THE UNIVERSITY OF MELBOURNE

MELBOURNE INSTITUTE
APPLIED ECONOMIC & SOCIAL RESEARCH

Research Insights

Does reason trump emotion in consumers' economic forecasts?

Reasoning is a powerful tool in decision making, but a study based on a longstanding survey of consumer sentiment shows that emotion and perception have equally influential effects on consumers' outlook for the Australian economy.

ISSN: 2653-004X

No. 02/19

October 2019

Do emotions matter in consumers' economic outlook?

Consumer surveys have been widely used by policymakers and practitioners to monitor economic activity in the consumer sector, due to their informativeness and timeliness. These surveys canvas a broad range of questions relating to consumers' family-specific information, such as, current and future family financial conditions, as well as general information, such as, expected future economic conditions, jobs prospects, inflation and house prices, etc.

Recent research has used consumer surveys to better our understanding of consumer behaviours—especially whether they form expectations as suggested by economic theories, and if these expectations translate into actual outcomes. These are particularly important issues because consumers supply labour, consume goods and services, save and borrow, and invest savings. Therefore, consumers' expectations (forecasts) and subsequent behaviours play a significant role in understanding aggregate economic activity.

The results from recent studies, however, indicate that how consumers form expectations and their behaviours are probably more complex than economists suggest. For example, in June 2019 the Reserve Bank of Australia (RBA) cut the target cash rate (the Australian policy interest rate) for the first time in nearly three years—amid subdued inflation pressures, slow wage growth and spare capacity in the economy—with the aim of boosting future economic activity. The Consumer Attitudes, Sentiments and Expectations (CASiE) survey, the Australian Survey of Consumers, was carried out during the week that the rate cut occurred, with nearly half of the respondents surveyed before the cut and the remaining surveyed after. Comparing the responses of these two sets of consumers sheds light on their reaction to the rate cut.

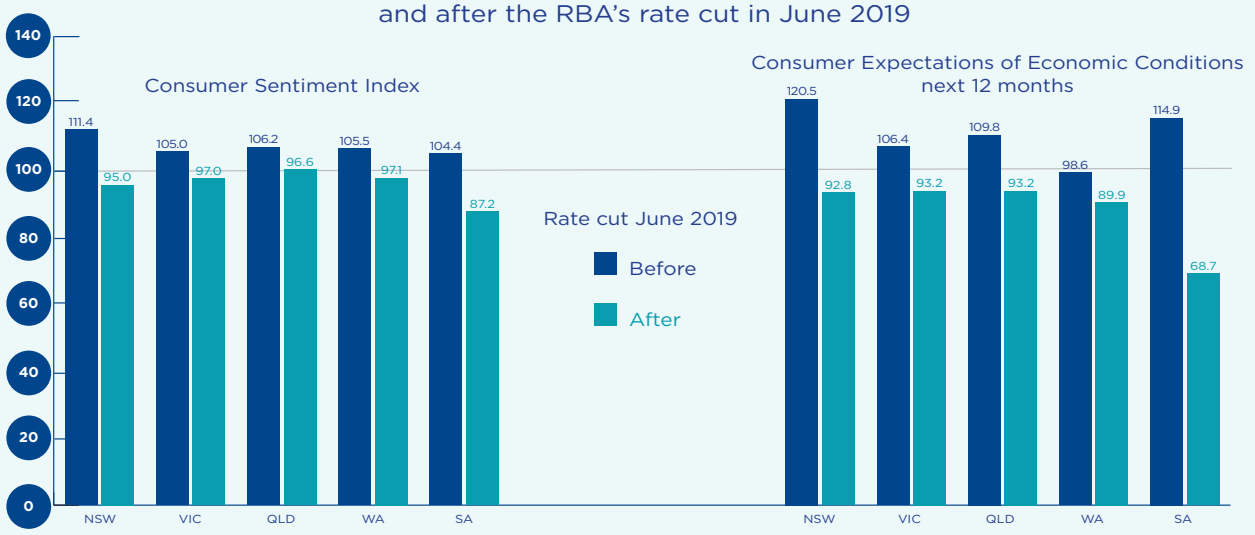
Surprisingly, Australian consumer sentiment dropped markedly after the rate cut with their expectations of economic conditions in the next 12 months worsening substantially (Figure 1). So, why does a favourable policy announcement, in the midst of weak economic activity unnerve consumers?

