The Outlook for Consumption: Resilient and Retrenchment

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Key Factors Affecting Consumer Spending

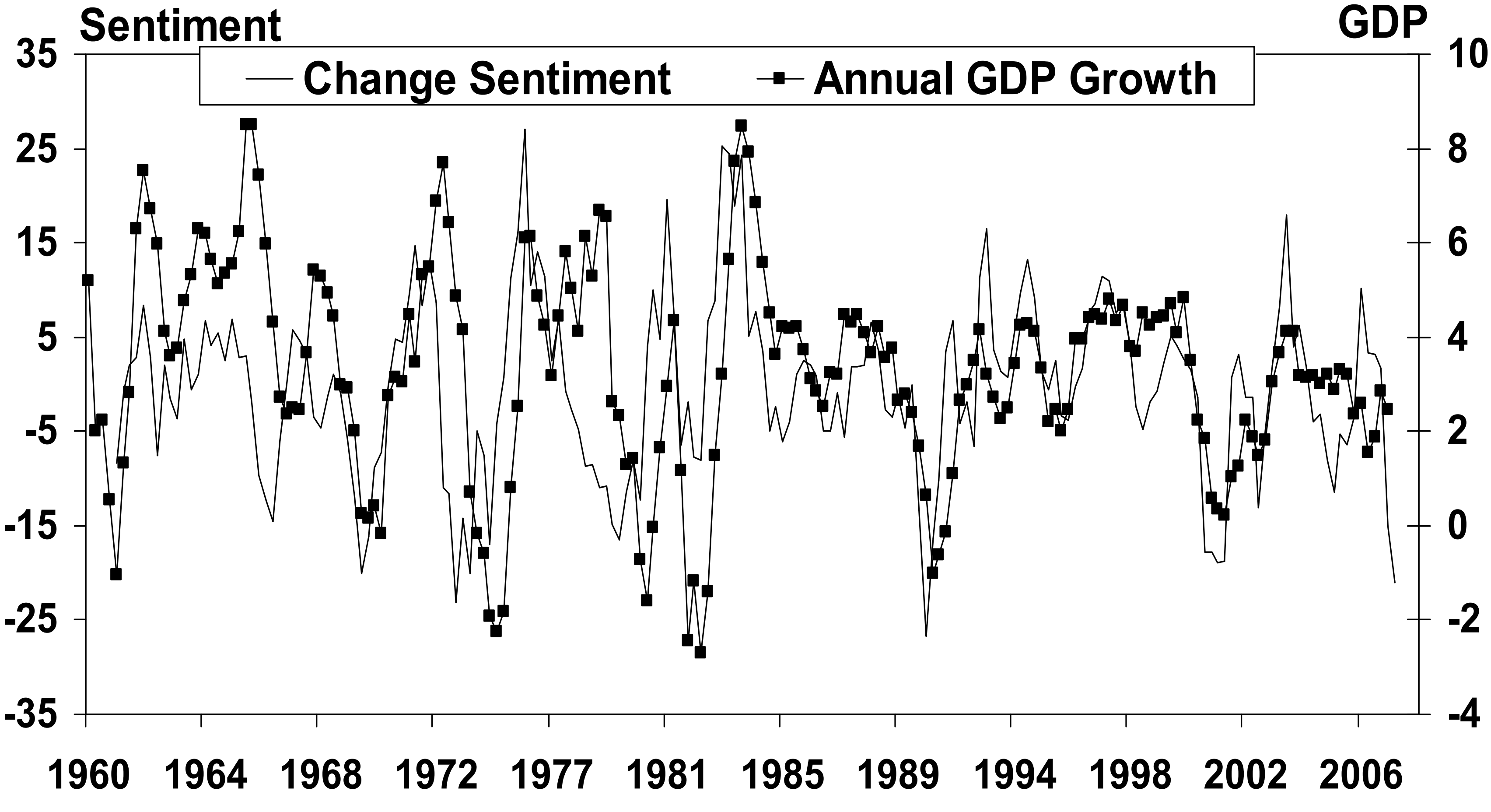
- **Broadening impact of decline in credit availability (despite rate cuts)**
  - Loans require higher credit scores, large down payments, and higher interest rates
  - Mortgages, home equity, revolving lines, installment loans, and credit cards
- **Falling housing and stock wealth**
  - Persistent fall in home prices; consumer uncertain when it will end
  - While wealth has small impact on spending, shift from big positive to negative
- **Higher inflation reduced growth in real incomes; slower job growth**
  - Real personal disposable income increased by just 0.3% in 4th quarter of 2007
  - Real hourly earning fell year/year for last 3 months (-1.1% in January).
  - Rising unemployment rate will persist into 2009
- **Precautionary motives rise relative to spending motives**
  - Ongoing reassessment of record debt burden and risks of record low savings
  - Constrained ability to cope with additional economic adversity
- **Personal consumption expected to grow by 1½ % in 2008**
  - 1st quarter weakest; negative quarters likely. Tax rebate temporary impact in 3rd quarter.
  - No rebound in housing until late 2008 or early 2009.

Tax Rebates and Interest Rate Cuts: How much help and how much harm?

- **Pulling out all stops prior to first sign of downturn**
  - Fed slashed rates from 5.25% to 3.0% in about four months (Sept 18 to Jan 30)
  - Tax rebate program equal to $150b or 1% GDP
- **How much short term help?**
  - Interest rate cuts mainly work through housing “channel” to impact real economy
    - Little expected impact on housing; most impact on financial markets
    - Despite cuts still have increasing credit standards which dampen consumption
  - Rebates target low/middle income; they were decimated by fuel and food price hikes
    - Will rise in precautionary motives mean most rebates are saved or used to repay debt?
- **How much long term harm?**
  - Fiscal and monetary policies create potential for higher long term inflation
    - Impact on inflation depends on how much of a recession would have occurred
  - Creates greater Federal deficit and encourages consumers to lower their savings
    - Increased need for tax hikes/spending cuts and higher savings in future: drag on GDP

