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Marta Lachowska

What Do Indexes of Consumer Confidence Tell Us?

The term "consumer confidence" regularly appears in our daily lexicon. The press reports on the ups and downs of consumer confidence indexes as indicative of economic prospects. Politicians refer to consumer confidence as something that legislation needs to help restore. Economists use it to forecast the national economy. But what does it mean? Does confidence reflect our expectations about future earnings? Does it reflect inflation expectations? Does lower confidence mean buy now before prices increase? Or is it independent of all of these and best described as "animal spirits," as coined by Keynes (1965)? Do we as consumers need both income and confidence to be able and willing to make purchases? These are questions that economists are still trying to sort out.[1]

It is crucial to understand whether consumer confidence is in any way useful in stimulating economic behavior.

Despite the ubiquitous presence of the word *confidence* in the public discourse, it is not understood how this collective consumer "attitude" is related to key economic indicators, such as stock market prices and inflation. The primary issue is whether the consumer confidence indexes contain additional information than what is found in other economic indices. There is no agreement. Since consumption behavior is a key aspect of macroeconomic modeling, it is crucial to understand whether consumer confidence is in any way useful in stimulating economic behavior.

A standard reference for understanding the role of sentiment in predicting spending is Carroll, Fuhrer, and Wilcox (1994), who conclude that sentiment contains information valuable for future consumption growth not captured by changes in income. (See also Ludvigson [2004] for a survey of literature on consumer confidence indexes.) More recently, Barsky and Sims (2009) study the dynamic path of income and expenditure following a shock to consumer confidence. The path of consumption following a shock to sentiment can point to either an animal spirits interpretation or an information view. The animal spirits view implies that following a sudden drop in consumer confidence, there will be an initial decrease of expenditure followed by decay back to trend. Conversely, the information view suggests a gradual reaction of output and spending. Barsky and Sims find support for the information view in their analysis. This finding is at odds with previous research findings concerned with the economic information

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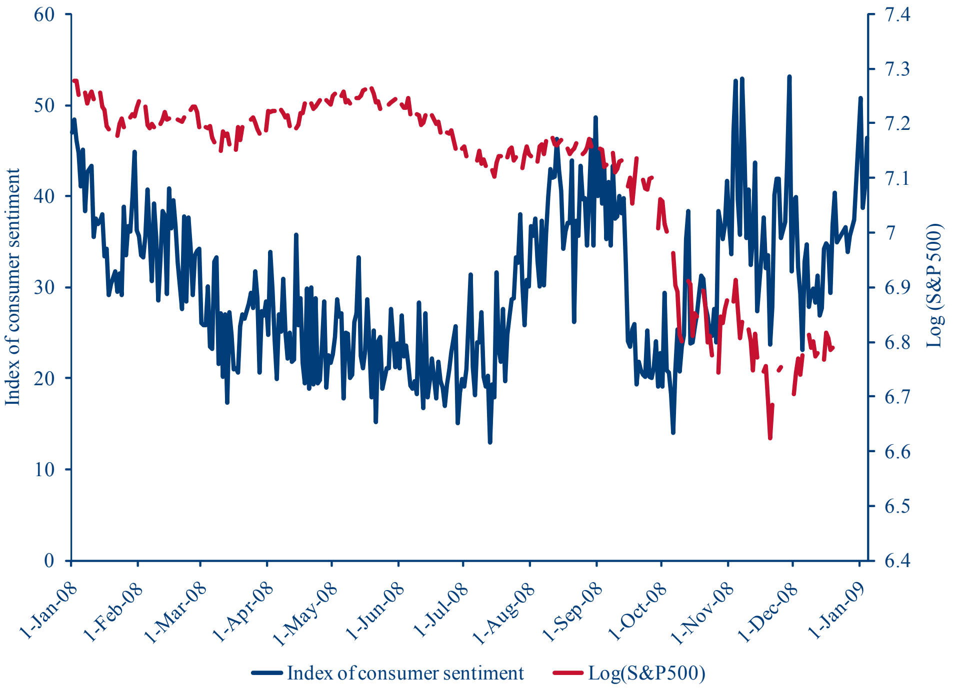
Figure 1 Consumer Sentiment and the Logarithm of Stock Prices (Standard & Poor's 500)



NOTE: Stock price data is spotty due to lack of observations on weekends.

contained in indexes of consumer confidence.

