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Chapter 12 Gross Domestic Product

This article from the November 2001 *Wall Street Journal Classroom Edition* examines how changes in consumer spending influence gross domestic product. In "The Psychology of Spending," *Wall Street Journal* Staff Reporter Cynthia Crossen shows how recessions affect consumer behavior and the role of scarcity in the choices we make about our everyday lives. At the time Crossen was writing, the United States economy had ended a long boom and appeared to be entering a recession.

Before reading the article below, you may want to look up the following terms: *albeit, attest, consumer spending, deprivation, disposable income, exuberance, gross domestic product, niche, recession, reverberations, salves, unprecedented, unscathed,* and *wild cards.*

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Say a recession was coming. Would consumers change their spending habits the way they did in previous recessions? Or does a New Economy give rise to a New Recession?

It has been 10 years since America's last serious economic decline, almost ancient history in today's fast-changing world. A decade ago, it was rising home prices, not stock-market gains, that gave people the illusion of infinitely expanding wealth. Millionaires in their 20s were rare. The personal savings rate among Americans was 7% of disposable income; now it's close to zero.

> *"The psychology behind what people buy—and don't—during lean times is a complex mix of economics, ego and the public mood."*

Today, with low unemployment, inflation and interest rates and an economy that's still growing, albeit slowly, there are economists who doubt the nation is facing a full-fledged recession. Yet, clearly all is not well: Energy prices have risen sharply; dot-coms and blue-chip companies have announced closures, layoffs and lower earnings; and sales of existing homes have fallen. Meanwhile, consumer confidence—one of the most important indicators of future spending—has slid to four-year lows.

How all this will affect consumer spending remains to be seen. The psychology behind what people buy—and don't—during lean times is a complex mix of economics, ego and the public mood. In the final quarter of 2000, Americans were still buying, though more slowly than when the year began.

Still, even a slight fall in spending has powerful reverberations, because consumer purchases account for two-thirds of the gross domestic product. As George Katona, an economist and expert in consumer psychology, once said: "Public sentiment can shift swiftly from exuberance to despair. When consumer confidence vanishes, so does a business boom."

Since World War II, the U.S. economy has had nine recessions, defined as two consecutive quarters of contraction of the gross domestic product. During these downturns, savings have come from all parts of the family budget: less meat, smaller cars, fewer telephone calls, lower thermostats and lapsed insurance policies. In the downturn during the materialistic 1980s, the usual consumer goods were hit hardest—refrigerators, washers, dryers and stoves—but people also cut back on carpeting, furniture, tools and liquor.

What items wealthy Americans would cut first in a 2001 recession isn't clear. Conventional wisdom holds that there would be less spending on

vacations, swimming pools, boats, jewelry, fine art, cameras, DVD players, restaurants, private schools, home improvements, landscaping, philanthropy, tips, club memberships, country houses, fur coats and luxury cars. But during tight times, even some of these luxuries remain popular salves for feelings of deprivation.

All of America's recessions have shared some characteristics: Companies slow production, reduce inventories and cut overhead; people lose jobs and try to make their money last longer. Some consequences might be worse this time around. Part-time jobs are often among the first to go, leaving teenagers, an increasingly powerful niche of buyers, with less disposable income. The dollar would probably weaken in relation to foreign currencies, so most kinds of imports would become less affordable. Real-estate values would fall, as people fled from high fixed payments on mortgages and home-equity loans. Credit-card use would drop, bankruptcies would rise.

As in all recessions, some people would escape relatively unscathed, and others might even prosper. People with lots of cash and not much debt would probably find cheaper, more negotiable prices, as well as less competition for the services of contractors, plumbers, decorators and travel agents. In general, recessions tend to reward old wealth and punish the working class, particularly in the manufacturing sector.

Yet each past recession also has held its own wild cards. In the 1970s, there was an unprecedented combination of rising prices and declining productivity. During the next decade, the federal budget deficit loomed so large that the government refused to help stimulate the economy with spending. And in the early 1990s, America was fighting a war in the Middle East, real-estate prices plunged and corporations cut hundreds of thousands of white-collar jobs.

What's different now? Many of today's newly rich can thank the stock market for what economists call the "wealth effect"—a sense of financial well-being that makes people spend. Economists believe that for each $1 of increased wealth, a person spends three to five cents.

But when the markets fall, a reverse wealth effect can take hold, as many retailers could attest to after the 2000 holiday shopping season. "Consumer confidence is more sensitive today to stock-market gains and losses than it was in 1990," says David Lereah, chief economist at the National Association of Realtors.

Since the Depression, the federal government has instituted several programs—Social Security, unemployment insurance, Medicaid and Medicare—that have acted as built-in stabilizers when the economy began slowing down. But recently, some states have tightened eligibility rules for unemployment insurance, and fewer people who lose their jobs may be able to collect benefits.

"The social safety net has been shredded," says Jeff Faux, president of the Economic Policy Institute in Washington, D.C. "We haven't had a full business cycle that would test the impact of losing automatic stabilizers such as welfare and unemployment insurance." Another uncertainty looms: In the past decade, health-care costs have skyrocketed. If people's falling budgets are eaten up by medical and drug costs, something else will have to give.

QUESTIONS FOR DISCUSSION

1. What is the role of scarcity in an economic downturn?

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2. **Analyzing Information** Explain how expectations of a recession affect consumer spending and the overall economy.

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3. **Synthesizing Information** Consumer purchases account for two thirds of GDP. One way to understand the impact of changes in consumer spending is to use a circular flow model. Use a traditional circular flow model to illustrate the connection(s) between consumer confidence and GDP. Be sure to label the changes that occur when the wealthiest reduce spending, both as consumers and investors.

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