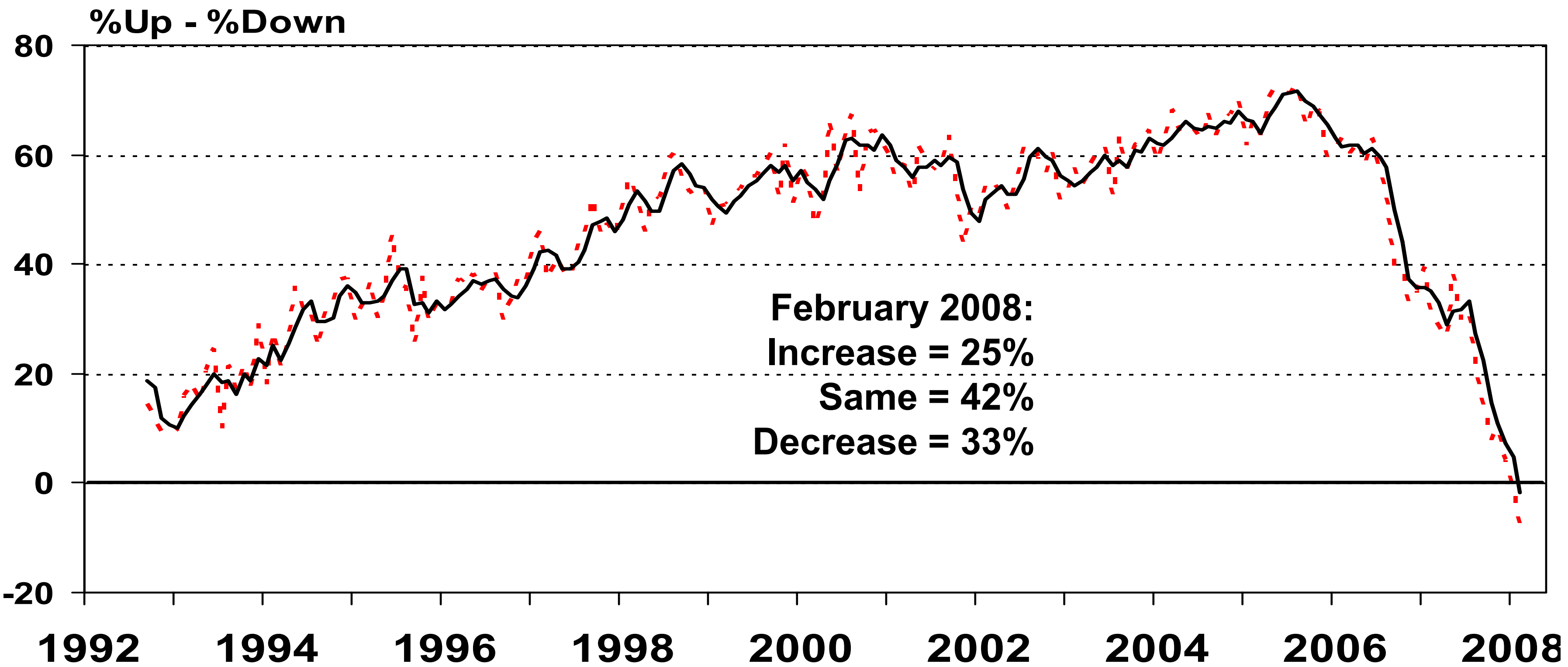
Change in Sentiment Index and Growth in GDP

Consumer sentiment has declined significantly since its peak in January 2007, with the extent of the decline indicating a downturn in personal consumption. Negative growth is expected in the 1st and 2nd quarters of 2008, and since consumption (not counting residential investment) accounts for about 70% of GDP, it threatens to push the entire economy into recession. Note that the chart below shows the correspondence of "raw" data, not the prediction of a model



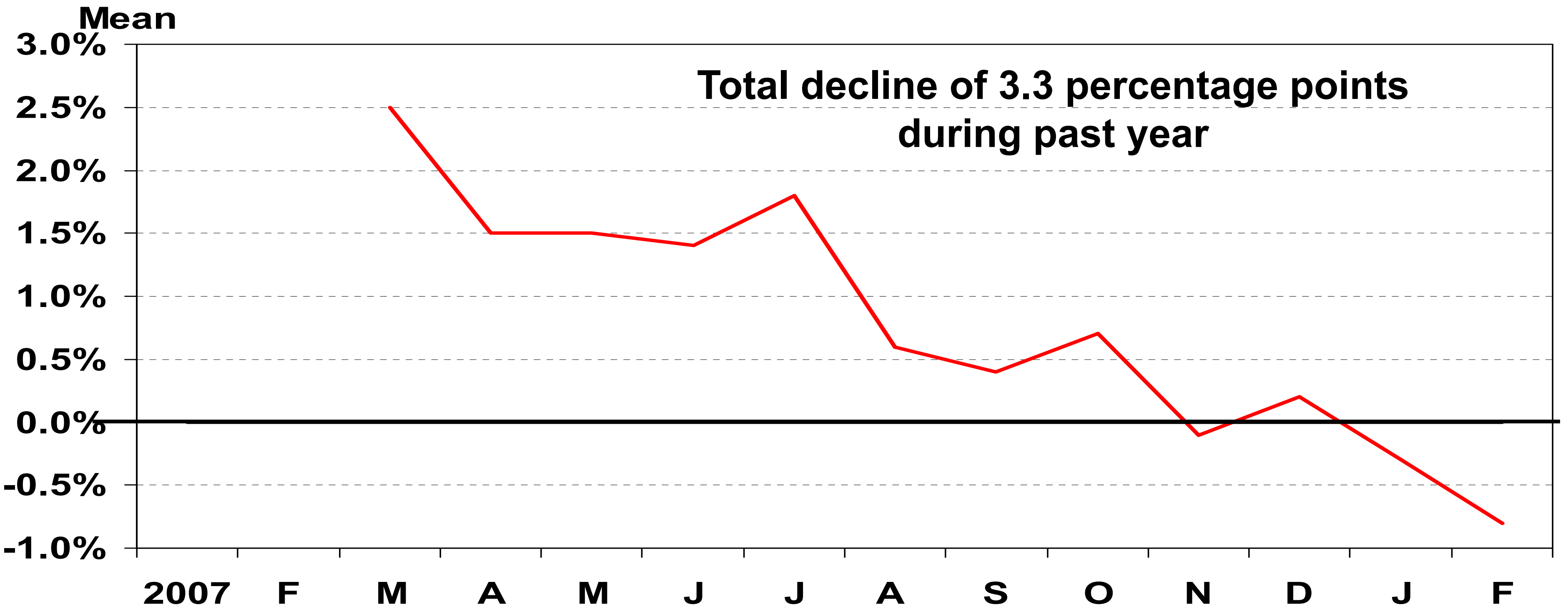
Homeowner's Perceptions of Home Values Plunge

Consumers perceptions of recent changes in the value of their homes have plunged. In February of 2008, just 25% reported gains in the value of their homes during the prior year, down from a peak of 75% in mid 2005. Declines were also reported by 33% of all homeowners, the highest figure recorded since the early 1990's. The largest declines were in the West and Northeast and among the highest priced homes.



