BY ROSS DEVOL

The pace of consumer spending will surely be a critical factor in determining whether the United States slips back into recession. It's not surprising, then, that many analysts believed the decline in consumer confidence reported last summer doomed the economy to a much-dreaded double dip.

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But our research suggests that, at least for the moment, consumer confidence is a poor predictor of purchasing decisions. Indeed, while consumer confidence is way down, the most direct cause seems to be disdain for the political gridlock in Washington – and that doesn't necessarily translate into fewer trips to Walmart.

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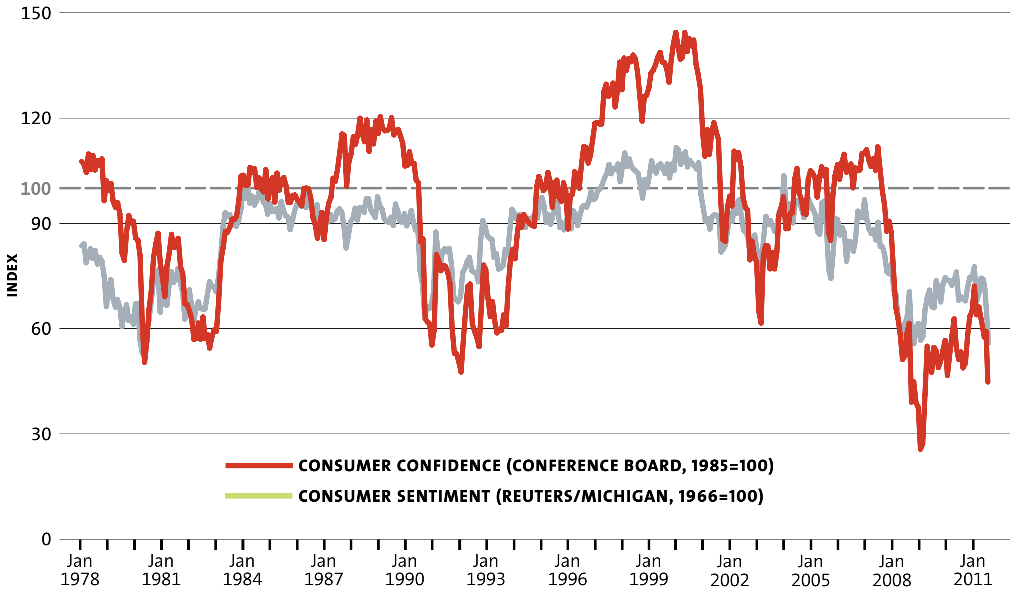
READ IT AND WEEP

Consumption represents almost 70 percent of U.S. GDP. And the standard auguries for future consumption are dismaying, to say the least. The two main surveys of consumer confidence – the Conference Board's Consumer Confidence Index and the Thomson Reuters/

CONSUMER CONFIDENCE INDEX VS. SENTIMENT



SOURCE: Federal Reserve Bank of St. Louis, Moody's Analytics.

University of Michigan Consumer Sentiment Index – both exhibited large declines last summer. The CCI fell to 44.5 in August, down by one-fourth from July's reading. This was the lowest level since April 2009, during the depths of the Great Recession. The CSI came in at 55.7 in August, down a full eight points and close to the record lows recorded during the stagflation of the early 1980s.

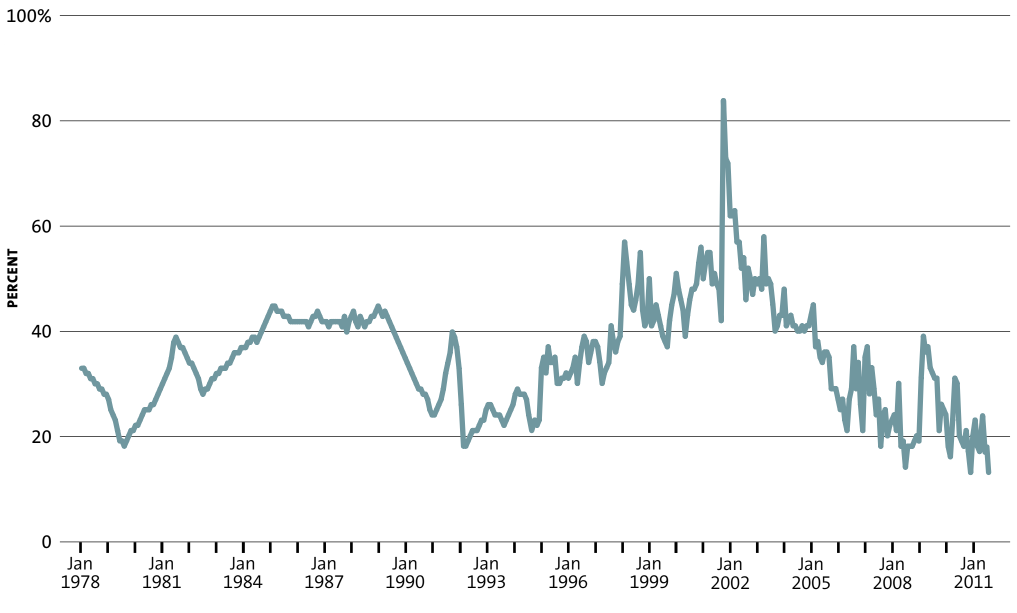
Arguably, consumers concluded that economic conditions had worsened significantly. But there's an alternative hypothesis: they merely lost confidence in the ability of Washington politicians to put aside partisan differences in order to address key economic policy issues. And if evidence supports the latter conclusion, does this mean that eroding consumer confidence will have a muted impact on actual spending behavior down the road? Our research indicates that this latter hypothesis is probably the correct one.

