The Outlook For Consumption in 2006:
Back to the Future

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Introduction

The recent decline in consumer confidence has been as large as prior to any past recession. Nonetheless, there are few if any economists that anticipate a recession will actually occur in the year ahead. Most observers have discounted the decline in confidence as due to special circumstances, and once those temporary storms have passed, confidence will spring back to its earlier high levels. It is the resilience of consumers that will prevail in the face of these new economic challenges just as it has in the past.

There is some cause to doubt this positive assessment as consumers find themselves in a situation in which they have less economic flexibility than they enjoyed in the past. Record indebtedness, a negative savings rate, rising interest rates, higher inflation, and an emerging slowdown in real estate prices have all limited their ability to respond to each new economic challenge. While it is hardly controversial to suggest that consumers will act to reduce their indebtedness and increase their saving, the question is by how much and how fast. There is no reason to expect a large shift to occur immediately, but there is some concern that an abrupt retrenchment in spending could develop and cause a recessionary downturn.

Of course, consumers account for only part of GDP spending, and even if there are widespread cutbacks in consumer spending, there may not be an overall downturn. This is especially true in our current circumstance, with additional government spending expected for the rebuilding efforts in the aftermath of the hurricanes. Nonetheless, the consumer is the elephant in the economy, who accounts for three-quarters of total GDP spending. Even a small decline in consumer spending would be difficult for the government to easily and quickly offset. To be sure, the federal government is more powerful than its flea-like size, and it has the ability to flit around and provide the right stimulus at the right time to cause the elephant to twist and turn to avoid a recession.

This much you all knew, as both the optimistic and the pessimistic assessments have been widely reported, with the addition of the early November survey data only adding fuel to the debate.

The critical issue is whether a tipping point was reached in August, when consumers suddenly adopted a more cautious and uncertain economic outlook. While the surge in gas prices was the proximate cause, the mere reversal of those price hikes will be insufficient to restore the former level of consumer optimism. The economic circumstances that consumers once found acceptable are now be viewed with a greater sense of trepidation, especially their indebtedness and low saving. Such a break from the past would signal the emergence of a new era in how consumers judge and react to changes in the economic environment. It should be no surprise that the likely suspects involve shifts in consumers' reactions to trends in inflation, employment, interest rates, financial assets, and real estate prices. While some of these concerns will fade in the months ahead, it is unlikely that the balance of these concerns will improve so much that it will tip the consumer back toward the optimism and resilience of the past anytime soon. My discussion of this important topic will be interwoven in my review of the current state of consumer confidence and the outlook for consumers spending in 2006.

Surge in Consumer Pessimism

The initial loss in consumer confidence occurred in August of 2005 (see Charts 1 and 2). In the prior month, the Index of Consumer Sentiment was virtually indistinguishable from the level that was recorded at the start of the year. In the August survey, completed prior to Katrina and the surge in gasoline prices to $3, the Sentiment Index had already fallen by 7.4 index-points, the eleventh largest decline recorded in more that three hundred monthly surveys. In the September survey, the Sentiment Index declined by an additional 12.2 index-points, equal to the largest monthly decline ever recorded, and then fell another 3.7 index-points in the October survey. The combined three month decline of 22.3 index-points was the second largest on record, only slightly smaller than the three month plunge form August to October of1990 when confidence fell by 24.3 Index points. The main concerns of consumers in both 1990 and 2005 were surging gas prices, falling real incomes, higher interest rates, and an expected increase in the unemployment rate due to the anticipated economic slowdowns.

Importantly, the similarities with the 1990 decline include a bounce back in the November surveys of 1990 and 2005. The preliminary data indicate a gain of 5.7 points in the Sentiment Index in early November, which was larger than the gain of 2.1 Index-points in the November 1990 survey. Such a pause reflects a period of time when consumers attempt to gauge the true extent of the weakness in the economy, and thus determine how they should revise their expectations. In the 1990 episode, confidence did not post any further losses despite the heightened uncertainty about the looming war with Iraq. In the current situation, the early November gain reflects the recognition by consumers that gas prices have receded faster than they had initially expected and personal incomes have improved by more than they had originally anticipated.

Importantly, in both instances the data indicate a downturn in consumer spending, with the anticipated decline in 2005 much less serious. The correspondence of trends in overall consumer sentiment and the annual growth rate in GDP indicates that consumers do not expect a recession in the year ahead, but they do expect a slowdown in the pace of economic growth to about 2% in the next few quarters (see chart 3).

Such an assessment implicitly assumes no further declines in consumer confidence during the next several months. The likelihood of additional declines in consumer confidence, however, is not zero given that higher prices for home heating are widely expected. On the other hand, continued declines in gas prices, a warmer than normal winter, and no further disruptions in energy supplies could prompt renewed confidence among consumers. Or so the headlines declare. In fact, the future course of consumer spending depends on much more than just the cost and availability of energy supplies.

Personal Finances Slump Due to Higher Gas Prices

People's sense of personal financial progress depends on their assessments of changes in their income and wealth as well as changes in the overall inflation rate. While trends in wages have typically been the most important element in consumers' evaluations, there have been times when changes in household wealth as well as changes in the inflation rate have dominated these evaluations.

Wealth has played a particularly important role in shaping these evaluations in the past ten years, first by outsized increases in the value of stocks and then by outsized gains in the value of homes. More recently, inflation has renewed its domination of personal financial assessments.

Indeed, more consumers mentioned hearing news of rising inflation than any other time in the long history of the surveys, higher than even in the late 1970's and early 1980's (see Chart 4). This question simply asks consumers to describe in their own words any recent economic developments they had heard.

The data represent the frequency that inflation has been mentioned throughout the history of the surveys, with the figures giving the net difference between favorable and unfavorable references to changes in the inflation rate. The greater impact in the recent months is partly due to consumers' habituation to very low inflation rates, even though the current inflation rate is not high by the standards of earlier decades. The explanation that only what's new is news, however, applies equally as well to the earlier periods when the peak inflation rate was more than twice its current level.

The surveys include another question that asks consumers to describe in their own words how their financial situation had recently changed (see Chart 5). The data indicates the net percentage of consumers who specifically mentioned that higher prices had caused their financial situation to worsen. Unlike the more general question about news, references to inflation did not reach an all-time peak but complaints that higher prices had diminished their living standards reached the highest level since 1982.

An alternate method to judge the impact of higher gasoline prices on household budgets is to calculate the proportion of personal disposable income spent on gasoline based on data from the national income accounts. The data for September 2005 indicate that consumers spent 3.8% of their incomes on gasoline, up from an average of 2.3% during the prior ten years and the highest share of income spent on gasoline since 1982 (see Chart 6). While it is still below the all-time peak of 4.4% recorded in 1981, it nonetheless represents a substantial drain on consumers' income, an amount equal to about 1.5% of their incomes. Overall, these aggregate figures generally confirm the survey data on the impact of inflation on personal financial situation of consumers, but offer no confirmation of the data on news heard about inflation.

