Expectations and the Economy

During my career as a consultant, I witnessed first-hand how confidence about the economy can affect business decisions. Changes in confidence influenced my clients' as well as my firm's hiring, pricing, and spending. In my time at the Fed, I've seen how changes in business and consumer confidence impact the economy as a whole.

Recently, consumer and business confidence have been moving in opposite directions. Consumer confidence is near all-time highs, thanks in large part to a strong labor market. The unemployment rate stood at a 50-year low at the end of 2019, and since March 2018, there have been more job openings than job seekers — unprecedented in the 20-year history of this data series. Wages have been increasing faster than inflation, and these real wage increases have helped boost consumer spending (which accounts for nearly 70 percent of GDP).

At the same time, business leaders have been feeling skittish. Uncertainty surrounding Brexit, the Middle East, politics, and trade negotiations have made it harder for them to plan for the future. In the December 2019 Duke CFO survey, nearly a third of companies said they were scaling back or delaying investment and more than half were stockpiling cash in response to economic uncertainty.

Uncertainty raises the threshold for business investment, which fell in the second and third quarters of 2019. I don't discount the idea that we could talk ourselves into a recession — particularly if business uncertainty begins to affect consumer confidence and spending.

Over the years, economists have attempted to incorporate confidence or "sentiment" into their models of economic activity. As Tim Sablik discusses in "Talking Ourselves into a Recession" on page 10, there are different ways to define sentiment, and isolating its effects on the economy is tricky. But overall, research suggests that the way consumers and businesses gather information and form expectations about the world shapes their economic decisions, much as you might expect.

I believe sentiment has become even more important and more volatile in recent years. News travels faster and farther today, thanks to smartphones and social media. Households and businesses are also more exposed to shifts in sentiment. More families are invested in stocks today than three decades ago, leaving them more exposed to sentiment-driven swings in the market. Businesses are more leveraged. And as I've discussed before, CEO short-termism has increased, making businesses more sensitive to the sentiment of the moment. (See "Business Short-Termism and Monetary Policy," *Econ Focus*, Second/Third Quarter 2019.)

The increased importance of sentiment could be affecting the ability of fiscal and monetary policy to influence the economy as well. In late 2017, Congress passed a significant tax cut. Normally, that kind of fiscal stimulus would be expected to boost the economy, and we did see strong growth and a surge in investment in early 2018. But that effect soon faded as worries about trade and, later, the monthlong government shutdown came to dominate headlines.

Similarly, the Fed shifted to a more accommodative monetary policy stance in 2019, which we would also expect to stimulate the economy. We see early signs of that in auto and residential spending. But in the presence of high uncertainty, we may not be getting the same "bang for the buck" as we used to. I think it's fair to say that financial markets are being moved more by trade than our policy stance these days.

Of course, a lot of the forces generating uncertainty today are outside of the Fed's control. The biggest boost to our economy would come from lessening uncertainty in government policy. Clarifying the rules would build business confidence and lead to increased investment, spending, and hiring. We saw that in the positive market reaction to the possibility of a Brexit deal and a trade agreement with China. American businesses are creative; they will adapt and optimize against almost any set of rules, as long as those rules are clear. **EF**

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