

**ECONOMICS:** US PERSPECTIVES—OCTOBER 22, 2010

# The Spending Conundrum: A Tale of Two Consumers

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Although US consumer spending is growing at a modest pace, underlying trends are uneven. Spending on durable goods is very strong, while services remain weak. In our view, this unusual pattern may reflect a growing spending gap among income groups that can only be addressed with a fiscal policy solution.

Consumer spending is still the linchpin for a stronger US economic recovery. But the data are sending mixed signals on the outlook. For example, spending on big-ticket durable goods, which often does well when consumers are upbeat and credit is readily available, has been relatively strong this year (**Display 1**). Yet spending on consumer services has been surprisingly weak, even though this category is typically resilient through business cycle fluctuations.

This apparent contradiction makes it difficult to gauge underlying trends and to explain what is preventing consumers from spending more. In our view, the spending data suggest that two different types of US consumer exist today, and they are driven by distinct motives. Understanding this distinction can help policymakers focus on the most appropriate policies to stimulate a lasting revival in consumer spending.

The most plausible explanation for the divergence between strong spending on durable goods and weak spending on

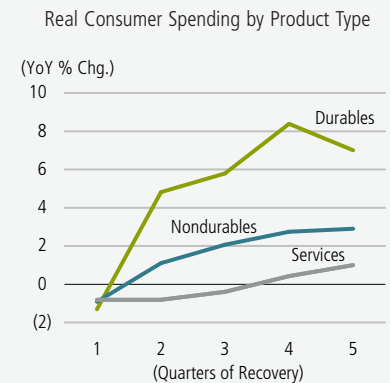
services is to consider the likely behavior of consumers according to income groups. Consumers with higher incomes, who continue to have access to cheap credit and have made more progress in repairing their balance sheets, may have already stepped up spending on big-ticket items.

However, as lower to middle income groups are still struggling with high debt, low liquidity and poor job prospects, they're being forced to cut back on a variety of services. This analysis implies that consumer spending is not being held back by interest rates, and another round of quantitative easing by the Federal Reserve is unlikely to provide the incentive that will convince people to open their wallets.

### Deciphering Spending Patterns

The strength of spending on consumer durables has been the biggest surprise in the recent data. Real consumer spending on durable goods increased at an annual rate of 8.8% in the first quarter and 6.8% in the second quarter. In the third quarter, spending on durable goods probably

Display 1  
Why Is Spending on Durables So Strong?



As of August 2010  
Source: Bureau of Economic Analysis and Haver Analytics

reached between 6.5% and 7.0%, based on our analysis of the retail sales data available through September. This implies a 7.5% gain in the first three quarters of the year—about double our estimate at the beginning of the year.

These numbers are surprising because consumers usually rely on credit to buy expensive products, ranging from cars to technology products. In addition, most people only spend on big-ticket items when they are optimistic about income and job prospects. Yet this year, durable goods spending has risen even though consumers' psychology has been jarred by high unemployment, weak household

balance sheets, tight credit conditions and uncertainty about the outlook.

However, in historical cyclical perspective, the recent growth in consumer spending on durable goods is in line with past recoveries (**Display 2**). The cumulative 8.5% gains since the recovery began in mid-2009 is below the robust spending recoveries of the 1960s, the 1970s and the early 1980s. Yet when compared with the modest rebound in durable goods spending after recessions triggered by the banking crisis and credit-crunch recession in the early 1990s and the equity market crash in 2001, the current bounce back looks remarkably healthy.

### Weak Spending on Services

Other pockets of consumer spending look especially weak. Growth in real consumer spending on services, which is usually fairly stable in both good times and bad, has barely budged during the initial months of the recovery (**Display 3**). Real spending on consumer services rose by just 0.1% annualized in the first quarter, followed by 1.6% in the second quarter. During the third quarter, spending on services is running at about 1.7%, based on data through August, making the current cycle the weakest of the postwar period.