Perhaps the greatest impact of inflation has been on how consumers view their future financial prospects. In both the October and November surveys consumers expected the weakest financial prospects in more than a dozen years (see Chart 7). Just 31 percent of all households expected their financial situation to improve during the year ahead, down from 42 percent three months ago. It was not that consumers anticipated much smaller wage gains, but that consumers expected larger increases in inflation than in the past. As a result, consumers anticipated the smallest real income gains during the year ahead in more than a dozen years (see Chart 8).

Inflation Expectations

These data would seem to indicate that consumers expect a rapid acceleration in the inflation rate during the year ahead. But that is not true. Indeed, inflation expectations declined in early November, nearly erasing the entire surge recorded in the prior two months (see Chart 9). Consumers expected an inflation rate of 3.5% in early November, down from 4.6% in October, but still above the 3.1% recorded in August. Even at this much lower level, the expected year-ahead inflation rate was still higher than any other time during the past decade. Chart 9 gives visual confirmation of the relatively low level of inflation that has sparked such widespread angst among consumers.

Long term inflation expectations fell from 3.2% in October to 3.1% in early November. This expected inflation rate was at the upper end of the band that these expectations have moved during the past few years. Moreover, long term inflation expectations have been consistently lower than short term expectations for nearly two years (see Chart 10). This indicates that consumers still view inflation as a temporary not a permanent problem.

The overall level as well as the short term nature of inflation expectations has led many to believe that consumers have exaggerated the inflation threat. It's all a matter of perspective: in August of 1971, President Nixon instituted wage and price controls as an emergency measure when inflation neared 5%. And a decade later, a renewed wave of optimism was prompted when inflation fell below 5%. To be sure, the overall economic context shapes people's perceptions of inflation. This is what made 5% inflation intolerable at one time and palatable at another time.

What's different is more than just perspective, it is that consumers sense a greater vulnerability to rising inflation even if the inflation rate is a mere shadow of the levels recorded in the past. This growing sense among consumers that they lack adequate defenses against inflation is due to changes in labor markets as well as to the changing economic circumstances of an aging population.

Weakened Job Prospects

Many also believe that consumers have exaggerated the threat to future job prospects given that the October unemployment rate for all workers was 5.0% and just 2.9% for married workers. In contrast, the overall employment ratio is still 1.8 percentage points below the 2000 peak. There is either an unusually large number of discouraged workers or an unusually larger number of workers who left the labor force voluntarily, or some combination of the two reasons. Some have argued the primacy of discouraged workers while others have pointed to the fact that the oldest of the baby boom generation is now approaching retirement, so that age corrected data would indicate a comparatively lower employment ratio.

When asked about what economic news consumers have heard, in addition to inflation, consumers have increasingly reported hearing of job losses (see Chart 11). These concerns did not start in September, but have been steadily increasing since mid 2005. While these references to job losses are only moderate in frequency, they would not normally be associated with a booming labor market.

When asked about future job prospects, three times as many consumers expect the unemployment rate to rise rather than to fall during the year ahead. The data indicate that consumers expect the unemployment rate to increase to just over 5½% by year end 2006 (see Chart 12). Job expectations have demonstrated a longstanding relationship with total personal consumption expenditures, with the current data indicating that the rate of growth will fall to about 2% during the year ahead (see Chart 13).

Consumers anticipate that fewer new jobs will be created as the result of an overall slowdown in the pace of economic growth during 2006. While the outlook for the national economy was not as bleak in early November as in October, more consumers still expected the economy to worsen rather than to improve during the year ahead. Overall, the majority of consumers judged these prospects to mean bad times in the economy during the year ahead, and the majority still expected a downturn sometime in the next five years (see Charts 14 and 15).

Along with the expectation of rising unemployment, the current workforce has become more timid in their demands for higher wages as well as for medical and pension benefits. This new reticence is based on the experiences of workers who have confronted off-shoring and out-sourcing as well as those involved in failed strikes and bankruptcy enforced dissolution of labor contracts. Job insecurity is not new; it dominated the concerns of consumers a decade ago giving rise to the headline description of the "jobless recovery" of the early 1990s. What's new is that consumers now feel that they can not defend their wages against even small increases in inflation. It is this new realization that underlies the hyper sensitivity of consumers to even small increases in inflation.

Inflation and Buying Attitudes

The buying plans of consumers have always been shaped by inflationary trends. The term inflationary psychology signifies a mind set that first took root in the mid 1960s and dominated spending decision in the late 1970s. Buying in advance of anticipated price increases created a dynamic that fostered and sustained the inflationary environment. In today's economy there is no advantage to buying products in advance when their real prices have been declining, as has been true for a wide range of goods in recent years. The closest situation to the past is when consumers judge a discount so attractive and unlikely to be offered again that they advance the timing of their purchase. This reaction is really quite different since it promotes the opposite dynamic as it acts to contain inflationary impulses: consumers are motivated to purchase when today's price is unusually low rather than to purchase simply because tomorrow's price will be higher.

While workers may feel defenseless against inflation, they attempt to avert declines in living standards by insisting on discounts that will enable them to avoid declines in their living standards. Wal-Mart is the perfect example: reviled as an employer by workers but favored for low prices by customers. The old inflationary psychology enabled firms to pass along all costs; the new inflationary psychology insists that firms find new ways to lower cost, lower profit margins, or go out of business.

This completes the circle of the new global paradigm: Workers feel defenseless against inflation in wage negotiations but still feel powerful as consumers in their demands for lower product prices. In turn, firms use any and all means necessary to lower their costs to be competitive in the global economy. While the old inflationary psychology enable all parties to survive, the new psychology is more likely to create winners and losers. Among the workers the winners are the highly educated, among firms the winners are those that can quickly adapt to changing global economic conditions.

Record Low Savings and Record High Debt

For a long time consumers had resisted raising even their year-ahead inflation expectations. Even though gas prices have recorded year-to-year gains for thirty-six consecutive months, it was only in early September when gas prices surged to above $3 a gallon that consumers expressed heightened concerns about inflation. Consumers thought that temporary price hikes were best dealt with by temporarily decreasing their saving or temporarily increasing their debt. Moreover, there was no need to make more permanent shifts to smaller more energy efficient vehicles or homes, with sales of SUVs and McMansions setting new records this past summer.

Consumers did set records for both high indebtedness and low savings. The personal savings rate was a minus 1.1% in the third quarter of 2005, the lowest level since the 1930's. Total debt also recorded a new record, weighing in at 124% of personal disposable income at mid year 2005 (see Chart 16). Monthly debt repayment accounted for 13.6% of monthly income, also a new record high (see Chart 17). Adding other financial obligations, such as rent payments and vehicle leases, the monthly payment total reached a new record among homeowners of 16.4% in mid 2005. Among renters, the monthly payment amount was significantly larger at 28.9%, but it was still below the prior peaks.