Most of the economic literature concerned with sentiment uses aggregate data. One exception is Souleles (2004), who matches individual-level microdata from the survey underlying the Michigan Index of Consumer Sentiment with data from the Consumer Expenditure Survey. Souleles's findings suggest that indexes of consumer confidence could be an aggregator of idiosyncratic information about economic prospects, which is observable to the consumer, but not otherwise to the researcher studying the data.

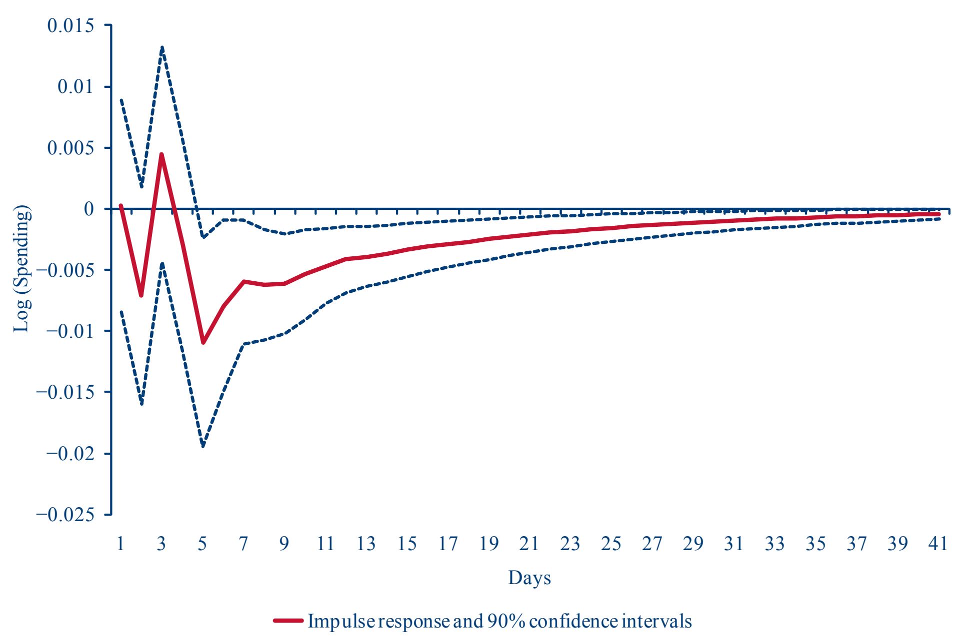
Data

Similar to previous work, my research tries to understand whether consumer confidence contains information relevant for spending but is independent of other measures, such as stock market prices, gas prices, or daily news reports. My approach to understanding consumer confidence differs from previous work in several ways, however. First, I use data with a much higher frequency than earlier work, which allows me to surpass the "chicken or the egg" causality problem. As updates about the state of the economy arrive at a slower pace than the variations in daily sentiment and spending, I can conclude that news reports may, in the short run, affect spending and confidence, but not vice versa. This allows me to isolate the causal effect of sentiment on spending.

Second, similar to Souleles (2004), I use individual-level microdata. Uniquely, these data collect information on consumer confidence and spending for the same individual, whereas previous research has resorted to imputing sentiment. Third, the information in the microdata can be used to contrast the reactions of different types of consumers.