Among recent prominent studies on consumer expectations, Drager, Lamla and Pfajfar (2016) use the US University of Michigan Survey and show that less than 50% of the US consumers form expectations consistent with each of three key economic concepts: the Income Fisher Equation, the Taylor rule and the Phillips curve. They find that, on average, only 6% of consumers form expectations consistent with all three concepts in a given period. Adding to this puzzling result, only 31% of economists form expectations consistent with all three concepts. These findings raise the question of what factors, other than economic ones, influence consumer expectations?

To address this question, we use the monthly Westpac-Melbourne Institute Survey of Australian Consumers to study the influence of relevant economic news and emotive events, on how consumers form expectations. The political science literature proposes that voting choice impacts views on the economy[1]. Borrowing from the political science and social psychology literature we measure consumers' expectations in response to emotive events, in this case we refer to federal elections that resulted in a change of government. The presence of a 'partisan screen' or partisan bias, means that voters view the economy more favourably if they support the incumbent government, and have a less favourable view if they are averse to the incumbent—irrespective of real economic activity (Figure 2).

Our research (Claus and Nguyen, 2018) provides three key insights into how consumers form economic expectations based on economic information and emotive responses.

Figure 1: Consumer sentiment and expectations before and after the RBA's rate cut in June 2019



Key Insights

1 Who governs matters in consumers' outlook

Investigating how consumers form expectations, subject to available economic news and election outcomes, helps us understand and measure the influence of the two factors: economic vs emotive. Our finding indicates that consumers form expectations by logically evaluating economic information (reasoning), as well as by reacting to the party in power (emotion). A change in government lowers inflation and unemployment expectations and raises the economic outlook of respondents who support the incoming government, other things equal. For respondents who support the outgoing government, the change in incumbent raises inflation and unemployment expectations and lowers the economic outlook. The effect of partisan bias persists until the government changes again.

2 Consumers subjective perception and emotion matter in inflation expectations

Our research indicates that there are two sides of consumers' inflation expectations: one appears to be influenced by reasoning and economic theory while the other by perception and emotion.

One the one hand, how consumers form inflation expectations in response to economic news appears to be consistent with the Phillips curve, in which high (low) unemployment is associated with low (high) inflation. This means that news about low rates of actual unemployment has an inverse effect on consumers' inflation expectation.

On the other hand, consumers appear to perceive high inflation as 'bad' and low inflation as 'good.' This perception together with their partisan bias leads to the formation of inflation expectation that is inconsistent with the Phillips curve. Specifically, subject to the outcomes of emotive events (i.e. elections that resulted in changes in the government), voters of the winning party expect lower inflation and lower unemployment, while voters of the losing party expect the opposite.

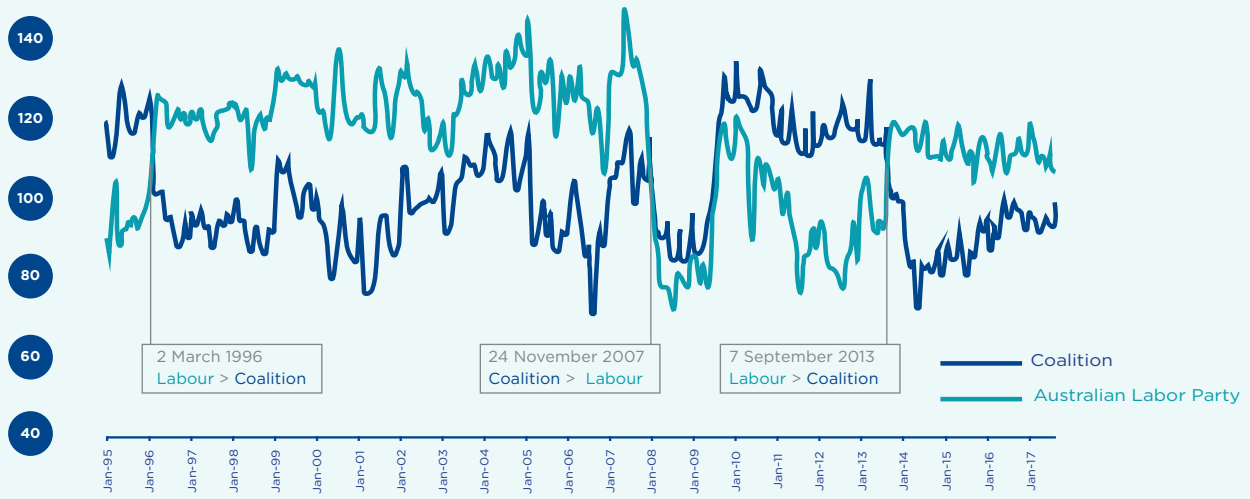
Inflation expectation is a key input in Central Banks' interest rate policy formulation, and neither emotion nor perception is one of its determinants from an economic theory perspective. The influence of perception and emotion indicates that how consumers form inflation expectation is probably more complex than economists currently assume.