Vehicle Buying and Higher Gas Prices

Higher gas prices have had a significant impact on vehicle buying plans. Throughout most of the past three years, consumers expected gas price hikes to be temporary. Indeed, purchases of large, low fuel efficiency vehicles reached a peak in the months immediately before Hurricane Katrina. To be sure, vehicle manufacturers devised a very appealing discount program that had a far greater impact than the dollar size of the discounts offered. Nonetheless, the record number of SUVs that were purchased were not bought with the expectation that gas prices were about to increase; indeed, most consumers expected gas prices to decline. The surge in gas prices following Katrina caused consumers to shift their views on gas prices toward the expectation that gas prices would be permanently higher than they had previously expected. Importantly, in early November consumers did not expect any further increases in gas prices in the near term but still anticipated increases over the longer term.

The shift in gas price expectations affected vehicle buying attitudes in two ways. First, there was a good deal of uncertainty about just how high the new permanent level would be in the future. Consumers typically react to such uncertainty by postponing purchases. The number of consumers that specifically mentioned this uncertainty when asked about their opinion about vehicle buying conditions was higher in recent months than anytime since the gas crisis of the late 1970's. The sharp decline in buying attitudes was reflected in sharply lower sales (see chart 18).

The second impact of permanently higher gas price expectations is that consumers have begun to rethink their preferences for the size and fuel efficiency characteristics of vehicles. This is by far the more important impact since it will have a significant impact on the sales of new vehicles and the value of used vehicles over an extended period of time.

Interest Rate Increases Expected to Continue

In contrast to the rapid shifts in expectations during the past year, the one expectation that has not changed is the near universal belief among consumers that interest rates will continue to increase during the year ahead. Three-quarters of consumers expected interest rate increases prior to the first Fed hike in late June of 2004 and that same proportion expected hikes after the twelfth and most recent hike (see Chart 19).

The widespread expectations of increases does not mean that consumers think current interest rates are high; they do not. In fact, conventional mortgage rates are still lower that just before the Fed began its current round of hikes. Consumers do think that higher interest rates will ultimately make credit more expensive to obtain as well as restrain the rate of growth in the overall economy. Perhaps the biggest impact on spending will be changes in the willingness of consumers to extract or cash-out home equity to support consumption.

Diminishing Wealth Effect: Home Equity Withdrawals

Consumers have used funds extracted from home equity to finance an increasing proportion of the consumption in recent years. Home equity has become a more important source of increases in household wealth as the market value of owner-occupied homes has risen by 9% annually over the past decade. The extraction of home equity can be accomplished by refinancing current mortgages, by the sale and purchase of a home, or by the use of home equity loans.

Consumers have repeatedly refinanced mortgages to take advantage of lower interest rates as well as to finance consumption spending. The proportion of refinanced mortgages that included cash-outs has varied over the years, from a high of 93% in 1989 to a low of 33% in 2003, with the most recent figure being 72% (see chart 20). Since this is just one of the three possible sources of home equity extraction, it does not follow that the extraction of home equity was recently less frequent than in the 1980s. It simply means that a smaller proportion of refinanced mortgages had cash-outs, but other ways to extract equity have grown.

Greenspan and Kennedy in a recent paper estimated that the combination of home turnover, refinancing, and home equity loans have generated an total amount of equity withdrawals equal to 6.9% of disposable income in 2004.[1] Base only on

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[1]Alan Greenspan and James Kennedy, "Estimates of home mortgage originations, repayments, and debt on one-to-four family residences," September 2005. Working paper, Federal Reserve Board, 2005-41.

refinanced mortgages, Freddie Mac estimates that in 2005 the amount of cash-outs equaled about 1.8% of income (see chart 21).

It is difficult to determine how much of these funds were used for consumption spending, although Greenspan and Kennedy estimate about half of the value of cash-outs and home equity loans ultimately finance personal consumption expenditures. Half of these estimates represent a substantial boost to consumption. Even if the pace of home equity extraction slow in the year ahead along with increases in mortgage rates, the impact on spending could be dramatic. For example, Freddie Mac estimates a drop in cash-outs of about $100 billion in 2006. Moreover, the very rapid pace of increases in home prices is also likely to slow in the year ahead. As a result, home equity extraction will offer much less support for consumption spending during 2006.

Home Market Vulnerable

Home buying attitudes have declined during the past year while home sales have remained high. The divergence between buying attitudes and actual sales has not occurred in the past (see chart 22). The cause for this divergence has been distinctive trends in the attitudes of ordinary home buyers and in the attitudes of people who are primarily interested in purchasing homes for investment purposes. Most consumers have judged the current level of home prices quite unfavorably. Indeed, consumer views of current home prices are the least favorable since 1982 (see chart 23). The other group of consumers have emphasized the importance of buying homes in advance of any further price increases or mortgage rate hikes (see chart 24). These are the investors, and it has been this group that has maintained home sales at record levels.

A key difference between these two groups is that ordinary consumers are slow to change their views on market conditions whereas investors can change their views rapidly. The housing market is vulnerable to sharper declines than usual given that demand is highly dependent on maintaining the interest of investors. While the data does not indicate that any sharp break is imminent, the data does indicate that home sales in 2006 are likely to trend downward by a modest amount.

Summary Outlook

Overall, the survey data indicate that most consumers do not expect a recession, but they do anticipate a slowdown in the overall pace of economic growth. The key difference between the economic outlook according to consumers, and the consensus economic outlook among economists, is that consumers expect the pace of economic growth to be slightly below its trend rate and economists expect the economy to expand at its trend rate of growth.

The critical difference as far as consumers are concerned is that they anticipate the slowdown to produce a slowly rising unemployment rate rather than a steady or declining unemployment rate that most economists predict. Whereas econometric models predict strong employment and wage growth, consumers anticipate that any increase in wages will be offset by a higher inflation rate. The main concern of consumers with their future financial prospects is that they anticipate little if any growth in their inflation-adjusted incomes, and this has been responsible for their more cautious spending plans.

If employment and wage gains are greater than consumers now expect, or if mortgage rates remain unusually low, if home equity extraction continues unabated, or if inflation quickly dissipates, consumers will spend more than they now anticipate. Unfortunately, the mere reversal of gas prices to the levels recorded prior to the recent plunge in confidence is unlikely to restore consumer optimism to its former level. The economic circumstances that consumers once found acceptable, especially their high levels of debt and low saving, are now viewed with a sense of trepidation. Such a break from the past signals the emergence of a new era in how consumers judge and react to changes in the economic environment.