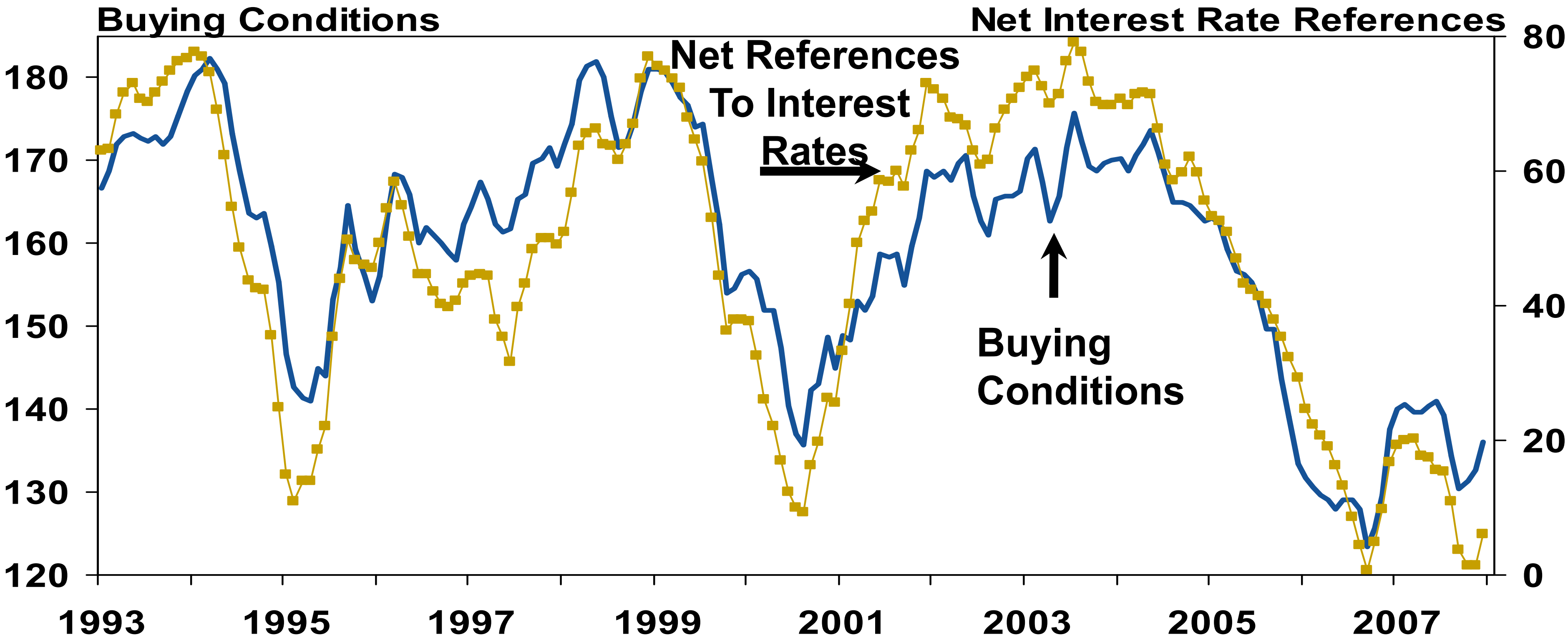
Home Values Expected to Decline in 2008

Homeowners expected the value of their homes to remain unchanged during the year ahead for the third consecutive month. The February survey found that homeowners expected a decline of 0.8%, representing a substantial decline during the past year.



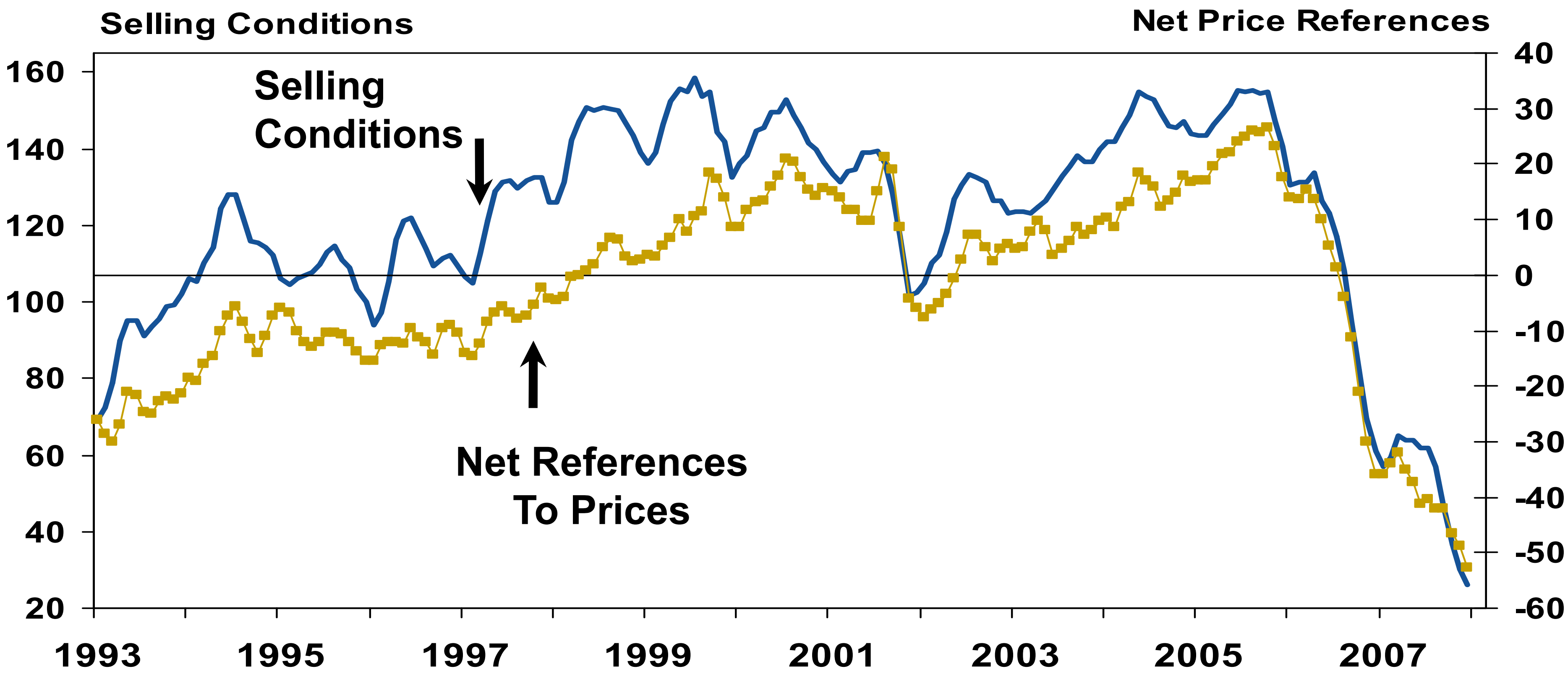
Home Buying Falls as Credit Standards Rise

Home buying conditions are viewed quite negatively by consumers mainly due to rising credit standards. Consumers more frequently complained about higher credit standards rather than high mortgage rates. Record numbers cited the availability of low or discounted home prices. The problem is that they do not know how low they will go, and hence were likely to favor postponement.



