"What is the role of consumer confidence in the business cycle, and how does it affect the economy?" *by Professor Jim Lee*

Consumers play a major role in the economy. This is because consumer spending accounts for two-thirds of U.S. output. Since households' economic outlook affects their spending behavior, their expectations influence the direction of economic activity in the business cycle.

Consumer confidence, or optimism about the overall economy, is commonly referred to as "animal spirits" after a famous economist, John Maynard Keynes. Keynes asserted that the Great Depression of the 1930s was largely attributable to a collapse of public confidence, which led to dramatic declines in consumer and business spending.

Today, consumer confidence receives a great deal of media attention. Rising consumer confidence is widely interpreted as a precursor to higher future household spending. It is therefore a leading indicator of the overall economy. If consumers are more optimistic about the economy, they will tend to spend more, especially on durable goods and other large purchases. A higher overall demand for goods and services will subsequently lead to higher output and employment.

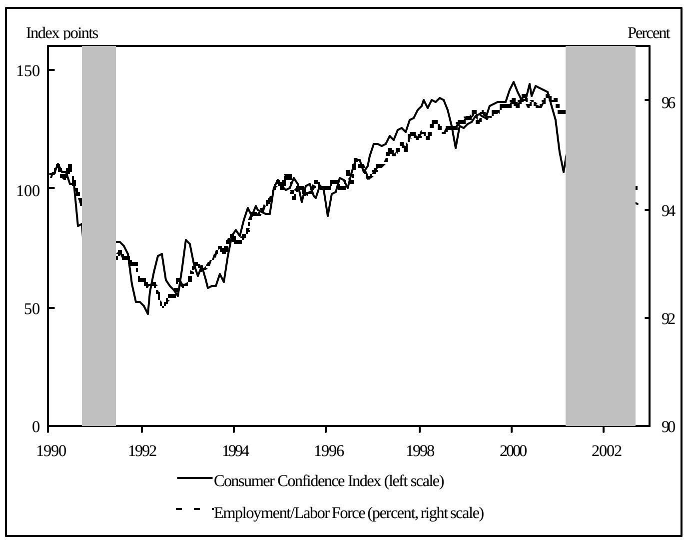
Higher consumer spending, however, may also lead to higher inflation. For this reason, the Federal Reserve, which seeks to maintain price stability, also pays close attention to changes in households' attitudes toward the economy. The Federal Reserve may raise interest rates in an effort to reduce any anticipated pressure on inflation. Since changes in interest rates affect financial markets, investors also watch closely any signs of change in consumer confidence.

The two most often cited measures of U.S. public confidence in the economy are the Confidence Board's Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index. Both indexes are based on monthly surveys of a large sample of U.S. households. In particular, the Conference Board's survey asks about 5,000 households nationwide questions concerning the present and future business conditions, employment prospects, and income expectations.

The accompanying figure shows over the past 12 years the patterns of the Consumer Confidence Index and a key measure of economic activity—U.S. employment as a percentage of the labor force. The shaded areas represent periods of recession. Note that the two variables tend to move in tandem over the business cycles since 1990. First, both consumer confidence and employment declined during the 1990-91 recession. The recession ended officially in March 1991, but most people felt that bad economic times extended well into 1992. Indeed, the employment condition did not improve until the Consumer Confidence Index reversed its downward trend.

During the subsequent recovery in the 1990s, movements in employment also closely mirrored movements in the level of consumer confidence. After reaching a peak of 144.7 in January 2001, the confidence index fell precipitously. Two months later, the U.S. entered a recession as employment began to decline as well, along with lower spending by households and business firms.

The close correlation between the ups and downs in household sentiment and the ups and downs in economic activity, however, does not necessarily mean consumer confidence drives the economy. Such a relationship may also reflect that, for instance, rising employment and thus brighter economic prospects boost confidence among households, rather than the other way around. For this reason, the role of any measure of consumer confidence in forecasting business cycle turning points remains debatable. Nonetheless, the fact that consumer confidence and economic activity have generally moved in the same directions over the business cycle highlights the importance of household sentiment in understanding the present and future economic conditions.



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