Indeed, recent economic developments have generated a new inflation angst, an intense apprehension about its potential impact on their future financial situation that goes well beyond the actual or expected level of inflation. This new appraisal of inflation has caused consumers to adopt new coping behaviors. There are several key differences. First, whereas the inflationary psychology of the 1970's was based on the premise that inflation was unavoidable, the new inflationary angst is based on the premise that inflation is avoidable. Second, whereas the dynamics of inflation and wage growth were primarily viewed as reflections of the domestic economy in the 1970's, the new view is based on the premise that the global economy now plays a much more decisive role. And finally, whereas the reactions of consumers added to inflationary pressures and a more volatile economy in the 1970's, now the reactions of consumers dampen inflationary pressures and lessen the volatility in the economy.

Consumers believe that they have no choice but to adopt new coping behaviors. To counter their defenselessness against inflation in wage negotiations, consumers have asserted their power to demand lower product prices. In turn, firms use any and all means necessary to lower their costs to be competitive in the global economy. Just as the coping strategies of the 1970's produced winners and losers, the new coping strategies will favor highly educated workers and favor companies that can quickly adapt to changing global economic conditions. These new coping strategies are likely to persist in the years ahead regardless of cyclical variations in the economy. More importantly, these new coping behaviors are likely to transform the economy as much as the inflationary psychology of the 1970's until effective public policy addresses the underlying inequities.