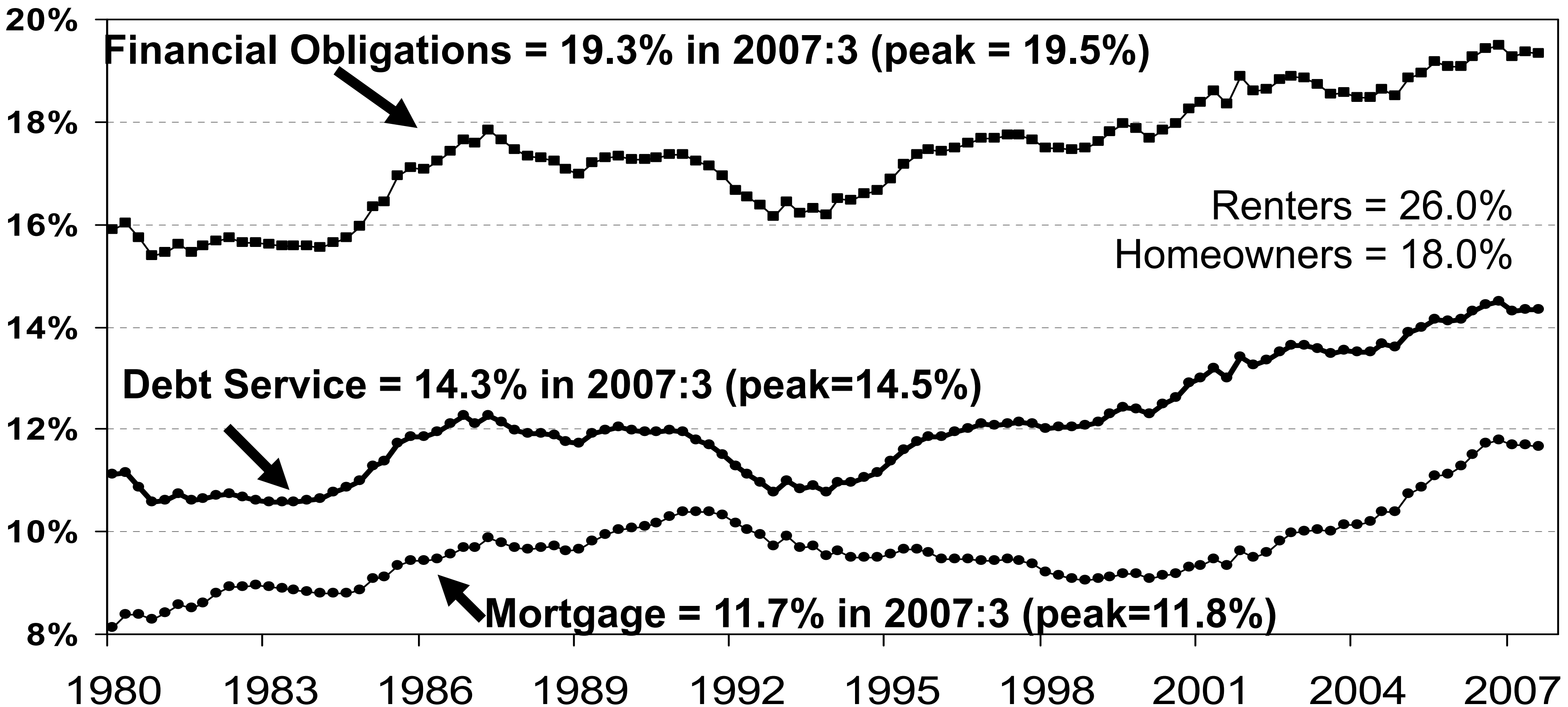
Home Selling Falls Along with Declines in Home Prices

Most home buyers are also home sellers and the lower market prices that now prevail are very unattractive to sellers. Most owners think the value of their home is near the past peak in prices and are unwilling to sell at a realistic discount. Even if they both sold and purchased a home at the same percentage discount, many home owners believe the loss in the value of their current home is much worse---losses are valued at twice comparable gains.



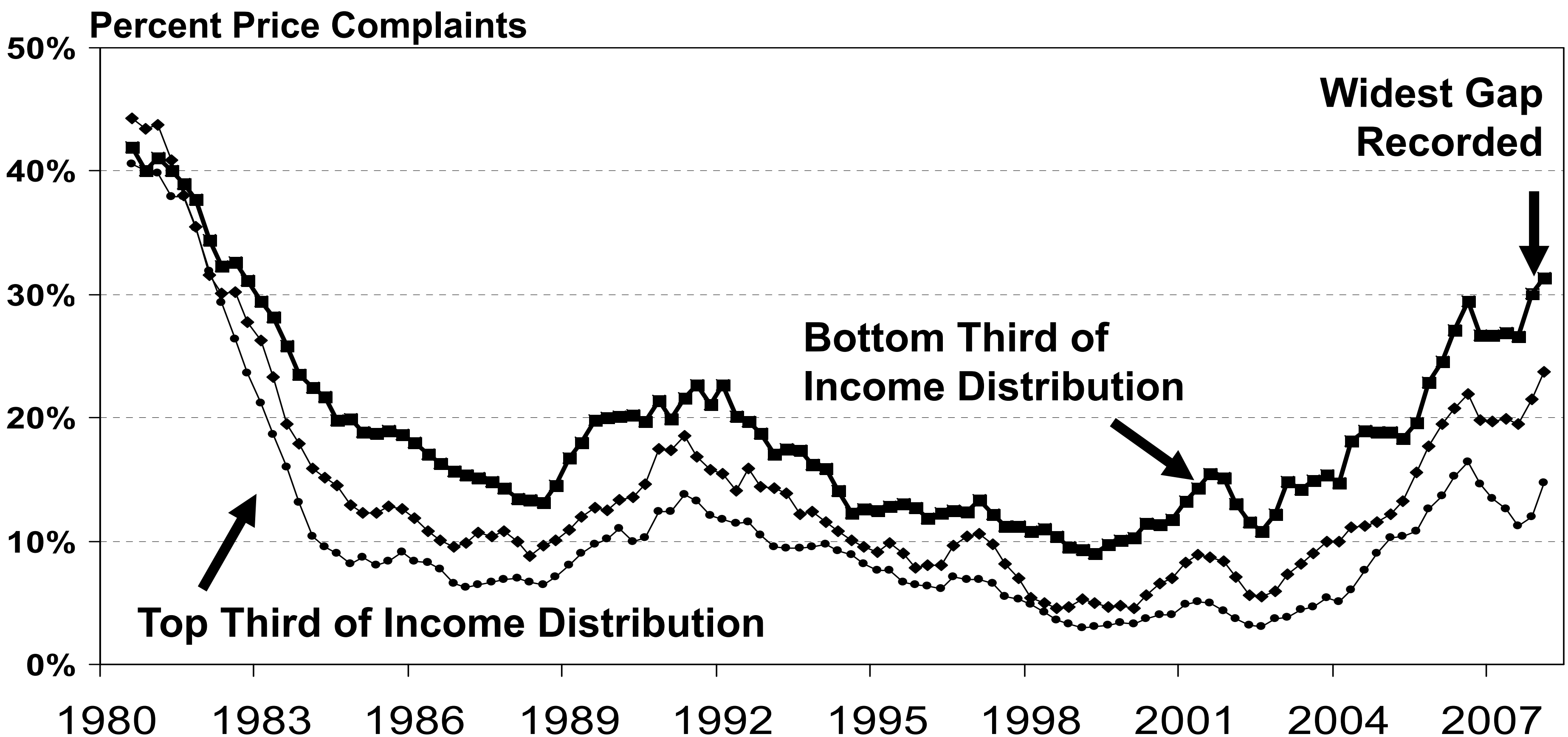
Debt Service as a Percent of Disposable Income

Most of the increase in debt has been due to rising mortgage debt (compare bottom two lines), and most of the increase in financial obligations (which includes debt-like obligations like rent, vehicle leases, taxes, etc.) has been due to debt (compare top two lines). Perhaps even more important, it is not that debt has increased, but that consumers judge the burden and potential risks of current debt higher than before. As a result, consumers will attempt to reduce debt and increase savings in year ahead.