The data on confidence and spending, called G1K, come from a survey conducted by the Gallup Organization; they are collected daily via telephone interviews with a random sample of about 1,000 individuals aged 18 and older and living in the United States. The G1K data include a variety of demographic measures, a set of questions on health, and also evaluations of living and working conditions. A unique feature of the survey is that it collects high frequency information on daily expenditure. The expenditure question reads as follows: "Next, we'd like you to think about your spending yesterday, not counting the purchase of a home, motor vehicle, or your normal household bills. How much money did you spend or charge yesterday on all other types of

Figure 2 Reaction of Spending Following a Shock to Confidence



purchases you may have made, such as at a store, restaurant, gas station, online, or elsewhere?" My sample collects this information on about 359,000 individuals living in the United States surveyed across 355 days, from January 2008 to January 2009.

The confidence measure is collected among the same subsample of the survey as the data on expenditure. The respondent is asked to evaluate the economic conditions in the United States. The question reads as follows: "Right now, do you think that economic conditions in this country, as a whole, are getting better or getting worse?" The answers are measured as getting worse, the same, or getting better. The G1K is the only data set that collects information on consumer confidence and spending for the same individuals. This feature is particularly attractive since the spending behavior and consumer confidence can be aggregated to a time series from the disparate information contained in the microdata, as opposed to pooling information from two separate, aggregate data sets.

In order to contrast the informational content in the sentiment index to information about economic prospects, I turn to external data. Stock market indices contain gyrations, and as they are collected at a high frequency, it is natural to consider whether the information contained in the stock prices reflects the swings in confidence. Previous research has highlighted the importance of stock prices as predictors of future productivity (see Beaudry and Portier [2006]). Presumably, if the stock market tells us something about the state of the economy, it ought to be relevant to consumers when they adjust their spending behavior.

Figure 1 plots the time series of consumer confidence and the logarithm of the daily series of close prices of the Standard & Poor's 500 index. It suggests that confidence and the stock market prices tend to share a common trend. This raises the question of whether the information contained in the index of consumer confidence contains an independent component that is predictive for spending.

If the fluctuations of stock prices carry information about economic prospects, spending should adjust to incorporate this update. If sentiment reflects information about future prospects, the reaction of spending following a shock to sentiment should be modest once the information available to the stock market is controlled for. However, if the dynamic path of spending remains unchanged, it is an indication that sentiment reflects some other relevant but independent information, divorced from news about the future behavior of the economy. Hence, the reaction of spending is indicative of the informational content confidence. To study this, I examine empirically the daily series of stock

Figure 3a Reaction of Spending Following a Shock to Log (S&P 500)