Chart 1: Index of Consumer Sentiment

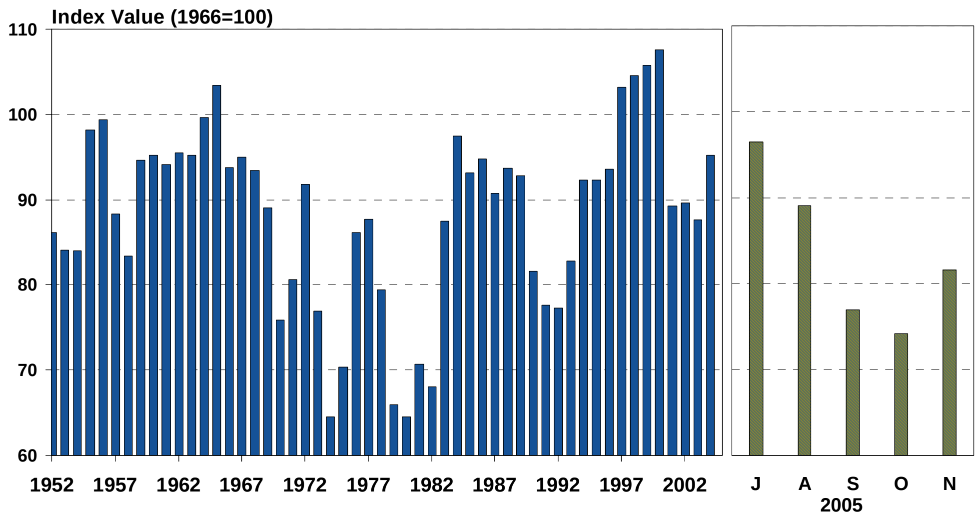

Chart 2: Distribution of Monthly Changes in Index of Consumer Sentiment

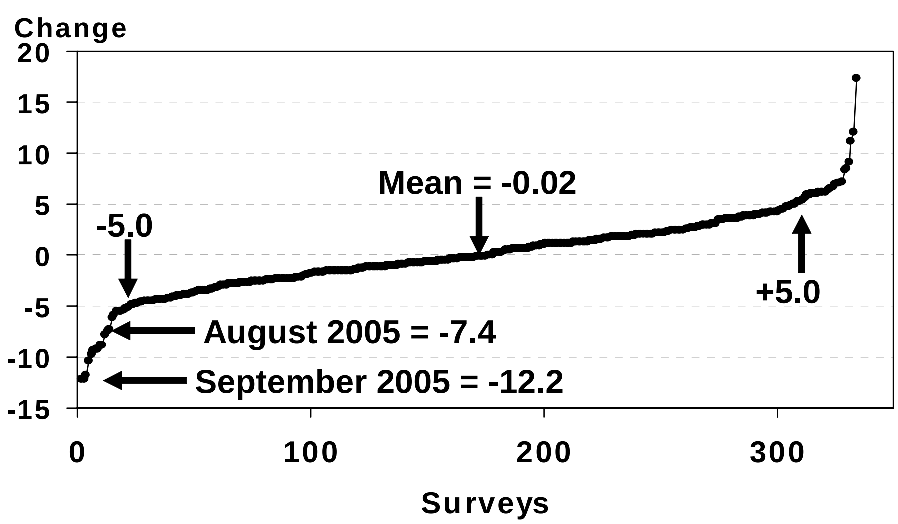

Chart 3 : Change in Sentiment Index and Annual Growth in GDP

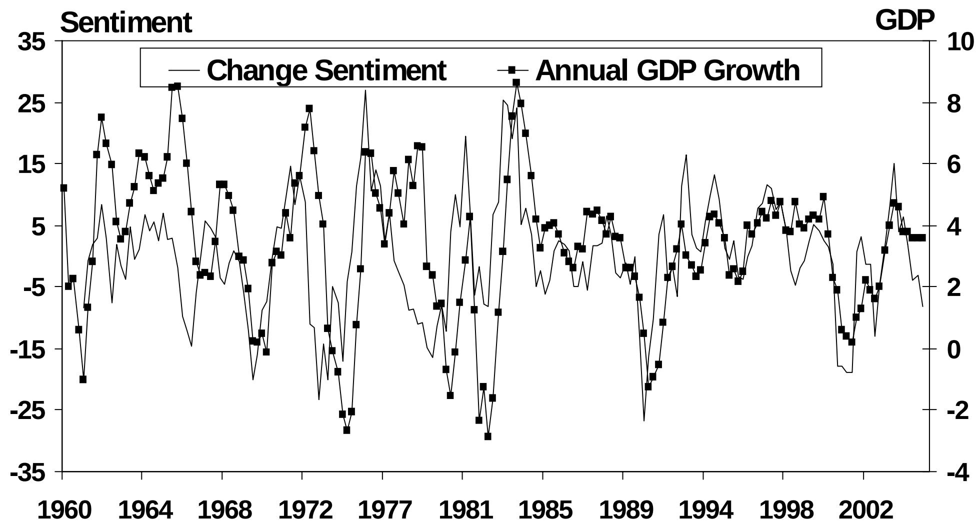

Chart 4: News Heard About Net Increases in Prices

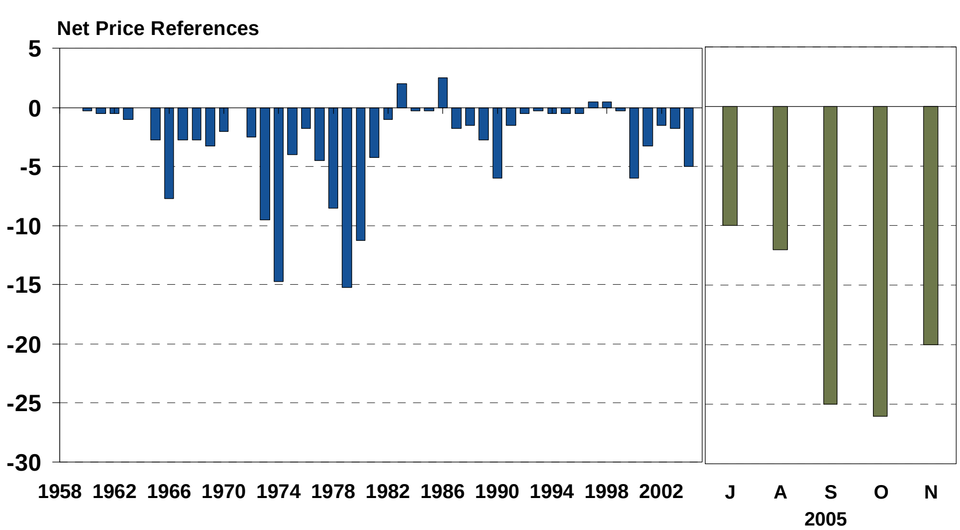

Chart 5: Consumers' Complaints about Rising Prices In Evaluations of Personal Finances