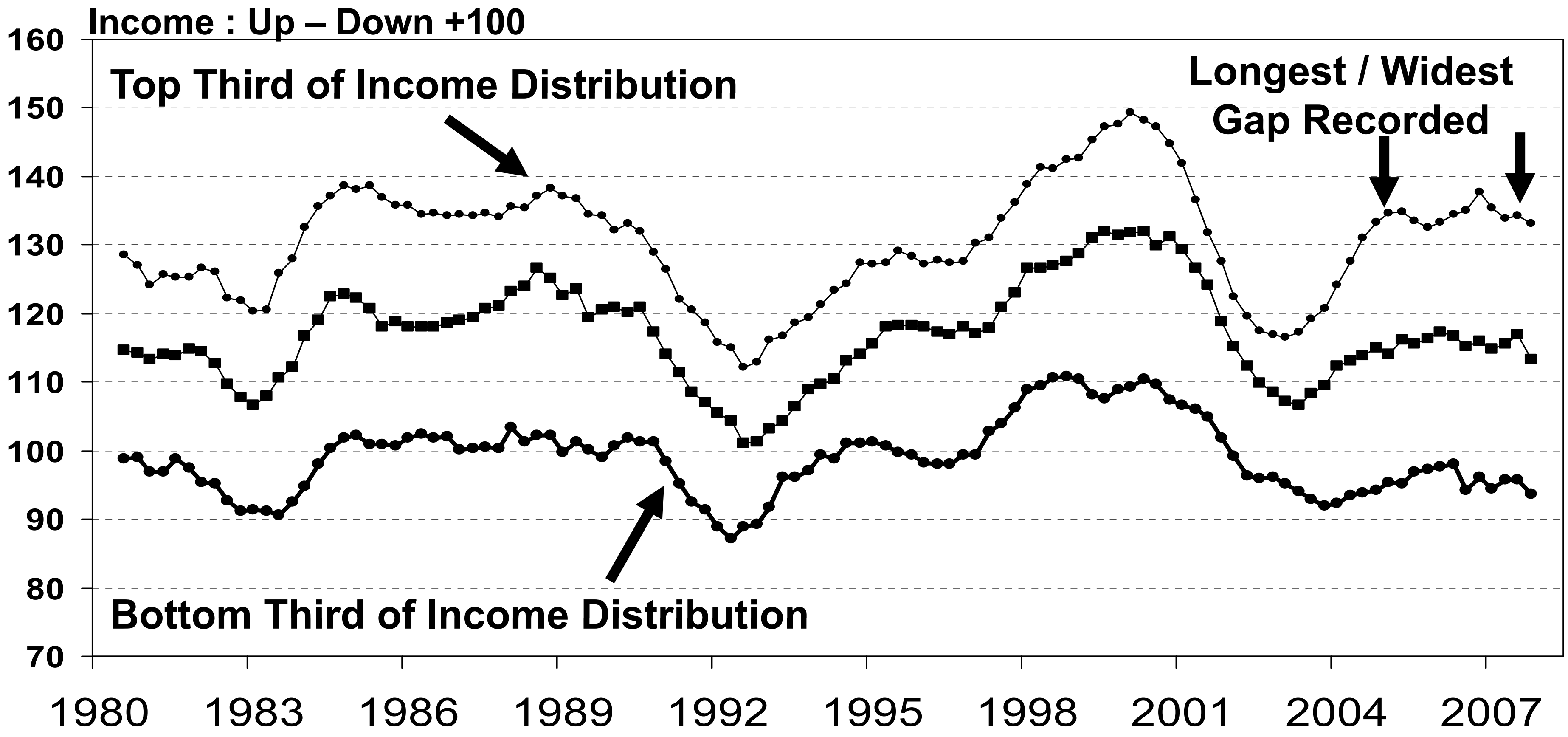
Rationale for Tax Rebate's Income Limits

High fuel and food prices have had a devastating impact on lower income households but not on upper income households. Even when inflation was at double digit levels in 1980, its impact was equally felt by all consumers. This will have a significant negative impact on the purchases of lower income households and very little if any on the purchases of upper income households. The top third includes incomes $75,000 or more.



Widest Gap on Record in References to Income Gains Among Thirds of Income Distribution

Higher income households have also benefited from more frequent income gains relative to lower income households. This reflects the widening income inequality over the past decades. To be sure, this comparison involves greater caveats since income gains and income position are related. Nonetheless, the data clearly indicate a record gap between income groups.



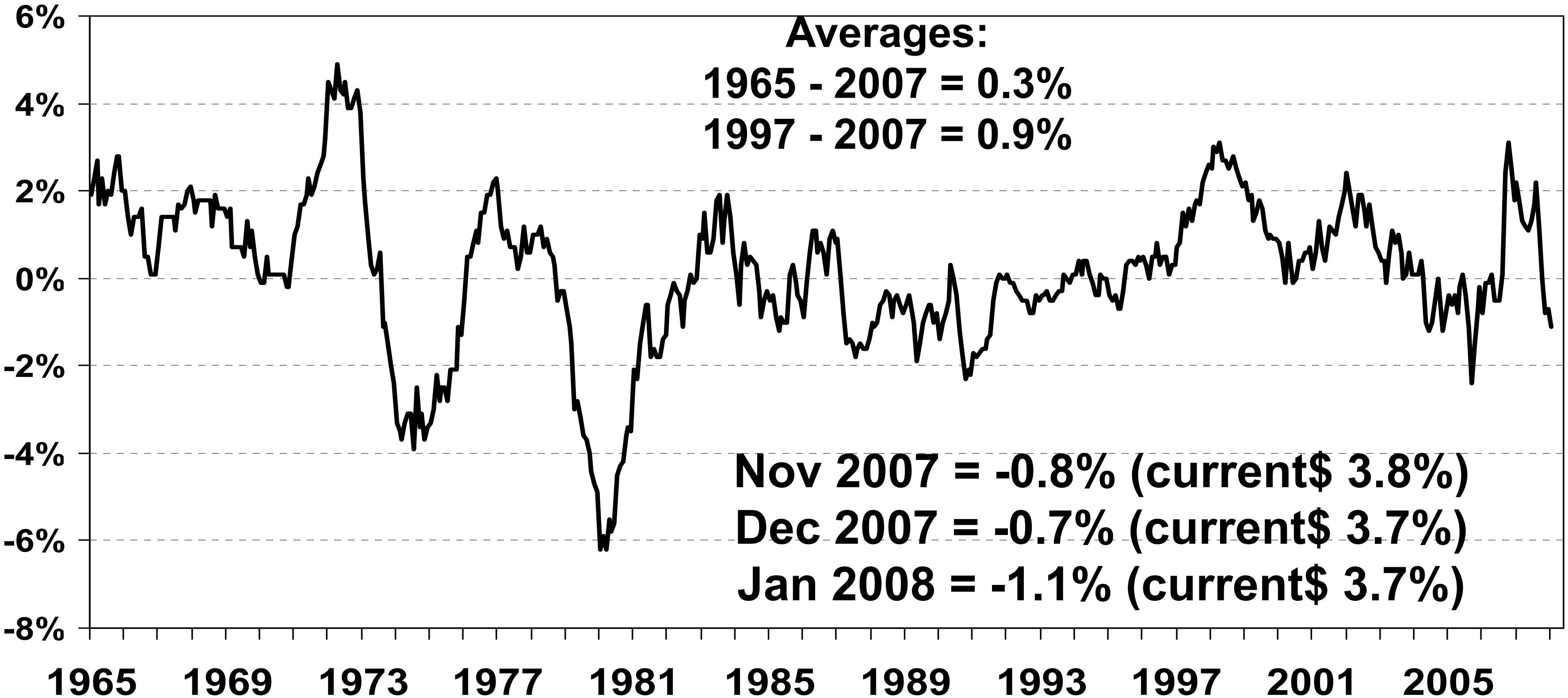
The Tax Rebate: Precautionary Uses Dominate

Consumers were asked in both 2001 and 2007 what they intended to do with their tax rebate: mostly spend it, mostly save it, or repay debt. Just one-in-five consumers reported that they would spend the money in both 2001 and 2008. Consumers were also asked if they intended to save or repay debt if they had any plans to spend the money before the end of 2008: just one-third of all consumers intended to spend the money before the end of 2008. Consumers were also asked if they thought the tax rebate would improve conditions in the overall economy. In response, 60% said that it would not have much impact.

