pandemic. The Trump presidency has generated a sharp partisan divide that has been fueled by emotions. These emotional forces have driven an almost instant and extreme change in economic expectations among supporters and foes when Trump was first elected, and then in the opposite direction when Biden was elected. While these opposing shifts were largely neutralized in terms of their impact on aggregate economy, the strongly felt partisan emotions have nonetheless had a devastating impact on social cohesion and civility. Closing the partisan gap depends more on actions than on words.

The emotional impact of the coronavirus pandemic on economic expectations has been quite different. There is no more emotionally laden situation than the possibility of your own death, the demise of family members, close relations, or friends. Pandemic emotions are universally negative and supersede concerns about the economy. As repeatedly noted in these reports, no complete renewal of economic expectations is possible without the assured defeat of the virus. Before detailing how pandemic emotions will shape future trends in economic expectations, a brief review of the underlying theory is warranted.

The centuries old view is that emotions are the root cause of biased and volatile economic expectations. The universal claim is that passion must be removed from reason in order to form accurate expectations. Darwinian evolutionary forces that promote the survival of the fittest have never eliminated or even diminished the power of passion. That objective was from the start a fool's errand since emotions and reason are both necessary to make rational decisions. Emotions play critical roles in setting the goals of decisions, energizing actions to form expectations, and driving the timely formation of expectations.

The most important impact of emotions on expectations comes from the automatic attachment of an evaluation to each piece of economic information that is perceived by consumers. Emotional responses occur much faster than conscious awareness of the same information, and these emotional responses are attached to the information by the time of conscious awareness. People realize, for example, that their heart began racing and their foot had already begun to apply the vehicle's breaks before they became consciously aware of any danger. It is a common occurrence that the automatic evaluation affects people's interpretation of the event, including both its causes and their responses. A negative evaluation is likely to diminish the influence of a positive change, just as a positive evaluation is likely to downplay negative events. While the conscious mind can override the attached evaluation, it is uncommon since emotions are learned and constantly revised with experience. This finding is challenging since it implies that evaluations typically occur before not after the conscious awareness of an event.

The negative emotions associated with the pandemic will have a significant impact on how information is interpreted and how it affects economic behavior. It is widely repeated that success against the pandemic is a critical first step to restoring robust economic growth, but that success is tallied over many smaller steps, with failures having much greater weight than successes. The pace of vaccinations and priority assignments will be more vulnerable to negative assessments, especially given the wide variations across states. The pandemic emotions mean that people will interpret even favorable news about the decline in the spread and increase in the numbers vaccinated as less negative rather than positive news. Moreover, Biden has effectively set the lowest acceptable minimum at 100 million vaccinations in his first 100 days. He must exceed that number by a substantial amount for people to view it as a positive development, and he has to provide vaccinations of another 150 million in the following 100 days; combined this schedule would account for the likely maximum of about 80% of the U.S. population who would agree to be vaccinated. People, whether vaccinated or not, will react negatively to delays into late 2021.

The other problem is to simultaneously promote growth in jobs and spending. To be sure, relief funds to protect households from the devastating financial impact from the pandemic is required. It is just as important to carefully consider who should qualify for relief payments. Much of the funds going to those with jobs has been held as precautionary savings in anticipation of future pandemic needs, or held back due to the limited spending options in the pandemic. Those accumulated funds represent a huge potential stimulus to the economy. While some have anticipated that the pandemic impact on the economy would suddenly disappear, it is much more likely that it will slowly fade but still have a negative impact until at least the end of 2022. Moreover, the amount of fiscal and monetary stimulus to states and local governments as well as much needed investments in infrastructure, combined with debt relief to households and the accumulated delayed impact of increased consumer spending, could spark increases in inflation and interest rates. The benefits are now seen as worth the risks, but it would be foolish to ignore these negative impacts as well as the indicators that would be used to signal potential excesses.

How emotions shape expectations from: Richard Curtin, Consumer Expectations: Micro Foundations and Macro Impact (Cambridge University Press, 2019).