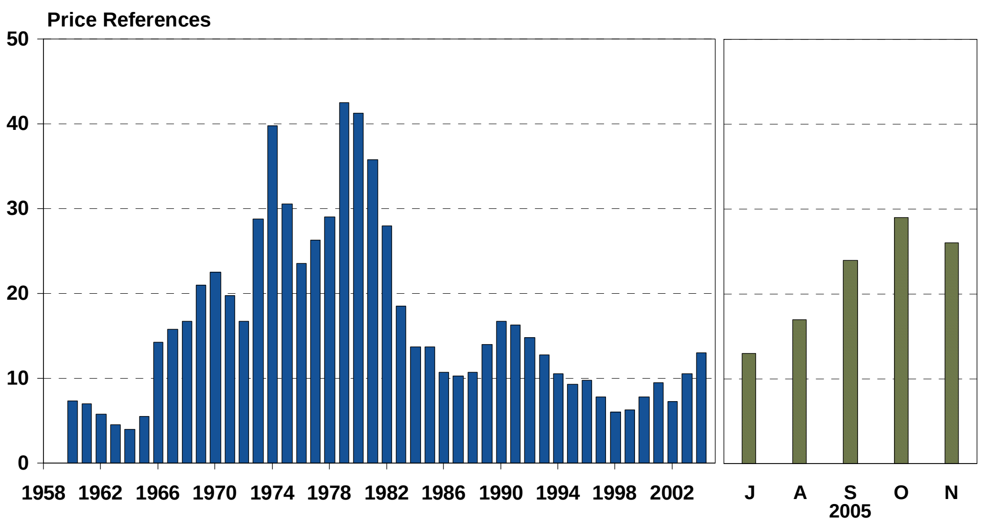

Chart 6: Gasoline Expenditures as a Percent of Personal Disposable Income

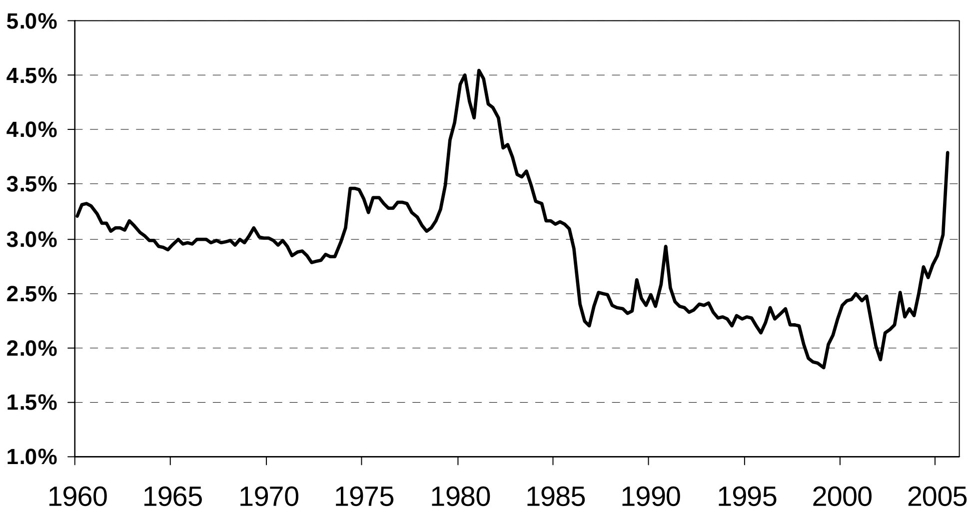

Chart 9: Inflation Rate Expected During the Year Ahead

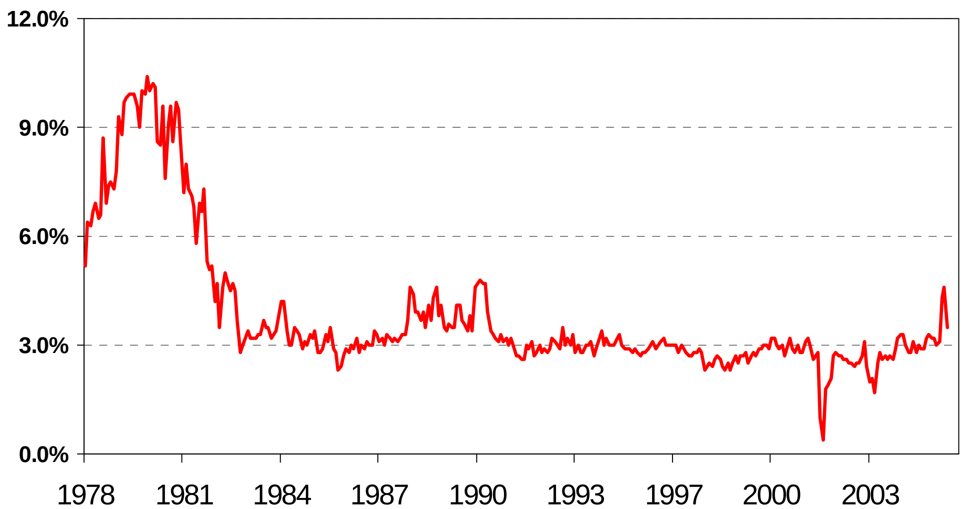

Chart 10: Difference Between One Year and Five Year Inflation Expectations

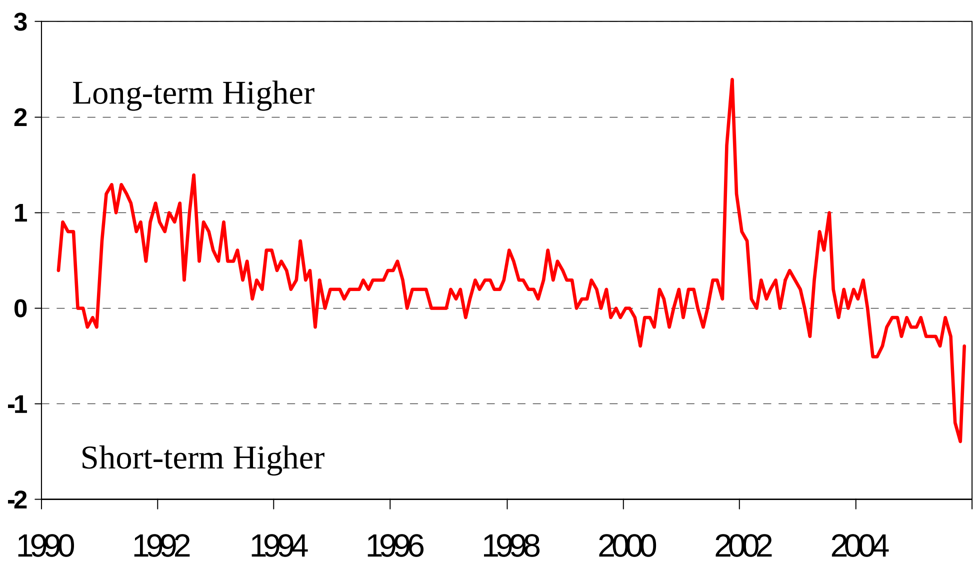

Chart 11: News Heard About Net Increases in Employment

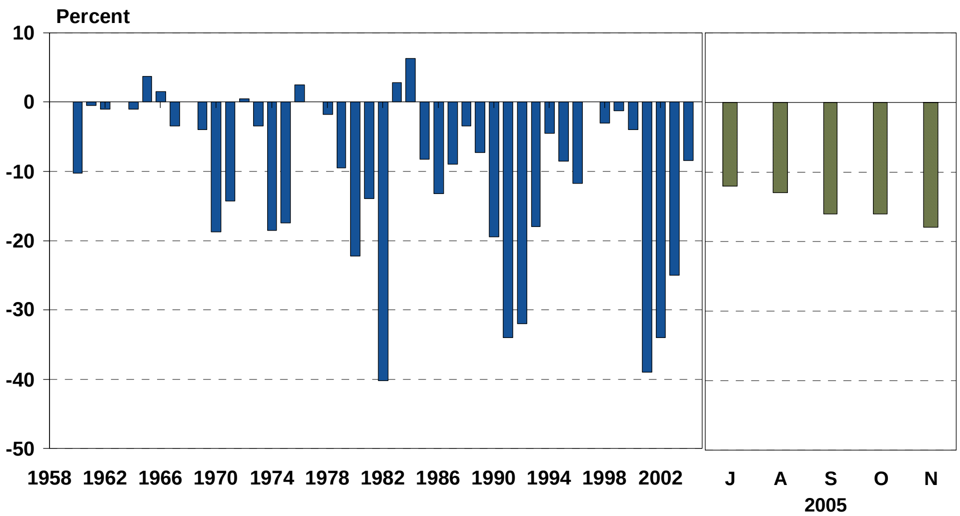

Chart 12: Unemployment Expectations & Change in Actual Unemployment Rate

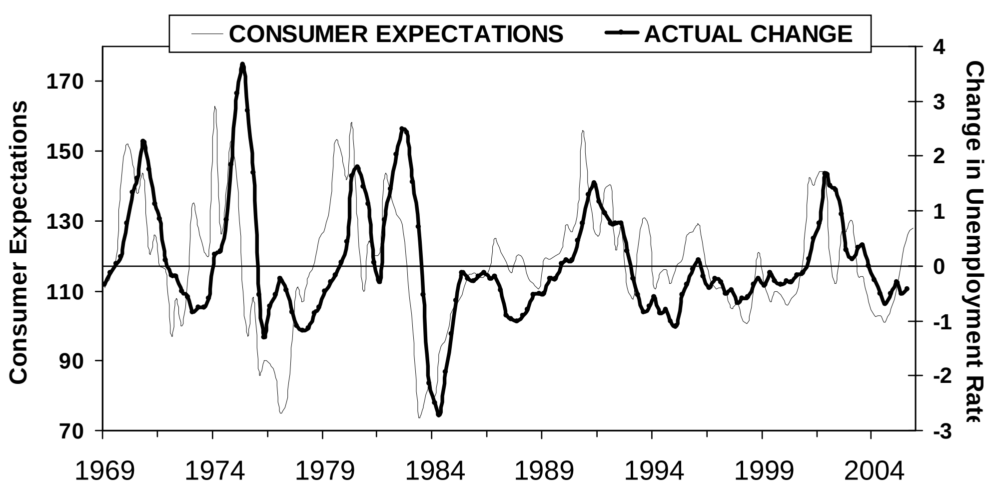

Chart 13: Unemployment Expectations & Growth in Personal Consumption Expenditures

