

CONSUMER EXPECTATIONS

Richard T. Curtin has directed the University of Michigan's consumer sentiment surveys for more than four decades. His analyses of recent trends in consumer expectations are regularly covered in the worldwide press. In this book, Curtin presents a new theory of expectations. Whereas conventional theories presume that consumers play a passive role in the macro economy, simply reacting to current trends in incomes, prices, and interest rates, Curtin proposes a new empirically consistent theory. He argues that expectations are formed by an automatic process that utilizes conscious and nonconscious processes, passion and reason, information from public and private sources, and social networks. Consumers ultimately reach a decision that serves both the micro decision needs of individuals and reflects the common influence of the macro environment. Drawing on empirical observations, Curtin not only demonstrates the importance of consumer sentiment, but how it can also foreshadow the cyclical turning points in the economy.

Richard T. Curtin is Director of the Surveys of Consumers at the University of Michigan, where he has worked for over four decades. His analysis of recent trends in consumer expectations are issued twice monthly and are regularly covered in the worldwide press. Data from the surveys are included in the US Index of Leading Economic Indicators. During his career he has consulted with a number of countries, helping them to establish comparable consumer surveys, as well as a wide range of US and international businesses and financial institutions. He received his BA from Michigan State University and his PhD in economics from the University of Michigan.

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Consumer Expectations

Micro Foundations and Macro Impact

RICHARD T. CURTIN

University of Michigan



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In memory of Eileen Curtin

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Preface

I have always favored the unexpected. Expected outcomes offer no new information. Results that are unexpected challenge orthodox views. While most discrepancies are resolved upon detailed examination, the few that remain have the potential to lead to a new understanding of human behavior. Over the past four decades, I have held a unique position that has allowed me to directly observe how people form and act on their economic expectations as the director of the University of Michigan's consumer sentiment surveys. I initially resisted the startling implications of my observations as they were in inconsistent with accepted theories in economics and psychology. The conventional view was that forming economic expectations required conscious cognitive deliberation of the information released by federal statistical agencies, and that accuracy demanded that reason prevail over passion. Forming expectations required knowledge of past economic developments, correct interpretations of ongoing trends, and the ability and willingness to make detailed calculations. While economists, especially professional forecasters, have demonstrated all of these skills, it was the consensus that most people could not accomplish the tasks of compiling, interpreting, and calculating economic expectations. At best, ordinary people had a very limited ability to form expectations. The bounds on their abilities were thought to be so severe that their economic expectations would amount to little more than uninformed guesses. People's economic expectations were thought to be influenced more by emotion rather than reason, the nemesis of economic rationality. This dismal assessment has been shared among all social sciences, including economics, psychology, political science, and sociology.

The expectations data from the University of Michigan surveys told a surprisingly different story. The data displayed a close correspondence with the trends in the official data series produced by the federal statistical agencies.

Even more challenging, rather than simply reflect the recent past, the expectations data predicted future economic events. How could representative samples of consumers predict future economic events as accurately as professional economic forecasters? The differences in skills, interpretation, and analytic abilities were too vast to justify nearly identical results. Without credible evidence to the contrary, the dominant explanation was that the survey data must somehow represent an illusion. It took me years to finally recognize that rather than an anomaly, it was the fundamental scientific theories of how expectations were formed that were incorrectly specified. After carefully listening to how respondents described their expectations as well as how they described their reasoning, I became convinced that the current economic and psychological theories of expectations did not capture how people used their full mental faculties to form expectations. Rather than a complex and difficult process, expectations seemed to be easily and automatically formed by the least educated as well as the most educated, by the youngest and the oldest, and by the richest and the poorest. People did not need advice about how to form economic expectations, or for any other expectations that they regularly formed. Expectations were formed naturally and automatically.

Evolutionary development has provided people with an efficient means to form expectations by fully utilizing their conscious and nonconscious cognitive abilities, their emotional resources, and by social interactions. This enhanced perspective enabled a new framework for understanding the expectations voiced by survey respondents. Accuracy is still the predominant goal in this new paradigm and the driving force of the formation process. The goal of the formation process, however, shifted from national data to the economic conditions that people actually face in their daily lives. This personalization of expectations is consistent with conventional economic theory, but it is implicitly denied in nearly all empirical research. Perhaps the most surprising finding of this revised definition of expectations is not that it enabled people to anticipate the conditions that they actually faced, but that it enabled them to anticipate how those factors changed over time in the economy as a whole. This meant that even though expectations were personalized, when aggregated across the entire population, those expectations still consistently tracked national trends. Consumer expectations thus reflected both micro considerations as well as macro realities.

More importantly, the personalization of expectations forced consideration of new tenets of rationality. The emphasis shifted from an exclusive focus on national data to include a heavy dose of local economic

conditions tailored to the specific characteristics of the individual. Rather than focusing on a single source of “official” information, people had to gather information from numerous, and at times conflicting, sources. Evolutionary development has provided humans the means to effectively and efficiently expand their capacity for cognition and learning well beyond the limits of conscious deliberation. Indeed, the capacity for processing information nonconsciously dwarfs the capacity of the conscious mind. There are few activities that people accomplish without the assistance of nonconscious cognition and learning, including forming and revising personalized expectations. The paradigm that emerged provided a distinctive explanation of why, how, and when economic expectations are formed.

