OF CONSUMER SENTIMENT AND THE ECONOMY
by
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A prominent contributor of psychology to applied economics has been the introduction of surveys of non-expert attitudes and expectations for use in forecasting and policy making. A particular example of this are surveys of consumer confidence. Attitudes, expectations and sentiment are terms that are frequently used when people refer to the psychological mood of consumers. These are distinct concepts. Attitudes reflect the feelings that consumers have about current conditions, and expectations are attitudes which have been projected to some point in the future. Both attitudes and expectations are subsumed into the larger category called consumer “sentiment” or “confidence”.

Initially it was thought that it is just the ability to buy, as measured by household income, which determines purchase of discretionary goods and services such as consumer durables, entertainments and holidays. However, Katona (1975) showed that willingness to buy, which can be assessed by means of surveys of consumer confidence about the state of both the general and household economy in the coming year, is also a major influence on discretionary purchases. Subsequent to this pioneering work of Katona, which was in marked contrast to the prevailing view that beliefs of consumers were of no significance in predicting their economic behaviour, regular surveys of consumer “sentiment” or “confidence” have been collected in the US and the European Union. The results of these surveys are presented in the form of an “Index of Consumer Sentiments” (ICS) which is widely accepted as a leading indicator of future purchase behaviour and even the business cycle more generally. Further, government departments frequently refer to the ICS in the planning of economic policy whilst the media often cites consumer confidence in its discussion of such policy. At MIER, such a survey is being carried out since 1988 for the same purpose as well. Called the consumer sentiments survey, it is conducted quarterly on a sample of over 1,200 households in Peninsular Malaysia to gauge consumer spending trends and sentiments. Together with the business conditions survey, another survey conducted by the Institute that depicts the supply side of the story, findings of the survey relating to consumer spending, incorporated into MIER’s short-term economic outlook report portrays the demand side. An index called the Consumer Sentiments Index (CSI) is also generated from the survey. The index has a demarcation level of 100 points which means that a reading of 100 points and above denotes positive consumer sentiments, while that below 100 points reflects otherwise.

Intuitively, it is clear that confidence or sentiment is an important causal factor in any one person's spending. If, for example, one feels that the government is mismanaging the economy and that this will lead to a recession and possibly cause him/her to be retrenched, one will not be inclined to purchase a new car than if one were optimistic about the future. Waves of optimism and pessimism do intervene and modify consumer responses to pure financial variables such as changes in personal income. Consumer psychology does matter. What is of particular importance is that consumer sentiment is a net contributor to the explanation of changes in discretionary consumer spending over time. That is, it provides unique information which is not found in the other variables generally perceived to explain consumer spending, such as income and employment. This expectations component of the overall sentiments index is more closely correlated with spending patterns. As consumers remain generally optimistic about both the economy and job prospects, the negligible decline in the index does not portend any dramatic shift in spending patterns.

However, the ICS displays strong seasonality, which suggests that not only future expectations are being measured, but also reactions to current circumstances. The existence of such seasonality suggests that the consumers participating in surveys may be influenced by current climatic conditions when expressing their sentiments about future economic conditions and obviously this may bias their forecasts. The MIER's CSI may attest to this. For example, when the Iraq war and severe acute respiratory syndrome (SARS) broke out in late 2002/early 2003, consumer sentiments in Malaysia, as reflected in MIER's survey, were affected to a certain extent. The CSI dropped from 112.8 points in fourth quarter 2002 to 105.2 points a quarter later. The reading was dragged down mostly by a decline in expectations about the future. Even so, the level of confidence remained above the 100-point demarcation level, suggesting that consumers generally remained hopeful and their spending plans were still holding up. Yes, they were in fairly good shape– but not strong enough to give a big push to the economy. This is because while the economy was not whipping up as many jobs then as in the past two years, uncertainties arising from the Iraq war were disrupting the world economic and financial veins, while the SARS scare tended to slow things down during that time.

The advantage of the ICS as a tool for explaining and, in some instances, forecasting consumer behaviour becomes apparent when the indices are viewed in conjunction with historical data for consumer spending on durable goods, a category that includes automobiles, appliances and furniture. In Malaysia, consumer spending on durable goods is not captured specifically as these goods fall within the basket of goods used to determine the consumer price index (CPI) which, in turn, comprised private consumption. According to the Department of Statistics Malaysia, private consumption for first quarter 2002 until third quarter 2003 were 3.3, 5.6, 4.2, 4.6, 4.3, 3.4 and 5.4 per cent, respectively, while the MIER's CSI for the same periods were registered at 104.4, 109.0, 108.9, 112.8, 105.2, 106.9 and 112.8 points, respectively. Here, it can be seen that periods where consumption turned downward or sluggish, as was the case in the first two quarters of 2003, were forecast by a deterioration in consumer psychology which had begun sometime earlier. The upswings in private consumption in second quarter 2002, fourth quarter 2002 and third quarter 2003 coincided with growing optimism. One must be cautioned against trying to correlate month-to-month variations in consumer sentiment with monthly squiggles in durable goods. In general, historical evidence suggests that consumer psychology will deteriorate before consumers rein in spending on durable goods. In contrast, there has been virtually no time lag between rising optimism and purchases.

One must be cognizant of two interesting factors which have, on occasion, distorted the traditional direct relationship between consumer sentiments and expenditures on durable goods. These factors are real interest rates and inflationary expectations. Inflationary expectations do, at some point, depress consumer psychology. The reason is that consumers know that periods of high inflation, in the US for example, have eventually been followed by recessions or by more restrictive government growth policies. Hence, when inflation is accelerating unusually fast, consumer psychology tends to deteriorate. At the same time, one would expect spending on durable goods to increase, at least for a while. This occurs as consumers buy now to beat future price increases. Thus, during periods of rapid inflation, the ICS could be falling as spending on durables rises.

Real interest rates, which are defined as nominal (or market) interest rates minus the expected rate of inflation, can also distort or accentuate the traditional relationship between consumer psychology and spending. If the rate of expected inflation is rising faster than the cost of a car loan, then the consumer's real interest rate is falling. One would expect that rising inflationary expectations and rising nominal interest rates would depress the ICS readings. However, as inflationary expectations rose faster than nominal interest rates, the real rate of interest fell. And that tended to stimulate spending by consumers even as their psychology deteriorated over this period. Thus, it is essential to remember that changes in inflationary psychology and real interest rates can temporarily mitigate the link between the ICS and spending. Of course, in a period when inflationary expectations are dormant or falling and real interest rates are rising or high, then one would expect consumer spending to be somewhat more subdued than their psychology might otherwise suggest.

In Malaysia, consumers represent an important cog in the wheel. This is because, as they almost always do, consumers will determine the degree of the economy's progress or slowdown because consumer spending accounts for the bulk of domestic demand. Consumer sentiment, thus, serves as a useful input for economic forecasting and policy making in the near term.

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