Measuring Things: ANOTHER LOOK AT CONSUMER SENTIMENT

By Lewis Mandell

Consumer sentiment tends to fall during periods of economic uncertainty. Therefore, it is not surprising to learn that the November 1991 Consumer Confidence Index of the Conference Board fell to 50.6 on a scale where the 1985 reading equals 100. This level was last reached in the spring of 1980, just prior to the recession of 1981-82 but at the peak of the Carter inflation. The index had been even lower in 1974 (43.2 in December) during the recession following the oil embargo associated with the Yom Kippur War of 1973.

While not in precise alignment, the University of Michigan's Index of Consumer Sentiment reflects the same consumer malaise. Both surveys show consumer confidence falling drastically over the last two years, rebounding only briefly in response to the military success in the Gulf War.

Special Importance of the Consumer

More than usual attention is being paid to consumer sentiment during the current economic downturn for two reasons. First, traditional Keynesian fiscal policies, which use added federal spending or tax cuts to stimulate economies during periods of prolonged recession, are precluded by the congressional budget agreement. Unless Congress repeals or modifies it or figures a way around it, the prohibition against deliberate additions to the Federal budget deficit essentially rules out fiscal policy. Second, the Federal Reserve's monetary policy has not worked well. Successive cuts in the discount rate have not stimulated business investment or consumer borrowing. Part of the reluctance to borrow at bargain rates is due to bleak outlooks by both consumers and businesses. Part may also be due to the regulator-induced reluctance of banks to lend to marginal customers.

As the result of self-imposed restrictions on fiscal policy and the impotence of monetary policy, there is great pressure put on the consumer to pull the economy out of the recession. Arguing in favor of a consumer-induced recovery are those who cite pent-up consumer demand, aging stocks of durables, low inventories and low interest rates. Presumably, a couple of years of deferred discretionary spending which has lowered debt obligations and which has increased the age of the automobile fleet will cause the consumer to "let go" at some point in the future. At that point, low inventory levels coupled with low interest rates will act as an accelerant as businesses invest heavily to cope with renewed consumer demand.

How Useful are the Indexes?

Since everything hinges on consumer attitudes, it's important to see just how well the indexes that supposedly measure them are able to predict future behavior. The use of such measures dates back to the post-war period when George Katona at Michigan's Survey Research Center hypothesized that in the emerging "mass consumption society" when a large proportion of families had "discretionary income," their decision to spend that income, rather than save it, was due in large part to their economic "sentiment." This sentiment related to how well-off they felt and their outlooks for themselves and for the overall economy. Other, similar measures were begun later by the Conference Board and Sindlinger, among others.

As large-scale econometric models were developed and became more precise, many incorporated the consumer sentiment index as an independent variable which could help predict spending on consumer durables and, hence, national income.

The usefulness of consumer sentiment was called into question, however, by a well-known econometrician who found that the index generally had little value in predicting automobile or nonauto durable purchases.[1] Furthermore, Harold Shapiro,[2] Hymans' partner at the University of Michigan's econometric forecasting project, found that the Michigan Index of Consumer Sentiment could itself be predicted by other readily-available data such as income, inflation rates, and stock prices. Consumers presumably read the papers and listen to the news and don't form their sentiment in a vacuum.

In light of these and other, similar findings, Katona himself reflected on the unique value of measures of consumer sentiment:

"1. Major changes in collective attitudes do not arise without good reason.

"2. The origin of the changes may be determined only after the fact: information on all objective changes at a given time does not permit the prediction of the resulting change in attitudes.

"3. The specific items of experience or news that are primarily responsible for a change in attitudes vary from time to time: therefore, the constellation of objective variables that is found to be successful in explaining attitude change at any given time may fail to do so at another time."[3]

In essence, Katona admitted that changes in consumer sentiment resulted from changes in other variables, but warned that it wasn't always the same variables that influenced sentiment. In the recession which began officially in 1991, low inflation and record stock price levels as measured by both the Dow Industrial Average and the S & P 500 Index seemed to have diminished sharply the relationship between those variables and consumer sentiment. The consumer indexes themselves thus appear more important since other economic variables are not currently good substitutes. This forces us to focus on the findings of Hymans, Mishkin[4] and others that the index is not a good predictor of consumer durable purchases.

In a recent empirical study, Garner suggested three guidelines for using consumer confidence indexes in economic forecasting:

"1. Confidence indexes are not reliable stand-alone indicators of durable goods purchases under ordinary circumstances. As a result, confidence indexes should not be used as primary forecasting variables.

"2. Confidence measures ordinarily have little complementary value when used in a forecasting process with other macroeconomic variables.

"3. Confidence measures may be useful in exceptional instances where confidence changes abruptly because of unanticipated noneconomic events."[5] (i.e. the Gulf War)

Conclusion

In spite of the importance of consumer outlook in ending the current recession in the United States, it is unlikely that indexes of consumer confidence will be useful predictors of an increase in spending for consumer durables. In lieu of an unanticipated noneconomic event, such as another war, it is more likely that consumer sentiment will itself respond to favorable economic indicators such as increased corporate profits, decreased unemployment, an upswing in housing starts, etc. The cause of such favorable economic news is yet to be determined.

In a related piece in this issue of Public Perspective, Everett Ladd suggests that consumer confidence indices measure more than economic confidence and reflect more broadly the national mood. While this hypothesis may explain the extremely low confidence readings in light of a relatively mild economic downturn (as measured by unemployment, etc.), I would offer two competing hypothesis. The first is that the corporate downsizing which is occurring, most notably with our largest corporations including IBM and GM, has not yet shown up in the unemployment statistics. Therefore, those consumers who have a high probability of being laid off over the next year exceed those now looking for work. The second hypothesis is somewhat more ominous. It suggests that our standard of living may have peaked nearly two decades ago (1973) and has since been declining. Heavy borrowing during the 1980s (consumer, business, and government) allowed consumption increases to mask this decline, but now it is payback time. Consumers are feeling the impact.

In the current "recession," consumer sentiment will be closely monitored by businesses and government policymakers not because it will signal the start of an upturn, but rather because the magnitude of the reaction will help indicate the likely strength of the recovery. The anemic third quarter upturn in real GNP may have officially ended the recession, but the concomitant decline in consumer sentiment offset the good news and may have plunged the economy into a double-dip recession or at the best, an extremely weak recovery. It will likely take some good economic news confirmed by a jump in consumer sentiment to convince businesses to avail themselves of the tempting low interest rates made available by the Fed.

References

[1]Saul H. Hymans, "Consumer Durable Spending: Explanation and Prediction," *Brookings Papers on Economic Activity*, No. 2, 1970.

[2]Harold T. Shapiro, "The Index of Consumer Sentiment and Economic Forecasting—A Reappraisal," in B. Strumple, J. Morgan, and E. Zahn, *Human Behavior in Economic Affairs* (Amsterdam: Elsevier, 1972).

[3]George Katona, *Psychological Economics* (New York: Elsevier, 1975), p. 101.

[4]Frederic S. Mishkin, "Consumer Sentiment and Spending on Durable Goods," *Brookings Papers on Economic Activity*, No. 1, 1978.

[5]Alan C. Garner, "Forecasting Consumer Spending: Should Economists Pay Attention to Consumer Confidence Surveys?", *Economic Review—Federal Reserve Bank of Kansas City*, May/June, 1991.

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