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CHAPTER 28 Planning a Budget

U.S.: Why Higher Rates Aren't Denting Consumers' Spirits

As long as job markets are tight, households will keep right on spending

by James C. Cooper & Kathleen Madigan

You would think that consumers might have become more wary of financial conditions by now. After all, the Dow Jones industrial average is off 8% this year, and the tech-oriented Nasdaq has plunged by nearly a third since mid-March. Moreover, mortgage rates have risen by a full point in the past six months. But so far, consumers have just shrugged, as if to say ''So what?''

With consumer confidence through May as high as ever (chart), it's clear that the labor markets are the major force shaping overall household attitudes and buying behavior. Nearly half of all households may own stock, but upbeat job-market conditions cut across a much broader swath of consumers. When jobs are as plentiful as they are now, and when employers are willing to bid up wages to get the skills they need, stock market volatility and a higher cost of borrowing, while still key influences, are less important.

To be sure, the second-quarter numbers on household spending won't match the booming 5.8% average growth rate over the past year. However, after the first quarter's 7.5% surge, when outlays were boosted by one-time factors such as mild weather and incentive-driven car sales, a second-quarter slowdown to a rate below the yearly trend will not be a surprise.

The key question in the outlook for the economy—and Federal Reserve policy—is this: Does the second-quarter slowdown in consumer spending portend a lasting slowdown in overall demand? So far, the answer appears to be no. Consumer fundamentals have eroded very little; and those of the labor markets, not at all. Moreover, the April drop in durable goods orders notwithstanding, business investment is also well supported by strong profits in the first quarter and by unexpectedly strong growth in demand.

THE FED'S MAIN CHALLENGE will be to rein in household spending in a lasting way, since consumers have accounted for the lion's share of growth during the past year. As the confidence data suggest, that will be very difficult to do without some loosening in overall labor-market conditions.

Despite interest-rate hikes totaling 175 basis points since last June, consumers in May said they were very optimistic about both their present situations and the future. The Conference Board's index of consumer confidence rose to 144.4 in May, from 137.7. The May reading was only slightly below the record high of 144.7 hit in January. ''Volatile financial markets and higher interest rates are not expected to have a significant impact on consumers' spirits,'' said the Conference Board's Lynn Franco.

Based on the survey, consumers expect to see improved business conditions, more jobs, and better income prospects in the next six months. Also, 52.8% of households surveyed said jobs were ''plentiful,'' up from the April reading, while only 11.4% described jobs as ''hard to get,'' down from April. That's not surprising, given that in April a record 64.9% of the working-age population had jobs.

Feeling extremely confident, consumers began their second-quarter spending on a solid note, as inflation-adjusted outlays for goods and services in April rose 0.3%. If that pace is maintained in May and June, spending for the quarter will rise at a 3.8% annual rate from the first-quarter level. That pace would be slower, but only in comparison with recent quarters, and the four-quarter growth rate would still be a very strong 5.5%.

ONE EARLY SIGN that consumer spending may cool off beyond the second quarter is the slowdown in household buying power (chart). In the three months ended in April, aftertax income grew 5.9% from a year ago, slightly faster than the 5.6% pace this time last year. But after adjusting for the energy-led pickup in inflation, real income growth has slowed, to 3.1% from 4.1%. Unless income growth speeds up again, household budgets now are capable of supporting one percentage point less of spending gains.

The resulting gap between income and spending growth has taken the household saving rate down to a record low three-month average of 0.5%. Given past wealth gains from both stock prices and home values, along with abundant job opportunities, consumers see no immediate need to build that nest egg back up anytime soon. But if conditions in the stock market, housing sector, or the labor markets change for the worse, look for households to start devoting more of their income to saving and less to spending.

A KEY SECTOR TO WATCH for signs that consumers are easing up will be housing. Although home sales this year may not match 1999's record pace, they're not likely to slow precipitously, either. Sales of both existing and new homes remain at high levels, and through mid-May, so did mortgage applications to buy a home (chart).

In fact, one reason for the steep 6.2% drop in April resales, to an annual rate of 4.88 million, may be a lack of supply, not demand. In January, the inventory of existing homes for sale plunged below 1 million for the first time on record. By April, the number had climbed only to 1.57 million. In contrast, the inventory of unsold homes averaged 2 million for all of 1999.

With few older homes available, consumers are snapping up new homes, which sold at a 909,000 annual rate in April. That's down 5.8% from March, but March sales were the second highest on record. The question for the Fed is how far must mortgage rates rise before the higher cost of borrowing outweighs the positive impact of increasing job security. Until those scales shift, housing will continue to do well.

Consumer demand is also a key fuel for the factory sector. True, durable goods orders fell 6.4% in April, reflecting a 20.1% plunge in bookings for electrical machinery. But data on orders for consumer hardgoods, available through March, show a continued uptrend. In the first quarter, they grew at an annual rate of 14.5%, after a 12.6% advance in the fourth quarter.

Even so, the record falloff in electrical equipment, mostly electronic components, was striking. Part of the reason, however, is a shortage of parts that is preventing manufacturers from filling existing orders. Plus, orders are extremely volatile. The April drop followed two large gains in February and March. Note that shipments of electrical machinery were virtually flat in April at a very high level.

Given the rebound in export demand plus the healthy fundamentals in the U.S., the factory sector does not look to be at risk. That could change, of course, if consumers start to lose confidence in their economic futures. But with households' sense of well-being depending largely on the health of the labor markets, consumers so far have every reason to keep the faith—and to keep on spending.