CONSUMER CONFIDENCE AND THE ECONOMY

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There are a number of key economic variables that are closely watched because they help identify the current state of the economy and provide some clues as to where the economy is headed. One of these indicators is the University of Michigan's Index of Consumer Sentiment. This index is designed to measure the level of confidence consumers have in the economy. This article explains why this index is closely watched, describes how the index is created, and presents what the index is revealing about the current state of the economy.

Why is Consumer Confidence Important?

Consumer confidence is important because it is a key factor that helps determine how much consumers are going to spend on goods and services, which is one of the major driving forces in the economy. From 1980 to 2000, expenditures by consumers accounted for 67% of total economic activity. Due to the fact that consumer spending is a major source of overall economic activity, most of the time it is safe to say that as consumer spending goes, so goes the overall economy. For example, in 1991, personal consumption expenditures, adjusted for inflation, declined 0.2% and overall economic activity, as measured by real Gross Domestic Product (GDP) fell 0.5%, but in 2000, real consumer spending increased 5.3% and total economic activity grew 5.0%.

Consumer confidence is a good indicator of consumer spending because the more confident consumers are about future economic conditions, the more likely they are to purchase consumer goods, particularly the relatively high-priced major purchases such as motor vehicles, houses, and household furnishings. If economic conditions are giving consumers favorable expectations about their job status and income, then they will be more willing to make major purchases by either drawing down savings or making a long-term financial commitment. Conversely, if consumers think unemployment is going to increase, and therefore feel less secure about their own income level, they will tend to be more cautious financially and be less inclined to make any major purchases at the present time. In short, consumer optimism creates consumer confidence, which makes consumers more willing to make major expenditures and financial commitments, whereas consumer pessimism about the economy erodes consumer confidence and makes consumers more reluctant to enter into major financial commitments.

The University of Michigan's Survey Research Center

Each month the University of Michigan's Survey Research Center conducts phone interviews with at least 500 consumers, and asks them approximately 50 core questions. These questions are designed to reveal how consumers feel about current and future economic conditions. Some of the questions focus on identifying whether consumers feel their current financial situation is better now than it was last year, and whether they consider now a good time to make a major purchase. Other questions focus on whether they think the general condition of the economy will reflect good or bad times during the coming year, and if they think their own financial situation will improve or become worse. The results from these questions are used to make three separate indexes: 1) the Index of Consumer Sentiment, which is the overall index that reflects consumers' views on both current and future economic conditions, 2) the Index of Current Economic Conditions, and 3) the Index of Consumer Expectations. The Index of Consumer Expectations is one of the components of the Composite Index of 10 Leading Economic Indicators.

Recent Developments in Consumer Confidence

The major recent development in consumer confidence is that after remaining at historically high levels since 1997, consumer confidence, as measured by the Index of Consumer Sentiment, fell sharply for three consecutive months beginning in December 2000, as shown in Figure 1. The index dropped from 107.6 in November 2000 to 90.6 in February 2001, which represents a 16% decline in the Consumer Sentiment Index. This marks the steepest three-month decline since the 1990-91 recession. In March, the Index of Consumer Sentiment rose slightly, but based on preliminary information for April, this gain was more than wiped out by another decline in April. Recent survey responses indicate that consumers expect unemployment to continue to rise through the end of the year, and as result, they are feeling less secure about their jobs and incomes and are becoming more cautious spenders.

This increased cautiousness on the part of consumers that has been reflected in the Index of Consumer Sentiment, has not, however, translated into a commensurate impact on consumer spending. This is particularly true in the motor vehicle retail market. During the first quarter of 2001, car and light truck sales totaled 17.1 million units, at a seasonally adjusted annual rate, which was actually up from the 16.2 million unit selling pace realized in the fourth quarter of 2000. Apparently, the steep price discounts and low finance charges offered by the auto companies have been successful at helping offset the fact that consumers are becoming more cautious in their buying attitudes. Motor vehicle sales are typically one of the first areas to reflect changes in consumer attitudes due to the relatively large financial commitment involved.

Given that the Index of Consumer Sentiment has declined steeply in four of the past five months, the concern is that this erosion in consumer confidence will result in sharp declines in consumer spending in the next few months, particularly in the motor vehicle and housing sectors. If this were to happen, then it would mean that the worst is not yet over in this current economic slowdown.

Figure 1