3 Central Bank's policy changes as signals of future activity

Surprisingly, when there is a decline in the Central Bank's policy rate, consumers' expectation of inflation falls. This is contrary to economic theory whereby a decline in the RBA's policy rate should put upward pressure on inflation expectations. Our research suggests that a rise in the policy rate appears to be interpreted by consumers as a signal that the Central Bank expects robust growth, rising inflationary pressures, and lower unemployment. In contrast, a decline in the policy rate is regarded by consumers as a signal of moderating growth and inflation, and higher unemployment. Hence, when consumers update their expectations in response to these signals, their expectations appear to be contradictory to economic theory (see García-Schmidt, 2015).

1. See for example Evans and Andersen (2006) and Gerber and Huber (2009) for empirical applications.

Figure 2: Consumer sentiment of Coalition and Australian Labor Party voters



Does emotional bias matter?

Consumers are typically the largest group of agents in a developed market economy so understanding their behavior is paramount to developing reasonable models of the macroeconomy and policy prescriptions. Our research indicates that reasoning and emotions are both important determinants for how consumers form expectations. In particular, events that should not affect consumer economic expectations from an economic theory perspective, do indeed persistently impact their expectations.

A key question is whether emotional bias matters. From a macroeconomic perspective, if about half of the population supports one side of the political spectrum and the other half of the population supports the opposition, the overly optimistic views of the incumbent government supporters would be offset by the strongly pessimistic views of opposition supporters. This means that the effect of the partisan bias on the aggregate economic activity is perhaps negligible.

However, the real economic implications of the partisan bias would only be negligible if voters are alike in every other way (such as financial wealth, income, education and risk preferences etc.) except political persuasion. If the two groups of voters, i.e. those who support the incumbent government and those who don't, have different marginal propensities to consume, invest or save, there would be real political business cycle effects that are independent of the actual economic policies pursued by the different governments.

Research Insights produced by the Melbourne Institute provide a clear and practical understanding of contemporary economic and social issues in Australia.

Supported by high-quality academic analysis, each Research Insight aims to make sense of complex issues to enable evidence-based decision making for policy and practice.

melbourneinstitute.unimelb.edu.au

Authors

Viet Nguyen
Melbourne Institute: Applied Economic & Social Research, University of Melbourne

Edda Claus
Wilfrid Laurier University

Further Information

Data:
The Consumer Attitudes, Sentiments and Expectations in Australia Survey, known as CASiE, is a monthly survey of 1200 Australian households across the nation. The survey is stratified by age, gender and location so it is representative of the Australian population. CASiE provides valuable and timely signals about consumer perceptions of the state of the economy. For more information, please visit https://melbourneinstitute.unimelb.edu.au/casie

Glossary:
The Taylor rule is a reduced form approximation of the responsiveness of the nominal interest rate, as set by the central bank, to changes in inflation, output, or other economic conditions.

The Phillips curve denotes the inverse relationship between inflation and unemployment.

The Income Fisher Equation denotes the expected nominal income as the approximate sum of expected real income and expected inflation.

References:
Claus, E. and Nguyen, V.H., (2018) Consumptor economicus: How do consumers form expectations on economic variables? Journal of Economic Behavioural and Organization, 152, pp 254-275.

Dräger, L., Lamla, M.J., and Pfajfar, D., (2016) Are survey expectations theory-consistent? The role of central bank communication and news. European Economic Review, 85, pp 84-111.

Evans, G. and Andersen, R. (2006), `The political conditioning of economic perceptions', The Journal of Politics, 68, pp. 194-207.

García-Schmidt, M., (2015) Monetary Policy Surprises and Expectations. Mimeo.

Gerber, A. S. and Huber, G. (2009), `Partisanship and economic behavior: Do partisan differences in economic forecasts predict real economic behavior?', The American Political Science Review 103(3), pp. 407-426.

Further reading:
Claus, E. and Nguyen, V.H., (2018) Consumptor economicus: How do consumers form expectations on economic variables? Journal of Economic Behavioural and Organization, 152, pp 254-275.
www.sciencedirect.com/science/article/pii/S0167268118301252

Melbourne Institute Bulletin of Economic Trends: Economic Activity in the Major States - July 2019

https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0004/3125470/STATE_MBET_July2019.pdf