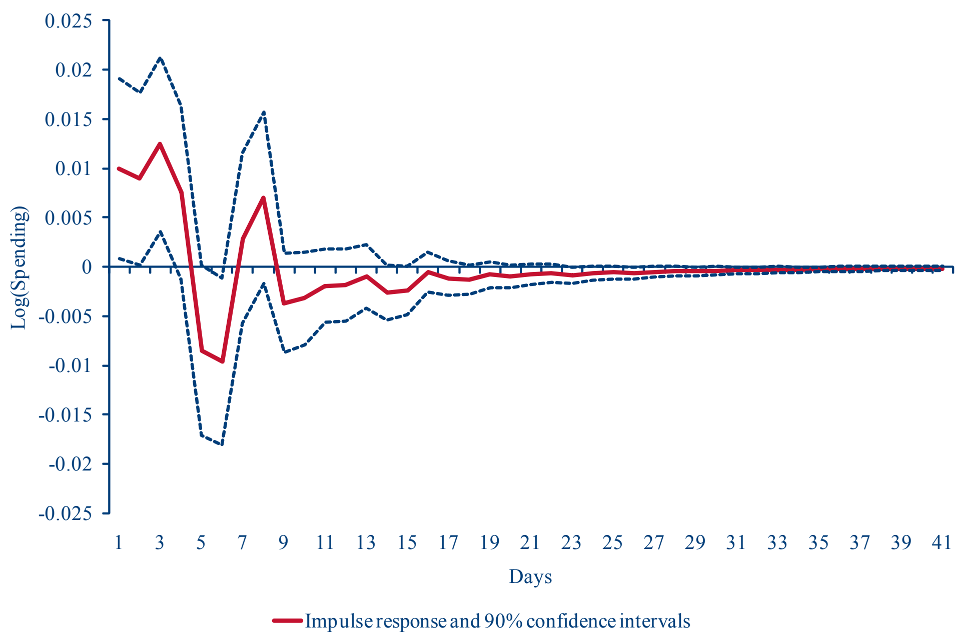
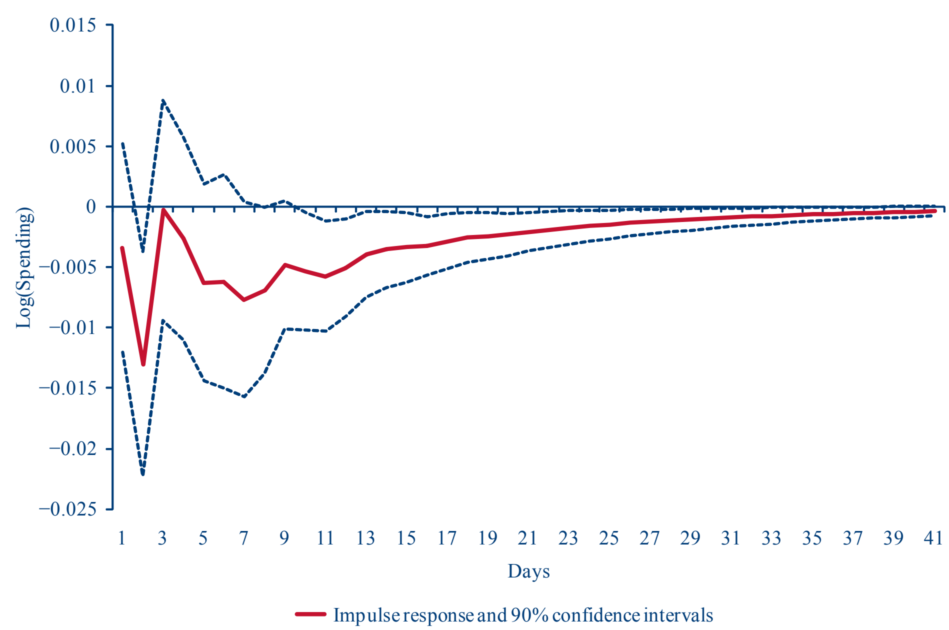


Figure 3b Reaction of Spending Following a Shock to Confidence



market prices and the daily time series of consumer spending and confidence from the G1K.[2]

Results

Consider first the simple bivariate dynamics of expenditure and confidence. Figure 2 shows the reaction of spending following an unexpected change in confidence—a "shock." It appears that spending reacts to changes in consumer confidence. This shock results in a displacement of spending that lasts for about 30 days, which is consistent with consumers acting upon a precautionary saving motive—if an increase in confidence correlates with an increased level of uncertainty (e.g., a higher variance in a consumer's income process), the prudent consumer will react by accumulating a buffer stock (see Carroll, Fuhrer, and Wilcox [1994]).

Next consider the empirical analysis when information on stock prices is included. Assuming that the stock prices are reflective of all the information available on the market about the state of the economy, once the stock prices are controlled for, confidence should not forecast spending if the consumer confidence index is another manifestation of the same information.

Figure 3a shows that spending reacts strongly and positively to a shock to stock market prices. Figure 3b shows that following a shock to sentiment, spending takes on a very similar pattern to the reaction found in Figure 2.

This suggests that information contained in consumer sentiment is not fully reflective of information on the stock market, as spending still reacts following an unexpected change in sentiment. Extending the conditioning information set of my analysis further to other survey measures originating from the G1K, I find that sentiment is also not a reflection of concerns about employment stability, which casts some doubt on the explanation of confidence as an aggregator of idiosyncratic information.

Does consumer confidence then reflect animal spirits? The principle of parsimony implies that for the animal spirits interpretation to hold, well-established models of economic behavior would need to be rewritten to support a theory where consumers decide to go shopping because they feel confident on a particular day. The results are best interpreted as indicating that confidence plausibly aggregates disparate information available to consumers, but not observable by the econometrician, and hence matters for forecasting changes in spending. This issue could be best explored further with a richer set of conditioning variables and a longitudinal component in the underlying microdata.

