Chapter 1

Does Consumers’ Confidence Cause Consumption Spending? An Analysis of Selected Countries under the Purview of Global Financial Crisis

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ABSTRACT

The present chapter addresses the financial crisis issue in light of its effect upon the interplay between the consumers’ confidence upon an economy and consumption spending of the households of the same economy. A simple correlation analysis for the quarterly data from January 1996 to October 2012 shows that the occurrence of the crisis has badly affected the consumers’ confidence and consumption spending of the developed countries. Emerging countries have performed well despite the crisis. Also that majority of the developed countries with a few developing ones produce the result of bidirectional causalities whereas in leading emerging countries, consumption spending is making a change in confidence in a ‘causal’ sense for the entire period of study. During pre-crisis phase the result show that the leading developed countries experience unidirectional causal relation from consumption to confidence. But in the post crisis phase seven out of twenty countries produce a line of causation going from consumption to confidence and nine countries fail to show any line of causation.

INTRODUCTION

The lessons from the recent crisis in the so called developed economies, known as Global Financial Crisis (GFC) and its aftermath upon the rest of the world have compelled the economists, policy makers and governments of different countries to redefine the concept of long run growth states of an economy. Under the framework of dynamic global system, the workings of new economic variables besides the traditional ones have proved their existence. The new factors that need to be
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incorporated as crucial elements in analyzing the developmental status of the world economies in the post globalization scenario are, among others, the maintenance of good confidence levels of the active economic agents like that of consumers and business houses as well as management of good and proper governance. Hence it deserves to reorient the working of the interlinkages among the new variables that can explain a possible part of such a crisis.

The current mortgage meltdown actually began with the bursting of the U.S. housing “bubble” that began in 2001 and reached its peak in 2005. The housing bubble is defined by rapid increases in the valuations of real property until unsustainable levels are reached in relation to incomes and other indicators of affordability. Following the rapid increases are decreases in home prices and mortgage debt that is higher than the value of the property. Many economists believe that the U.S. housing bubble was caused in part by historically low interest rates (Shiller, 2008; Allen & Carletti, 2009; Carmassi, Gros, & Micossi, 2009; Schneider & Kirchgassner, 2009). After the meltdown in the financial institutions and takeover of larger banks by governments, there became a deficit of credit, which led to local business and international trade. International trade declined by 12 per cent in 2009 and world’s GDP dropped by 5.4 per cent in the same period (Chor & Manova, 2010). In response to the crash of the dot-com bubble in 2000 and the subsequent recession that began in 2001, the Federal Reserve Board cut short-term interest rates from about 6.5 per cent to 1 per cent. Between 2004 and 2006, the Federal Reserve Board raised interest rates 17 times, increasing them from 1 percent to 5.25 per cent. The Fed stopped raising rates because of fears that an accelerating downturn in the housing market could undermine the overall economy. Subprime borrowing was a major factor in the increase in home ownership rates and the demand for housing during the bubble years. The U.S. ownership rate increased from 64 per cent in 1994 to an all-time high peak of 69.2 percent in 2004. The demand helped fuel the rise of housing prices and consumer spending, creating an unheard of increase in home values of 124 per cent between 1997 and 2006. Some homeowners took advantage of the increased property values of their home to refinance their homes with lower interest rates and take out second mortgages against the added value to use for consumer spending. In turn, U.S. household debt as a percentage of income rose to 130 per cent in 2007, 30 per cent higher than the average amount earlier in the decade. With the collapse of the housing bubble came high default rates on subprime lending. The share of subprime mortgages to total originations increased from 9 percent in 1996 to 20 per cent in 2006. Subprime mortgages totaled $600 billion in 2006, accounting for approximately one-fifth of the U.S. home loan market. The number of subprime loans rose as rising real estate values led to lenders taking more risks. Some experts believe that Wall Street encouraged this type of behavior by bundling the loans into securities that were sold to pension funds and other institutional investors seeking higher returns.

A Federal Reserve study in 2007 reported that the average difference in mortgage interest rates between subprime and prime mortgages declined from 2.8 percentage points in 2001 to 1.3 percentage points in 2007. This implies that the risk premium required by the financial institutions to offer a subprime loan declined. This decline occurred even though subprime borrower and loan characteristics declined overall during the 2001-2006 period, which should have had the opposite effect.

The impact of such crises travelled throughout the world like an epidemic via trade and service channels. The shares of exports, imports and total trade volumes of USA, France, UK, Germany, Greece, Japan, South Africa, Brazil, etc in world trade have fallen during the phase of 2009-10. There was a remarkable decline in the world trade share of the European Union from 40 per cent in 2008 to 36 per cent in 2010. The same story also