NUTS AND BOLTS

A bit of background. The Conference Board first used the CCI in 1967 as a gauge of the health of the United States economy from the consumer's perspective. There are two major components: consumers' *current perception* of business and employment conditions (with a 40 percent weight) and *expectations* for business, employment and income conditions looking six months ahead (60 percent weight). The base of the index is set to 100 in 1985, a year that was neither a trough or peak in the business cycles and thus not a misleading point for long-term comparisons. Each month a survey is sent to households, with the goal of gathering 3,000 completed questionnaires. The index is one of the earliest monthly economic indicators available. It was designed as a leading indicator, presaging broader economic trends.

The Thomson Reuters/University of Mich-

CONGRESSIONAL JOB APPROVAL RATING, GALLUP POLL



SOURCE: Gallup News Service.

igan CSI, available since 1946, was a product of the pioneering efforts of George Katona, a distinguished psychologist at the University of Michigan. Professor Katona blended consumer psychology with macroeconomic theory and modeling technology in an effort to predict the pace of consumer purchases – and thus activity in the broader economy. His work influenced cutting-edge social sciences in areas ranging from behavioral and experimental economics to evolutionary psychology and neural sciences.

The CSI is estimated from data gathered in phone interviews with at least 500 households a month; its base period is 1966. Three broad areas are covered: personal finances, business and buying conditions (both contemporaneous) and consumers' expectations for the future. In all, 50 core questions are included.

Both the CCI and CSI attempt to capture how consumer purchasing decisions will shift across time. Both are based on the idea that cognitive, emotional and social factors all influence consumers, and that changes in expectations lead them to adjust their behavior. Should I buy a car today, or wait because I expect interest rates on auto loans to fall? Or will inflation erode my buying power, making it smarter to purchase now?

EXPLAINING CONSUMER CONFIDENCE

A wide range of economic and financial factors are believed to influence the formation of consumer expectations, and thus consumer purchases. Surely, the 9.7 percent decline in the S&P 500 recorded in August explained some of the anxiety last summer – the decline reduced consumers' net worth and may have generated the expectation that wealth held in retirement accounts and other savings would slip further. The stock market, however, can't explain the extent of the plunge in consumer confidence recorded that month. Arguably, consumers were rattled by the partisan rancor in Washington over the need to raise the debt ceiling and to reduce the budget deficit. This sort of uncertainty, I believe, doesn't provide an environment conducive to developing informed assessment. I've used statistical methods well-established in the economist's tool kit to test the hypothesis.

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The starting point, of course, is to find a proxy that captures public opinion about Washington. Survey data on Congressional job approval fit the bill because they are done on a monthly basis. Moreover, one poll goes back almost four decades: the Gallup organization has been asking people whether they approved of the job that Congress was doing since 1974.

In August 2011, just 13 percent of respondents approved – and one could be forgiven for questioning the sanity of that 13 percent. This matches the lowest percentage ever tallied (in December 2010). Indeed, the figure was actually lower than in the midst of the financial meltdown in late 2008.

Congressional approval ratings, it turns out, do have a statistically significant impact on each of the measures of consumer confidence. Meanwhile, consumer confidence accounts statistically for much of the variation in consumption over time after controlling for a variety of factors, including disposable income, household wealth and home sales. The CSI, incidentally, explains more variation (and at a higher level of confidence) than the CCI.

But, strikingly, the impact of consumer confidence/sentiment on consumption seems to be declining. We divided the period in half (with one running from 1978 to 1989 and the other from 1990 through the second quarter of 2011), and then re-estimated the equations. In the latter period, consumption was just one-fifth as elastic with respect to the indexes as in the former.

WHAT ALL THIS MEANS

Consumer confidence indexes have helped to explain consumer spending even when the impact of standard economic and financial variables is accounted for. However, surveys of consumer confidence are not infallible predictors of consumer spending, especially when they have been heavily influenced by political conditions in Washington. And recently, politics seems to be taking the driver's seat.

Another factor seems to be related to the widening income gap between the top 5 percent of the income distribution and everyone else. The top 5 percent account for an increasing share of consumption, but I suspect that the surveys undersample these households. As a result, the surveys don't appropriately reflect their sentiments, weakening the correlation with consumer spending.

The lesson here? Analysts must watch what consumers do, not what just what they say, in forming projections for consumer spending and GDP in the current environment.