Tax Rebate Will be . . .	**Initial Use**		**Use by end of year**
	2001	2008	2008
Spent	22	20	32
Saved	32	35	28
Repay debt	46	45	40
Total	100%	100%	100%

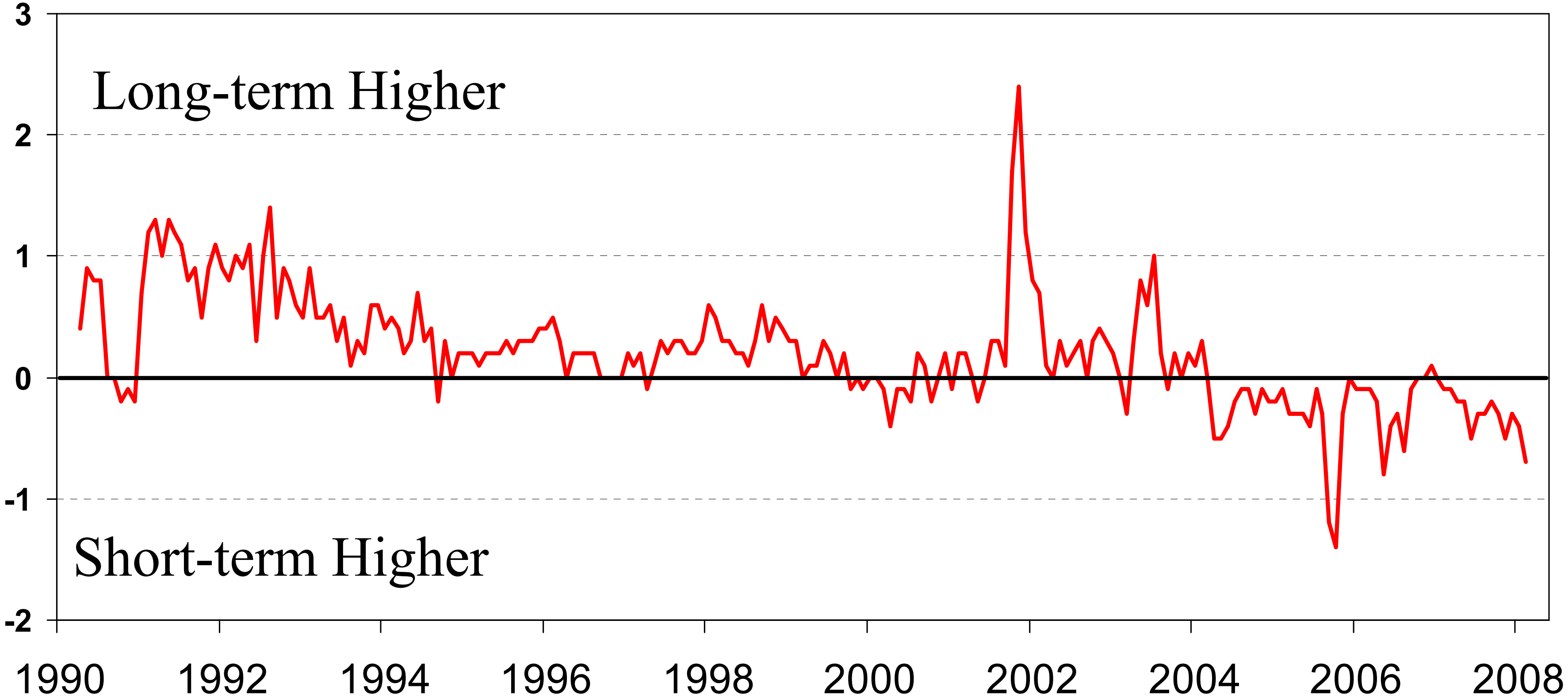
Real Average Hourly Earnings Decline

Real hourly earnings among production and non-supervisory workers declined year-to-year by -1.1% in January Nominal wage gains remained only slightly below last year (4.2% vs 3.7%), but a much higher inflation rate reduced real gains substantially (from 2.2% to -1.1%).



