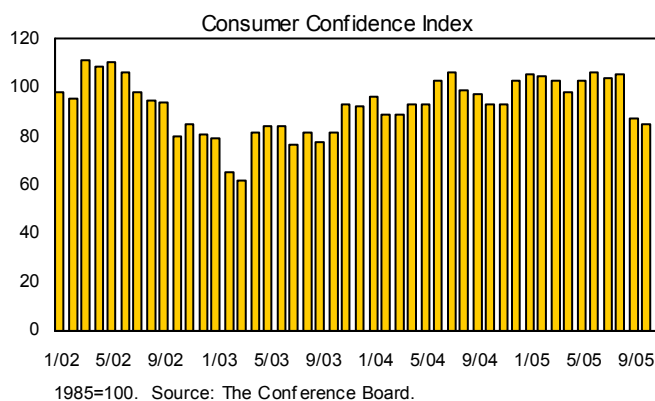




When the Going Gets Tough, Consumers Go Shopping

Consumer confidence is falling. The Consumer Confidence Index dropped in September to 87.5 from 105.5 in the previous month. It was the biggest decrease in the past fifteen years. The index fell again in October to 85.0, the lowest level in the past two years.



The Conference Board, a business-supported think tank, publishes the monthly Consumer Confidence Index based on a survey of about 5,000 households around the country. As can be seen in the chart above, the index hit the lowest level in the months leading up to the conflict in Iraq, but has been gradually rising since then.

Hurricanes pummeled consumer confidence

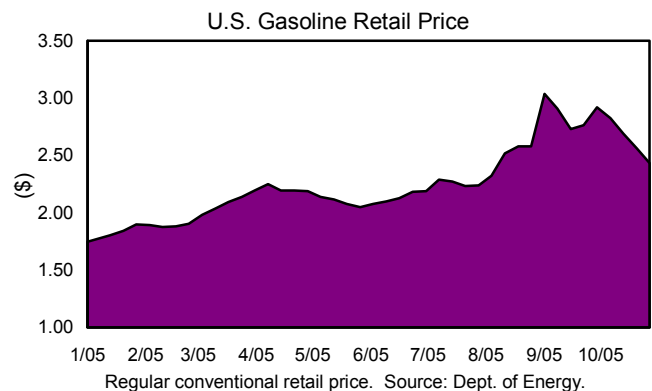
That, however, changed when Hurricanes Katrina and Rita battered the Gulf Coast region. The suddenness of the drop in the index suggests that the hurricanes were a major factor in deteriorating consumer confidence. There is no arguing that witnessing the devastation of New Orleans on television day after day had a strong psychological impact on U.S. consumers, even though the real economic impact of the hurricane has proved to be quite limited.

Recently we have learned that the third-quarter GDP growth rate was 3.8%, which was higher than the 3.3% growth during the second quarter. In other words, the economy accelerated in the third quarter, despite considerable disruption in economic activities during September.

While the hurricanes were the most obvious reason for increasing pessimism, there were other factors that also dampened consumers' economic outlook. Repeated

interest rate hikes by the Fed have made credit card debt and home equity loans more expensive for consumers. The new tougher bankruptcy law may also have made consumers more cautious.

The unfolding political drama involving both the White House and Congress may be weighing upon consumer sentiment. Mounting U.S. casualties in Iraq were perhaps another factor. Still, in terms of the impact to consumers' pocketbooks, rising gasoline prices surely have been the number one concern when people responded to recent sentiment surveys.



Among all products that consumers buy regularly, gasoline tends to have a disproportionately large impact on their perception of inflation. First and foremost, gasoline is a necessity for most Americans. Outside of urban centers with good public transportation, one must drive to work, to school, and practically everywhere else. To forgo buying gasoline because of higher prices is simply not an option for most families.

Second, the price of gasoline is easy to remember. It's a product one buys frequently, and prices are posted prominently on street corners. Historical comparisons are also easy because gasoline prices are always quoted for the same unit (per gallon), and there is little quality differentiation other than regular, midgrade, and premium.

Higher gasoline prices ultimately reduce discretionary income, which is defined as the amount of money available after taxes and essentials (such as food, clothing, shelter, and basic transportation) have been taken care of.

Simply put, higher gasoline prices leave less money for discretionary spending and also for savings. In coming months, the higher cost of heating oil will further reduce discretionary income for households in the Northeast and other places.

Will consumers reduce spending?

It is widely believed that falling consumer confidence will eventually lead to reduced spending. Academic research has shown that some correlation exists between consumer sentiment and spending, even though the relationship does not seem to be particularly strong.

The latest report from the Department of Commerce showed that consumer spending increased by 0.5% in September. Post-hurricane insurance payments led to the biggest increase in personal income in ten months and boosted spending.

While overall spending in September was considerably stronger than in August (when consumption fell by 0.5%), consumption of durable goods slumped 2.3%, mainly due to weak auto sales. Yet, increased spending on other goods and services more than made up for the decrease.

So, consumers are saying that economic conditions are worsening, but at the same time they have increased their spending and reduced savings. (The U.S. savings rate remains in negative territory.) This is contrary to the commonly assumed relationship between consumer sentiment and spending.

One possible explanation for an apparent disconnect between consumer confidence and spending data is that

the latter do not make adjustments for changes in product prices. Consumers may reduce expenditures on recreation and clothing, for example, due to higher energy prices, and, therefore, receive less satisfaction from the same amount spent. (After all, they are getting the same volume of gasoline and less of everything else.) But such shifts among different products do not affect the total consumption figure. Thus, consumers are less satisfied, but the spending will remain stable or even rise (if increased energy-related expenditures are not completely offset by reductions in other areas).

Another argument is that a person's macro view of the economy has little influence on how he or she allocates personal resources (microeconomic decisions).

Perhaps the most compelling explanation (based on the observation of my own behavior as well as that of others around me) is that some people go shopping when they're blue. I'm not suggesting that we are a nation of manic-depressive shoppers, but I personally know quite a few individuals who hit the mall whenever they're feeling a little depressed.

While falling consumer confidence generally does not bode well for the economy, it appears unlikely that it will lead to a rapid contraction of consumption or, for that matter, a recession. As long as tough consumers among us are diligently combing through our local shops for bargains, economic expansion will continue.

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Economic Forecasts – November 2005

UNITED STATES	2003	2004	2005	2006
Real GDP Growth (%)	2.7	4.2	3.6	3.6
Unemployment (%)	6.0	5.5	5.1	4.9
CPI Change (%)	2.3	2.7	3.5	2.8
Federal Funds (%)	1.1	1.3	3.2	4.5
Housing Starts (millions)	1.85	1.95	2.04	1.88
Car/Lt. Truck Sales (millions)	16.6	16.9	17.1	16.7

Bold: Actual.

The information in this report is based on data available as of November 1, 2005, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.