Notes

This article contains statements not referenced due to space constraints. For a complete bibliography, see Lachowska (2011).

1. The severity of the recent recession has highlighted the ongoing need to understand the underlying causes of macroeconomic distress. A large literature on real business cycles attributes recessions to fluctuations in technology. An older view, associated primarily with Keynes (1965), ascribes the variations in economic activity to drops in consumer demand. In recent years we have witnessed resurgence in interest in bridging the divide between the latter view and the real business cycle approach, for example, in the literature on news-driven business cycles. The turbulence of the last recession has also sparked a renewed interest in nonstandard explanations of consumer behavior; see, for example, Akerlof and Shiller (2009) and Farmer (2010).

2. Since the U.S. stock market data are only available on weekdays, in order to merge this information I exclude the data on spending and confidence that was collected on the weekends. The sample used for estimation in Figures 2 and 3a–b consists of 238 observations occurring on weekdays.

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John A. Turner

The Policy Challenges of Increasing Longevity

Paying for the Costs of Living Longer

Increases in life expectancy for males and females in the United States are expected, yet the financing of neither private pensions nor Social Security explicitly address them. My book, *Longevity Policy: Facing Up to Longevity Issues Affecting Social Security, Pensions, and Older Workers,* focuses on public policy issues concerning Social Security, pensions and work at older ages that arise because people are living longer. It draws on international experience to recommend solutions of these issues. (See p. 9 for information on how to order the book.)

The premise of the book is that public policy should recognize longevity policy as a distinct area that affects many programs and policies. Longevity policy is best treated as a unified policy area because of the interrelationships between work at older ages, Social Security, and pensions. Rather than treating the issues raised by life expectancy in policies toward the employment of older workers separately from policies concerning Social Security and pensions, a unified approach would facilitate making needed changes in each of the areas. Because of interconnections between these three areas, policy will be more effective if it incorporates them together.

In the long term, increases in longevity are the main aspect of demographic change that increases Social Security's costs. A key parameter in determining the costs of providing Social Security benefits is the dependency ratio, which is roughly the ratio of the number of individuals over 65 (potential beneficiaries) to the number of individuals aged 15–64 (potential tax payers). A study by the Social Security Administration Office of Actuaries indicates that if a baseline of 2008 is chosen, increases in life expectancy after that date have little effect on program costs through changes in the dependency ratio for the first 20 years, but after 2030 they are projected to account for all the changes in the dependency ratio (Goss 2010). Thus, in the long term, increases in life expectancy are key determinants of financing.

The international evidence suggests that life expectancy in the United States will continue to increase. In 2005, life expectancy in the United States at age 65 for women and men were 19.0 and 17.0 years. In that year, the figures in France were 19.8 and 18.2. In Japan, they were 23.4 and 18.5. In all, the life expectancy figures were higher for women in at least 17 countries and higher for men in at least 13 countries (National Center for Health Statistics 2009).

Policy Recommendations

As Table 1 notes, my book offers five major policy recommendations; three in the area of Social Security, one for 401(k) plans, and one for defined benefit pension plans. My first recommendation in the area of Social Security is to index benefits by life expectancy just as defined contribution pensions do when annuitizing benefits. This would reduce annual benefits (but not expected lifetime benefits) to offset the increases in lifetime benefits that accompany increases in life expectancy. A desirable side effect of this policy would be the likelihood that its reductions in replacement rates over time might induce individuals who are able and willing to do so to work longer.

Given the widespread antipathy toward raising Social Security contributions, and the improvements in the ability of people to work in their early sixties, my second recommendation for Social Security would be to raise the early retirement rate from 62 to 63. Any change in the early retirement age would presumably take effect 15 or more years in the future, with a phase-in period starting at that point. It should be noted that whereas the early retirement age currently is 62, when President Franklin Roosevelt signed the Social Security Act into law, and for more than 20 years at the start of Social Security, it was 65.