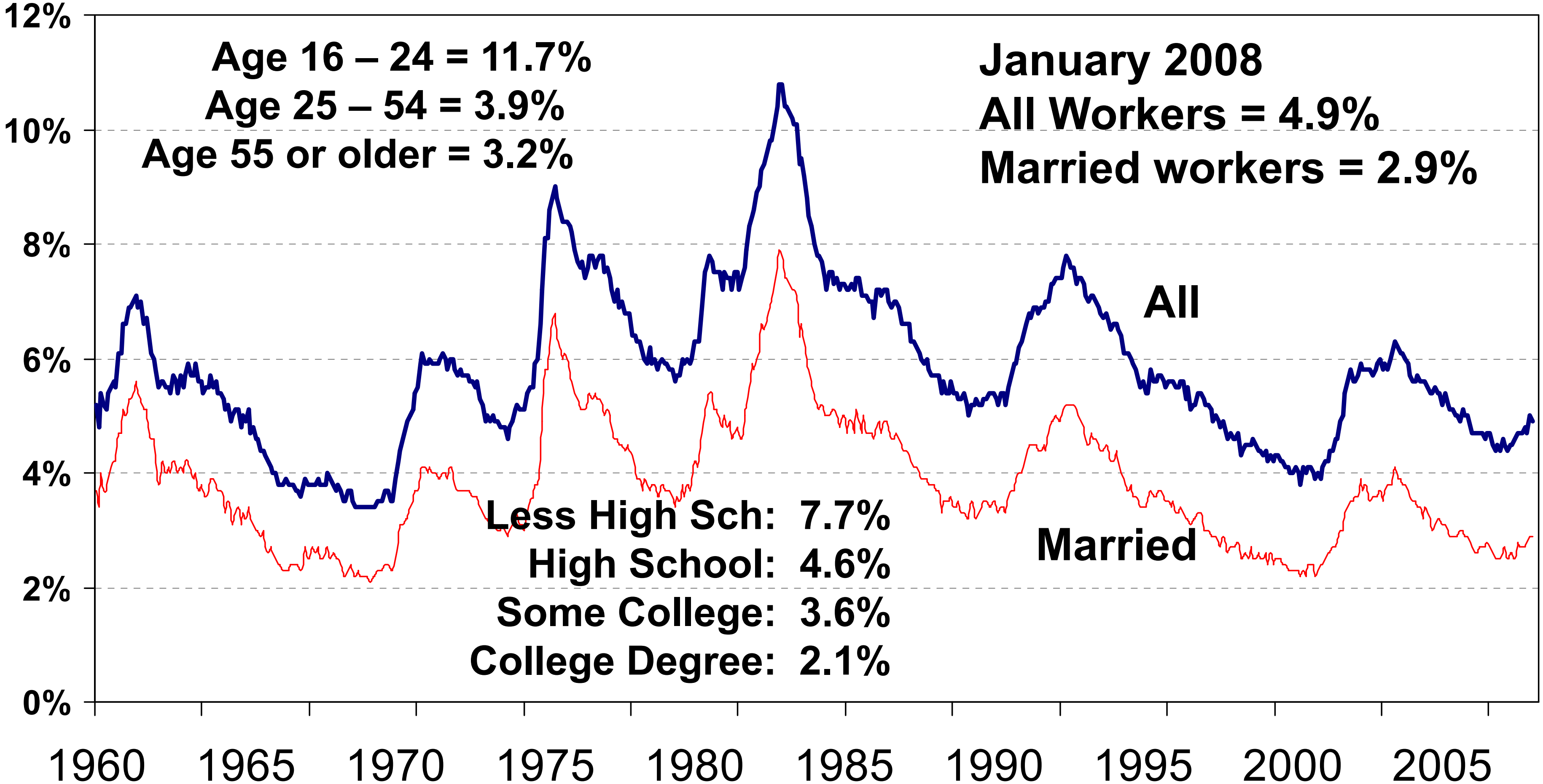
Higher Near-Term Inflation Expected

Consumers expected a year-ahead inflation rate of 3.7% in the February 2008 survey, up from 3.4% in the prior three months. The only good news on the inflation front was that consumers did not expect a higher long term inflation rate, a proxy for core inflation. Indeed, as shown by the chart below, for most of the past four years, short term inflation has been above the expected long term rate, an unusual situation over the past decades. These data suggest that the Fed still has some time before an inflationary psychology overtakes consumers, which would then become difficult to quickly reverse.



National Unemployment Rate

The current unemployment rate is still low by historic standards, only above 4% for the youngest workers, but it is likely to increase throughout 2008 and into 2009 due to persistent below trend growth in the economy.

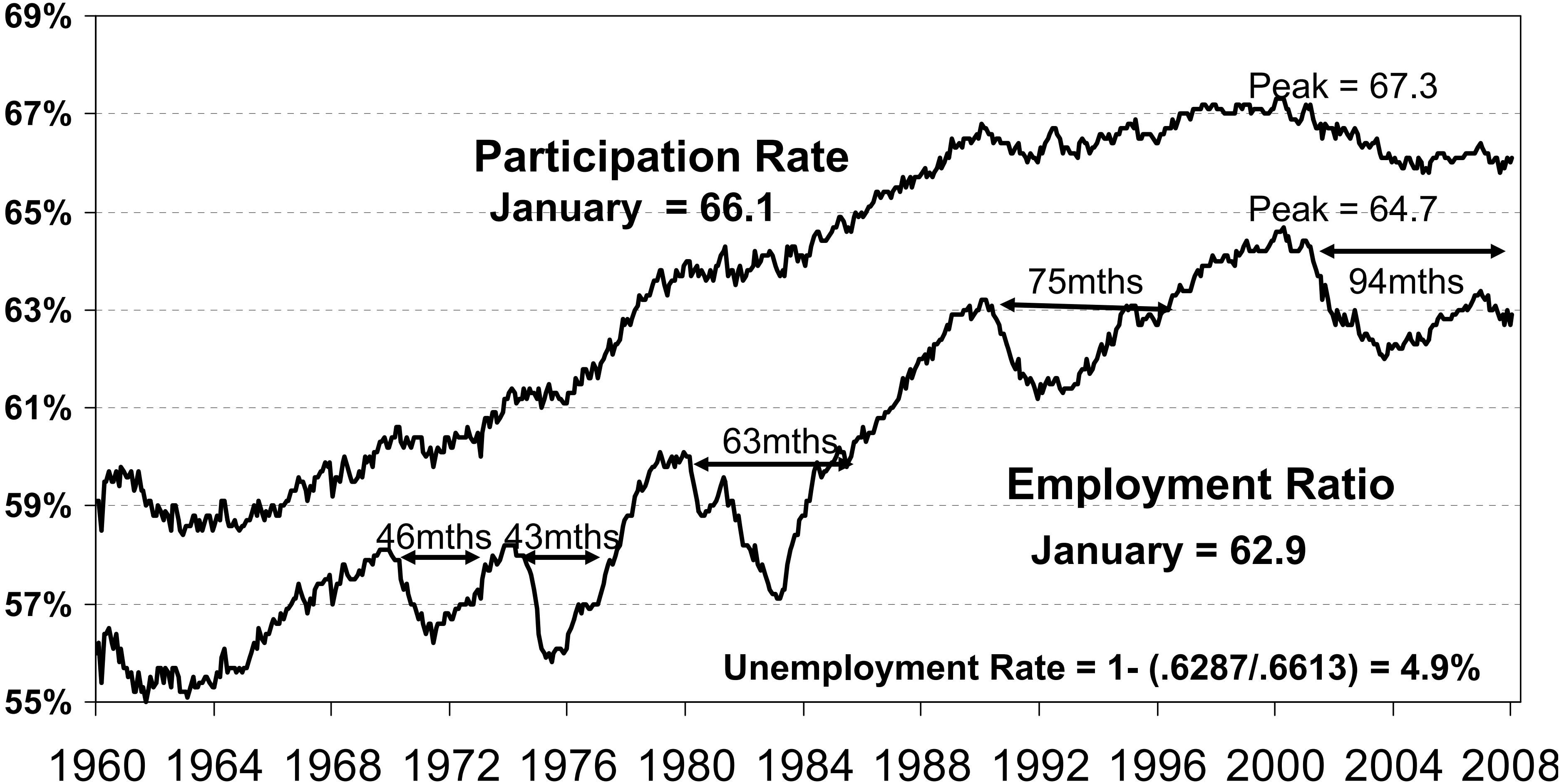


Decade Averages:

1950s = 4.5% *1960s* = 4.8% *1970s* = 6.2% *1980s* = 7.3% *1990s* = 5.8%

Labor Force Participation Rate and Employment Population Ratio

The low unemployment rate in part reflects changes in the labor force participation rate, which has remained well below its prior peak for seven years. While it may well remain below the 2000 peak for year to come as the baby-boom generation begins to retire, the largest drops in participation rates has been among the youngest, with relative gains among the baby-boomers.



References to Income Uncertainty in Decisions to Postpone Purchases

Normal variations in purchases reflect changes in market prices, interest rates, and overall credit conditions. Sustained retrenchment of spending plans critically depend on concerns about future job and income prospects. The chart below shows the proportion of consumers who volunteer their concerns about their future jobs and income prospects in response to questions about their buying plans. These concerns as high as during any prior recession.