The services data reveal some curious trends. Consumers have greatly reduced real spending on outpatient medical services and spending on dental services has even declined. People are cutting back on discretionary services such as cable and satellite television as well as gaming. They're also spending less on personal care services, and relying less on professional, legal and financial services. When people have less cash flow or are under severe financial stress, they often try to perform tasks on their own and to eliminate or postpone unessential personal services.

In the nondurable goods category, spending is running close to our forecast and is also in line with historical patterns (**Display 4**). Spending on nondurable

goods rose by 4.2% annualized in the first quarter, followed by 1.9% in the second quarter. Preliminary data for the third quarter suggest that spending on nondurable goods will reach about 2.3% in the third quarter. Price discounting has helped prompt volume gains in some categories, such as food and clothing, but the unpredictable pattern of discounting explains why spending gains in this category have been rather volatile.

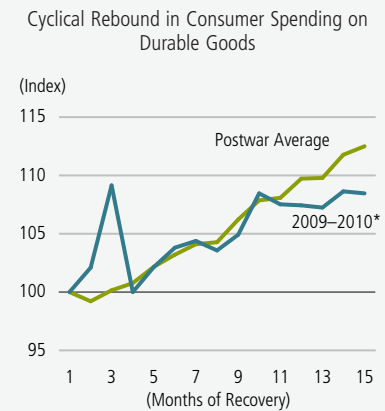
Overall, spending trends in the first three quarters of the year are in line with our forecasts for real consumer spending growth of 2.5% during 2010. After advancing by 1.9% and 2.2% in the first two quarters respectively, we estimate that US consumer spending is on course to post gains of 2.5% in the third quarter. When combined, this adds up to a growth rate of about 2.2% for the first three quarters, in line with our initial estimate.

### Policies to Promote Spending

Still, the divergence in spending categories requires attention. Spending on durables has historically been the segment that leads in the early stages of a recovery. Although quarterly gains of 7% to 8% during 2010 are not the strongest on record, it suggests that monetary policy is working and the lack of access to credit is not the main reason that spending has not picked up at a faster pace.

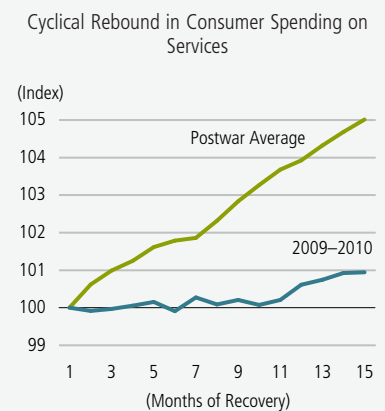
At the same time, lackluster spending on consumer services signals that many distressed households are cutting spending on basic and discretionary services. In our view, fiscal policy is the best way to jump-start this type of spending. The government should focus on extending current tax rates to avoid inflicting heavier taxes on households next year. In addition, a competitive corporate tax structure should be fostered to attract capital and investment into the US and help create jobs. We believe these types of initiatives ultimately will promote a sustainable rebound in consumer spending that will help maintain momentum for the economic recovery. ■

Display 2  
Durable Goods Rebound Is near Average



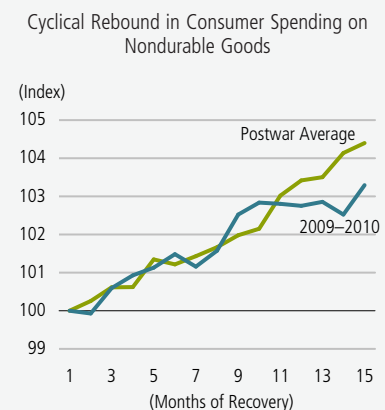
As of August 2010  
\* July 2009 – September 2010  
Source: Bureau of Economic Analysis and Haver Analytics

Display 3  
Spending on Services Is Extremely Weak



As of August 2010  
Source: Bureau of Economic Analysis and Haver Analytics

Display 4  
Modest Rebound in Nondurables



As of August 2010  
Source: Bureau of Economic Analysis and Haver Analytics

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