The question can be raised as to why the Social Security early retirement age should be raised given that Social Security allows workers to postpone retirement and rewards that behavior with increased annual benefits. Social Security provides incentives for workers with longer than average life expectancy to postpone retirement because the increased benefits they receive are for more than the expected number of years of life. However, the actuarial adjustment for postponed receipt of benefits is insufficient to provide such incentives to people with shorter than average life expectancy. In any case, regardless of the incentives for taking or postponing receipt of benefits, many people are shortsighted and take benefits at age 62, the earliest age they are available, even though they would financially be better off by postponing benefit receipt.

Policy discussions about raising the retirement age in Social Security are often confused and misleading. Often, those discussions refer to the normal retirement age, which is the age at which a person can receive what are considered to be full benefits. For people currently age 62, that age is 66, but changes already in law raise it to age 67 for people born in 1960 and later. When my book refers to raising the retirement age in Social Security, it is referring to the early retirement age.

Life expectancy indexing of benefits and raising the early retirement age are hard choices. But retirement income policy is fundamentally about making hard choices, both by individuals and national policymakers. An alternative to working longer is to increase savings and contributions to Social Security and pension funds to pay for retirements that are lengthened by improving life

Table 1 Overview of Major Policy Recommendations

Policy area	Policy	Goal
Social Security	Life expectancy indexing of benefits	Help restore solvency
Social Security	Raise early retirement age from 62 to 63	Raise benefit level to offset benefit cuts
Social Security	Longevity insurance benefit payable at age 82	Provide better targeting of benefits, offset benefit cuts
401(k) plans	Require that annuities be offered when a defined benefit plan is not also offered	Encourage annuitization of 401(k) plans
Defined benefit plans	Life expectancy indexed defined benefit plan	Encourage provision of defined benefit plans

SOURCE: Author's recommendations.

expectancy. Whatever changes are made in public policy, the option of increasing personal savings to finance early retirement remains for individuals. Individuals who wish to retire early can plan to do so by raising their savings. That said, many individuals find retirement planning, with its long time frame, difficult to do.

My final major recommendation for Social Security is a proposal for a new benefit, called longevity insurance, that would be payable starting at age 82. It focuses on two vulnerable groups: 1) workers who retire at age 62 in poor health, with poor work prospects and little in retirement resources other than Social Security; and 2) retirees in their 80s who have spent down their non-Social Security assets and rely primarily on Social Security benefits.

It is important to have private pensions take into account life expectancy increases as well. My main recommendation for 401(k) plans is to encourage more people to annuitize their 401(k) plan account balances, taking into account insights from behavioral economics. For example, annuities could be purchased in units while working, rather than being purchased as a single lump sum at retirement.

My first recommendation in the area of Social Security is to index benefits by life expectancy just as defined contribution pensions do when annuitizing benefits. It would de-risk defined benefit plans of most of the longevity risk that plan sponsors still bear, which could encourage the provision of defined benefit plans.

Conclusions

The premise of my book is that public policy should recognize longevity policy as a distinct policy area. Policy should be developed that is directly related to the effects of increasing life expectancy. Rather than separately treating the issues raised by life expectancy concerning Social Security, pensions, and work at older ages, a unified approach should be developed that recognizes the interrelationships. A unified approach that included policy toward work at older ages, policy strengthening pensions, and policy strengthening Social Security would arguably facilitate the needed changes in each of the areas. Dealing with only one area may be more difficult and less effective than dealing with all the areas at the same time. Together, the policies recommended in this book would encourage work at older ages, move Social Security toward solvency, provide better targeting of Social Security benefits, increase annuitization of 401(k) accounts, and encourage employers to provide defined benefit plans.

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John A. Turner is director of the Pension Policy Center in Washington, D.C.

Upjohn Press Book Wins Richard A. Lester Award

Stephen A. Wandner's *Solving the Reemployment Puzzle: From Research to Policy* has won the Richard A. Lester Award for the Outstanding Book in Industrial Relations and Labor Economics for 2010. The award is given by Princeton University's Industrial Relations Section and heads up the yearly list of "Noteworthy Books" chosen by the Section.