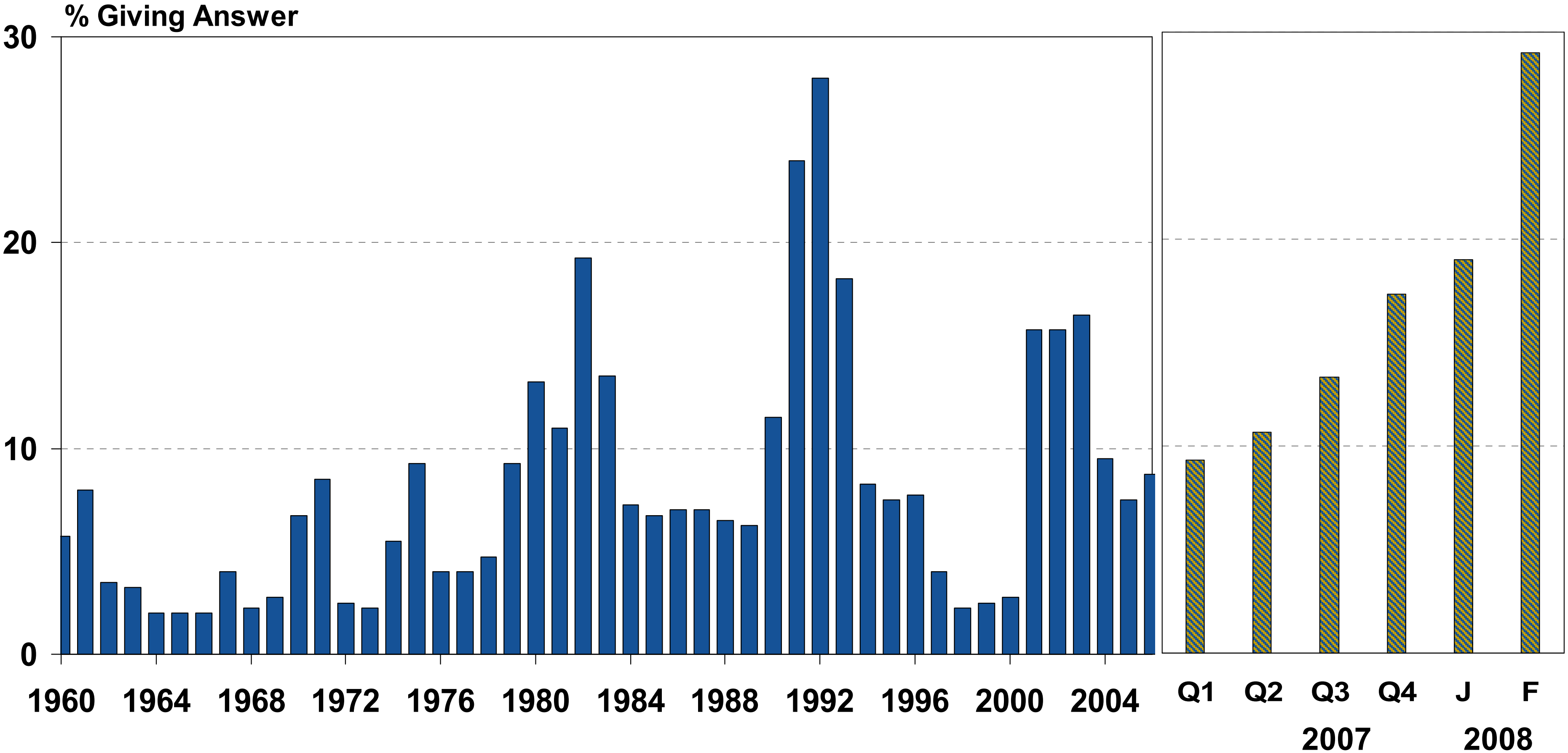
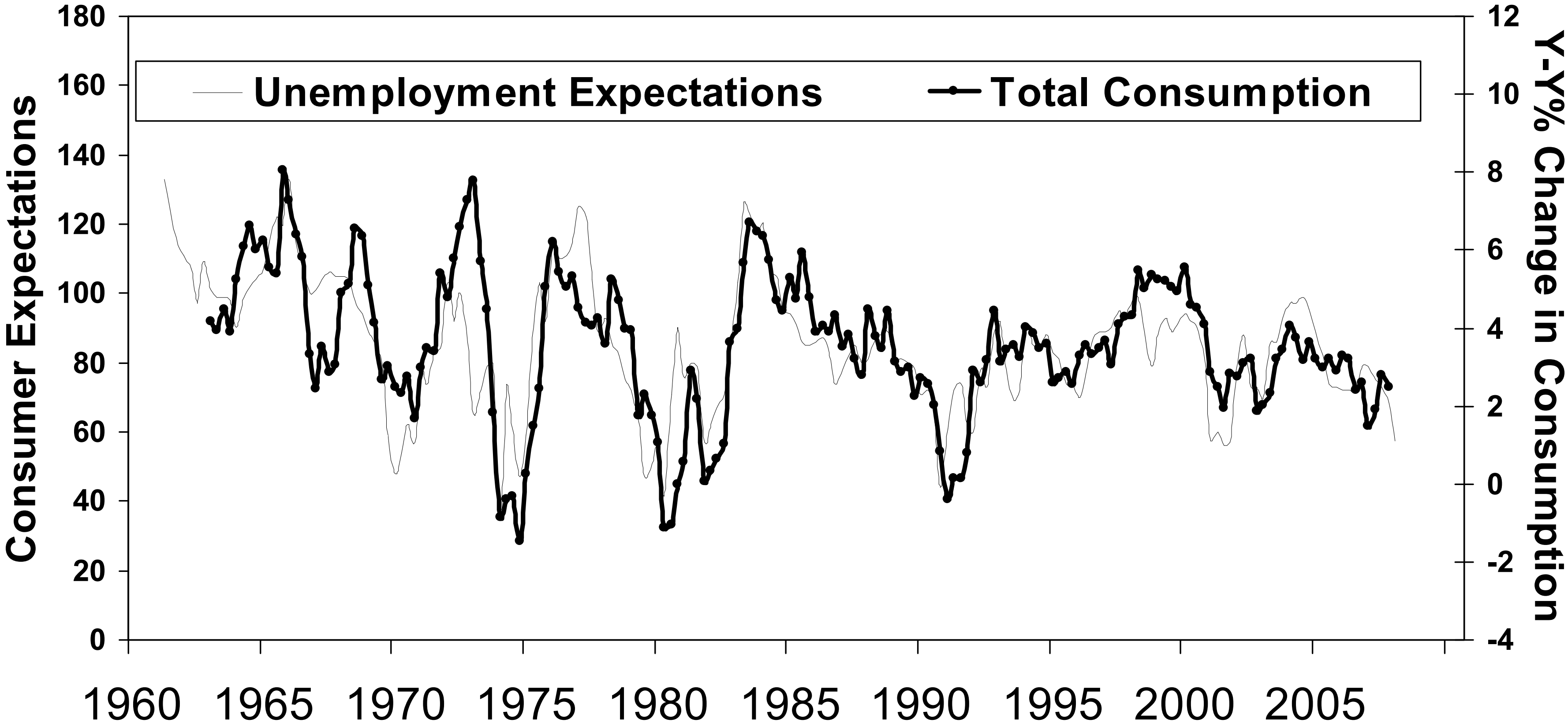


Chart 18: Unemployment Expectations & Growth in Personal Consumption Expenditures

Expected changes in employment and unemployment have a significant impact on total personal consumption spending. Unemployment expectations represent more than just the potential loss of jobs but also represent the prospects of changing jobs or getting larger wage increases. As shown below, these expectations affect spending and are an important element in the forecast for 1½% growth in 2008.



The Main Risks:
A Deeper Decline and a Slower Recovery

- **A longer and deeper recession could develop if:**
  - Increasing impact of higher credit standards on consumer borrowing
  - Continued declines in home values and stock wealth
  - Persistently high energy and food prices
  - Meager or negative employment growth
  - Vulnerability of consumer finances to exogenous shocks

- **A slow recovery from a mild downturn could develop if:**
  - Higher credit standards persist
  - Slowly rising unemployment rate until early 2009
  - High debt and low savings take longer time to re-balance
  - Shifts in tax policy dampens spending of top income subgroups
  - Fed may be as aggressive on inflation upside as on recession downside