Another major divergence from orthodox economic theory that has emerged from my research is consistent with the Aristotelian notion of holism. This principle implies that the macroeconomy cannot be fully explained solely based on its micro components. This goes against the dominant economic view that the macroeconomy is simply a sum of its micro components, the so-called micro foundations of macroeconomics. In contrast, holism implies that the macroeconomy partly determines the actions of its micro components. The focus of the University of Michigan’s sentiment surveys is the prediction of macroeconomic trends, especially those surrounding economic cycles. Empirical tests center on the correspondence between the sample estimates of the changes in consumer expectations and trends in the macroeconomy. The predictive success of these tests has meant that consumer sentiment surveys are now measured in more than six dozen countries in every inhabited continent in the world. Moreover, the new paradigm also provides a scientific foundation for self-fulfilling expectations as well as the occasional penchant for irrational exuberance and irrational fears that can produce booms and busts.

I owe a great debt to George Katona, my mentor, friend, and colleague, who started these surveys at the University of Michigan in 1946. The ideas and theories in this book represent an extension of his work, although they were never advanced by Katona. Importantly, the scientific infrastructure needed to accomplish this research was developed by Katona, Rensis Likert, Leslie Kish, Charles Cannell, James Morgan, and others at the Survey Research Center. These path-breaking developments included probability methods to select nationally representative samples, robust interviewing and coding methodologies, computerized data management and statistical analysis programs. While all these elements are now commonplace, they were revolutionary innovations in the 1940s.

Successfully completing monthly surveys that provide a consistent series of measurements over many decades is an enormous task. This accomplishment has been due to very many people at the Survey Research Center at the University of Michigan. I have benefitted from the efforts of over one thousand people over the past four decades, ranging from senior researchers and administrators to interviewers and research assistants. Most assume that the repetitive nature of the surveys would mean that it was a routine task that once learned, could be easily repeated. In contrast, nearly every month presented new challenges to complete the survey within the fixed deadlines. Moreover, maintaining data quality has been a constant challenge given that the survey research program has extended over the past three-quarters of a century, and has witnessed dramatic changes in the economy as well as changes in the finances, size, composition, and demographic characteristics of households.

Patricia Maher and Ann Munster deserve special recognition for their tireless efforts in maintaining the survey's scientific methodology and high data quality over the past three decades. My current research staff is led by Zeynep Tuba Suzer-Gurtekin, along with Edward Ellcey, Vivian Burgett, and Jim Zajkowski. My research has also benefitted over the years from a large contingent of student research assistants.

The most help in advancing my research was provided by the hundreds of thousands of survey respondents who shared their insights about their economic situation. The generosity of these respondents infused my research with economic substance unattainable from any other source of economic data available to me. Indeed, the success of this research would have been impossible without their willingness to share their knowledge as well as their economic hopes and fears. Their reasoning was equally as important as their passions.

Funding for this research was provided by many corporations, financial institutions, and government agencies over the long life of the project. I had to devote much of my time to securing the necessary funds to finance this research over the past four decades. Currently, Bloomberg L.P. is the major source of financial support. The Federal Reserve Board has provided support over the entire history of the project. The intense domestic and international interest in the data is dominated by its forecasting ability. Even at the University of Michigan, interest in the project has been narrowly defined by its predictive performance, especially how its forecasts compare with other surveys or predictions based on econometric models. As a consequence, my time has been heavily dominated by these comparative concerns to secure adequate

funding to continue the project for another year. No month was complete without my writing at least a mid-month and a final report on the latest movements in consumers' expectations and their implications for the national economy. Naturally, each report generated a barrage of questions and requests for data and advice from a broad spectrum of interested parties. Although assessing the predictive performance of the sentiment data is easily accomplished, these statistical tests left the basic conundrum unanswered: how can ordinary people form expectations that accurately forecast macroeconomic trends. It is this more fundamental question that this book addresses.

While interdisciplinary research is common at the University of Michigan, this research will challenge many social scientists as it emphasizes the importance of nonconscious cognitive processes, the critical role of emotions and social influences, as well as the principle that accuracy is the dominant motivation for forming and revising expectations. The interdisciplinary theory contained in this book is perfectly generalizable to a host of other expectations people form about their political and social environment. Forming expectations has benefitted from an evolutionary process that efficiently utilizes all aspects of people's mental faculties. The evolutionary goal of expectations is to maximize the potential of the most limited resource of the human mind, conscious cognitive deliberation. For this survey project to thrive in the twenty-first century, it is necessary to develop new measurement techniques that cover the full range of people's mental faculties.

All the University of Michigan survey data used in this book, including cross-section and time-series data, question wording and sample design, are available on the project's website: umich.edu/~umsurvey. The European data can be accessed by their website: ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/business-and-consumer-surveys. Special thanks go to the University of Michigan Press, OECD, and Routledge for permission to reprint small portions of my prior publications.

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