In the book, Wandner, a former official in the U.S. Department of Labor, provides a detailed insider's view of the process for creating workforce-related policy during the Clinton and Bush administrations, and discusses how rigorous scientific research was used (or not) to develop and implement that policy.

Read more about the book at http://research.upjohn.org/up_press/205/.

Also on the list of "Noteworthy Books" for 2010 from the Upjohn Press is *Mothers' Work and Children's Lives: Low-Income Families after Welfare Reform* by Rucker C. Johnson, Ariel Kalil, and Rachel E. Dunifon. In it, the authors examine the impacts welfare reforms have had on the work-family balance of low-income working mothers.

"[This] study makes a valuable contribution to our understanding of low-wage work. It would be an excellent supplemental text to any social science course on poverty or social welfare policy." –*Journal of Economic Literature*

Read more about the book at http://research.upjohn.org/up_press/10/.

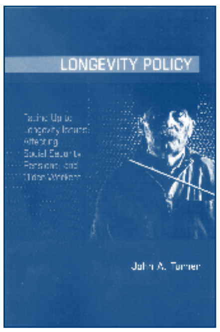
New Books

Longevity Policy

Facing Up to Longevity Issues Affecting Social Security, Pensions, and Older Workers

John A. Turner

Turner argues that, instead of treating issues relating to older age, Social Security, and pensions separately, we need to recognize the interrelationships among these areas and adopt a unified approach toward policy.



He begins by documenting the overall increase in life expectancy, the ensuing distributional issues observed in the United States' diverse population, other related demographic changes, and the costs associated with increased longevity.

Turner then proposes a package of complementary longevity policies. These policies would reinforce one another in accomplishing several things: they would help encourage work at older ages, move Social Security toward solvency, provide more efficient targeting of Social Security benefits, increase annuitization of 401(k) accounts, and encourage employers to offer defined benefit plans to their workers. If adopted, they could facilitate the adjustment of workers and pension systems to the costs and benefits of a longer life.

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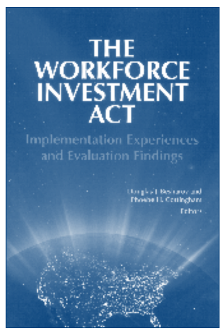
The Workforce Investment Act

Implementation Experiences and Evaluation Findings

Douglas J. Besharov and Phoebe H. Cottingham, eds.

This book presents a group of papers that provide the most comprehensive and up-to-date look yet at WIA's program performance and impact. The papers were commissioned for a meeting held with staff of the European Commission for a discussion of WIA lessons and the implications for future workforce programming in the United States as well as Europe. They are organized into five areas: 1) understanding WIA, 2) program implementation, 3) performance management, 4) impact evaluations, and 5) future evaluation choices.



In addition, the contributors detail how WIA performance management systems function and present various evaluation techniques for assessing workforce programs.

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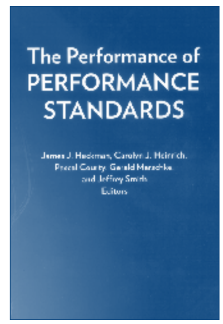
The Performance of Performance Standards

James J. Heckman, Carolyn J. Heinrich, Pascal Courty, Gerald Marschke, and Jeffrey Smith, eds.

Incentives and accountability for government performance are central to contemporary government reform agendas across the globe. Still, the lessons on intended and unintended effects of incentive and performance management systems from several decades of study and practice do not appear to be reflected in the current design and implementation of these systems in the public sector.



This serves as motivation for the contributors to this volume. Led by Nobel laureate James J. Heckman, they use U.S. employment and training programs as their laboratory for investigation. Drawing on a variety of superior data sources, they explore how performance standards and incentives influence the behavior of public managers and agency employees, their approaches to service delivery, and ultimately, the outcomes for participants.

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