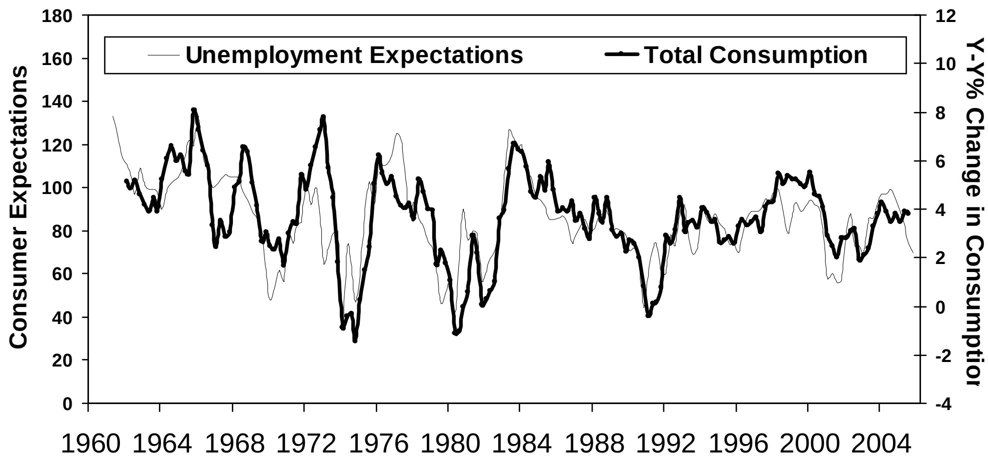

Chart 14: One-Year Outlook for National Economy

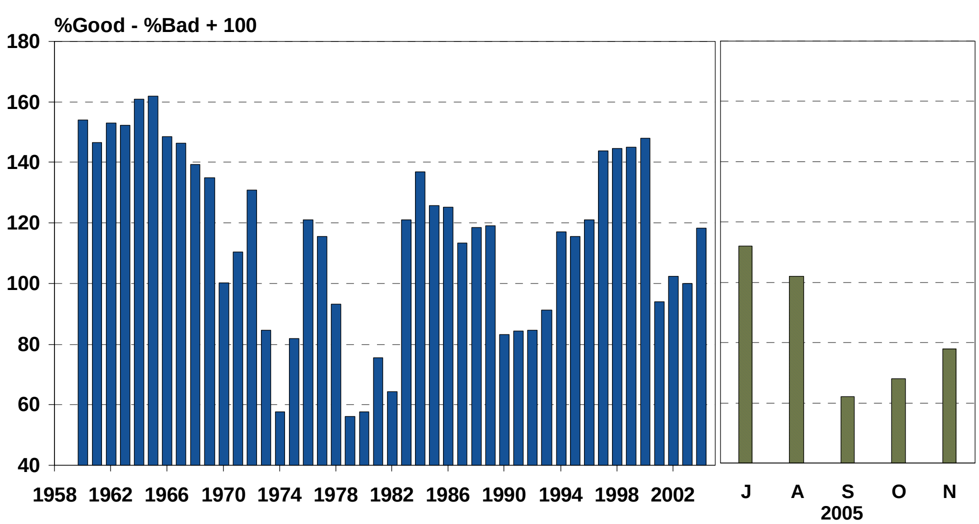

Chart 15: Five-Year Outlook for National Economy

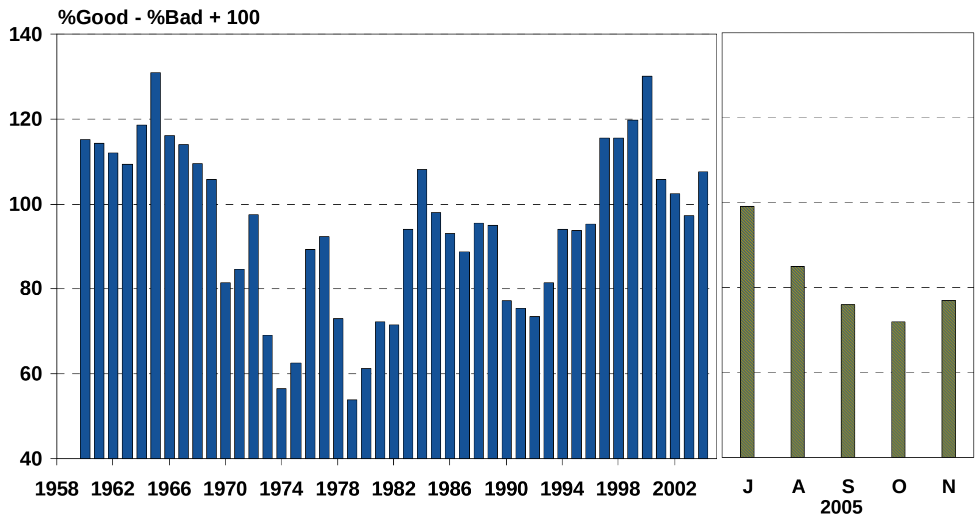

Chart 16: Total Outstanding Debt as a Percent of Personal Disposable Income

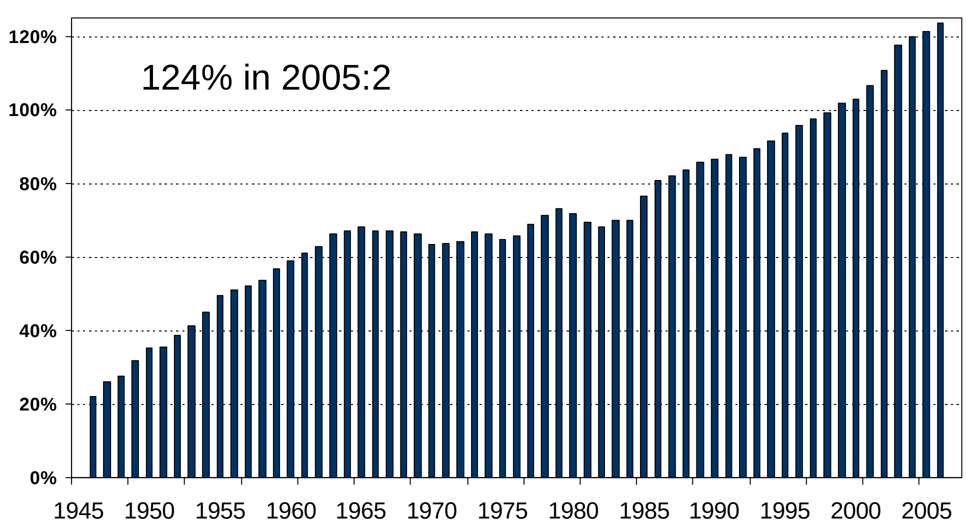

Chart 19: Expected Change in Interest Rates During the Year Ahead

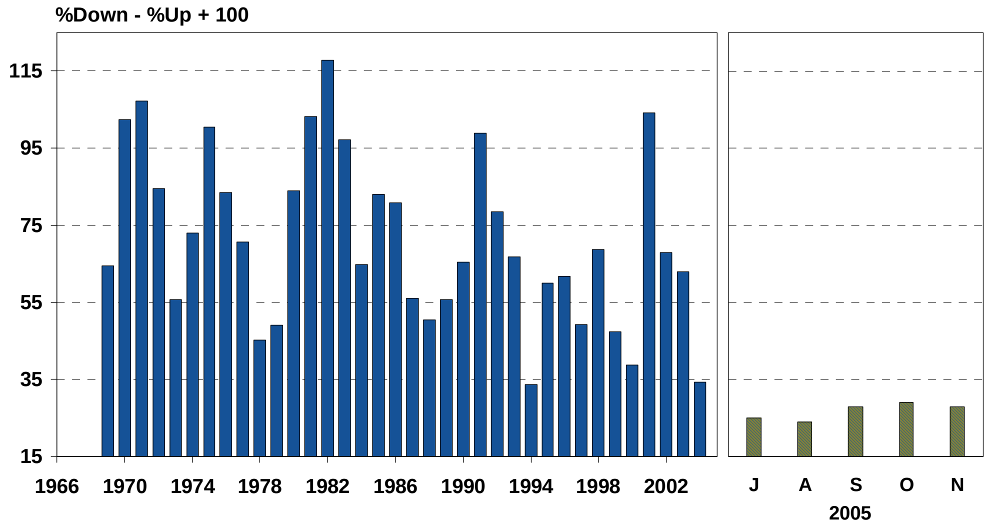

Chart 18: Vehicle Sales & Vehicle Buying Attitudes

(Year-to-Year Change in Series)

