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Consumer confidence

Bleak households

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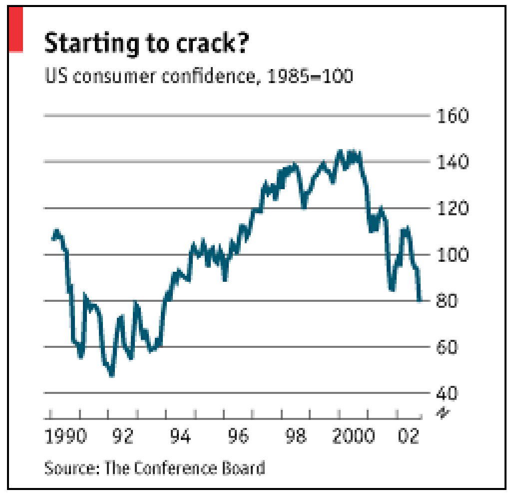
American interest rates, at their lowest for 40 years, are heading lower

THE odds have risen of America's Federal Reserve cutting interest rates at its next meeting on November 6th. Although new figures this week showed that GDP growth remained robust in the third quarter, the economy may now be shrinking—or be just about to.



The most striking news is the plunge in the Conference Board's index of consumer confidence, from 93.7 in September to a nine-year low of 79.4 in October. This drop, the fifth consecutive month of decline, was much bigger than expected. Consumers seem to have been rattled by lower share prices and deteriorating job prospects. Consumer confidence is no perfect predictor of spending, but the size of the decline since May has only ever before been experienced during or just before a recession.

Over the past year, consumer spending has supported the American—indeed the world—economy virtually single-handed. If consumers now decide to sit on their wallets, while business investment remains depressed, another recession looks hard to avoid.

Until now, consumer spending has been propped up by tax cuts, and by a combination of falling interest rates and rising house prices that have encouraged borrowing. This has allowed households to put off any belt-tightening, even as their equity wealth has shrunk. Mortgage-equity withdrawal has been running at a record rate, and much of the money was used to buy cars and other consumer goods. Now consumers may be starting to wake up to the fact that equity holdings are worth about $7 trillion less than they were in 2000. Lower wealth and lower expected future returns on assets mean that households need to save more and spend less.

Since the Fed met in September, retail sales, manufacturing output and durable-goods orders have all fallen. Most economists now expect rates to be cut next week. Some are tipping a half-point cut. The deciding factor may be October's job figures, due on November 1st.

The Fed faces a dilemma. Households are already up to their neck in debts, and another rate cut might encourage them to borrow even more. This, say some, is simply postponing the day of reckoning. Then again, if consumers reduce their spending, another recession when inflation is already low could risk deflation—a dangerous notion when mixed with lots of debt. Japan's experience suggests that the Fed should do everything it can to avoid that.