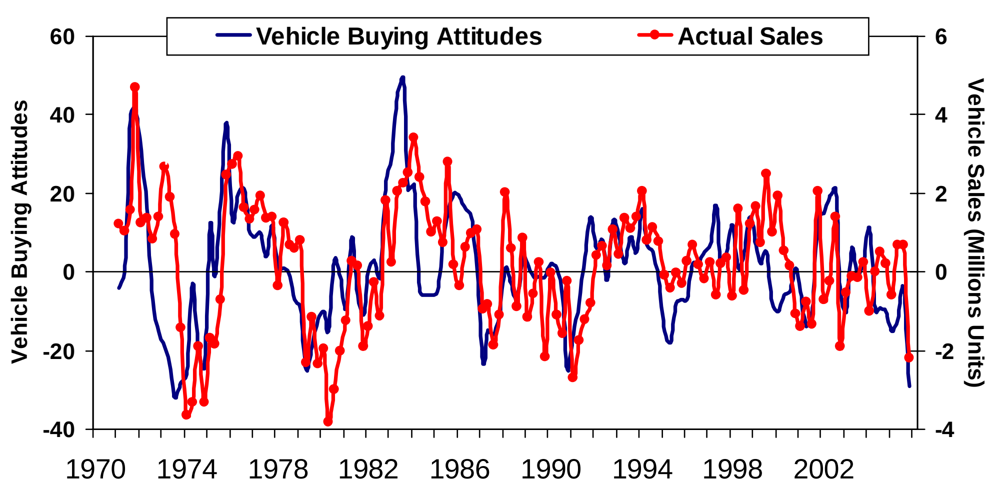

Chart 21: Equity Extraction As a Percentage of Personal Disposable Income

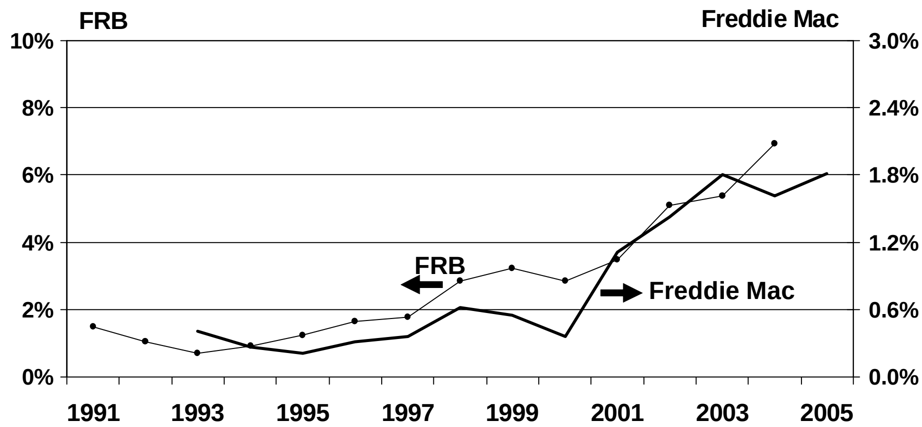

Chart 22: Home Sales and Home Buying Attitudes

(Year-to-Year Change in Series)

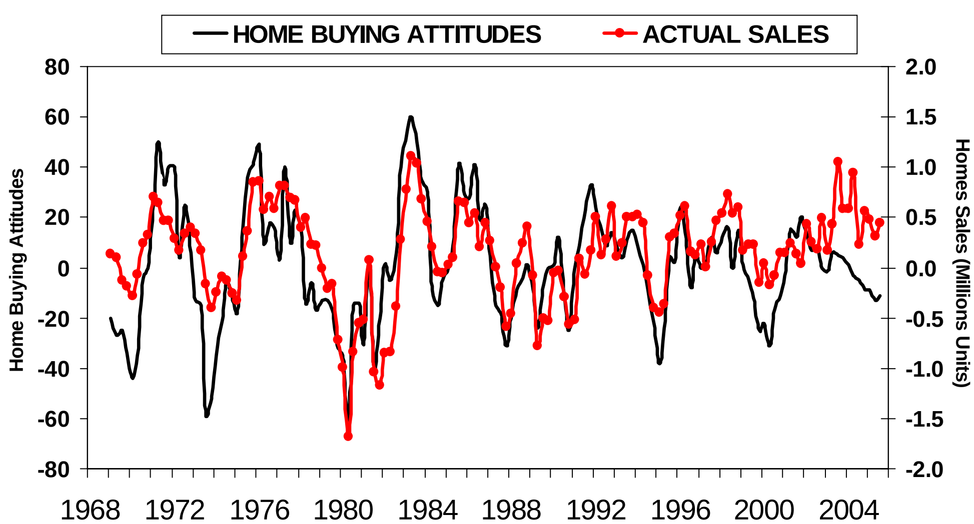

Chart 23: Net References to Home Prices In Assessments of Home Buying Conditions

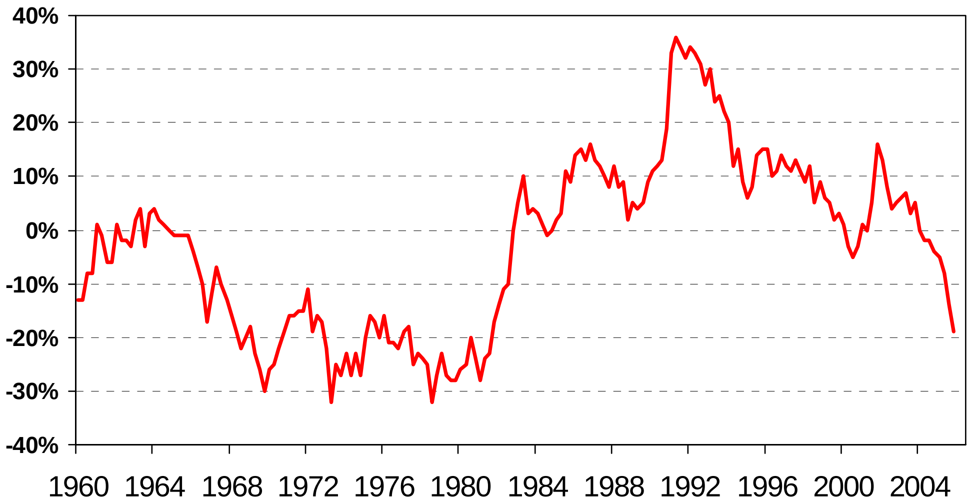

Chart 24: Home Buy-in-Advance Rationales: Prices and Interest Rates