

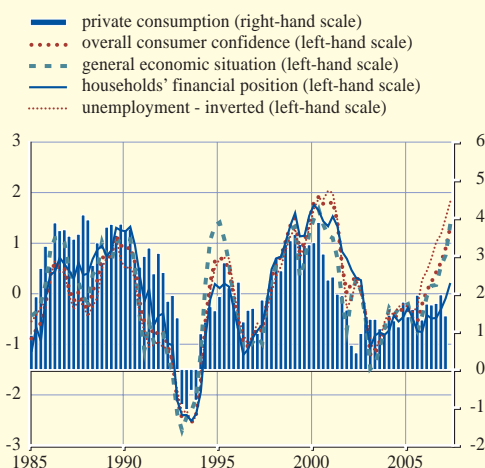
Box 5

RECENT DEVELOPMENTS IN CONSUMER CONFIDENCE

Over the past two years the European Commission measure of consumer confidence has risen sharply and by May 2007 had reached its highest level since 2001 before declining slightly in June and July. During the same period household spending was more muted (see Chart A). The protracted gap between confidence and consumption is relatively unusual; in the past they have tended to move broadly together. But the rise in the overall measure of confidence may overstate the strength of households' assessment of their economic well-being. The increase in overall consumer confidence has, until very recently, been driven largely by improvements in consumer expectations about developments in the labour market and the general economic situation.¹ In the past, these series have had a lower correlation with real household spending than the sub-component of confidence which records households' expectations about their personal financial

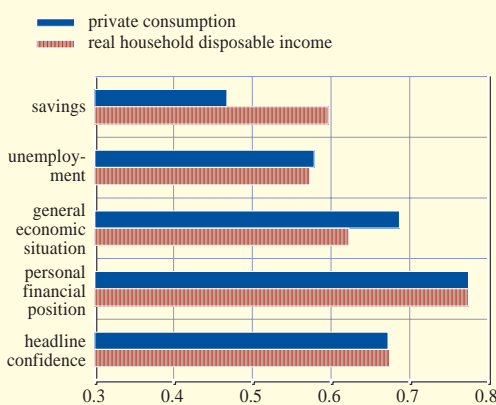
Chart A Components of consumer confidence and private consumption

(standard deviations from series means; year-on-year growth)



Sources: Eurostat, European Commission Business and Consumer Surveys and ECB calculations.

Chart B Correlations between components of confidence, private consumption and real household disposable income



Sources: Eurostat, European Commission Business and Consumer Surveys and ECB calculations.
Note: Correlations between percentage balances and annual percentage changes, Q1 1985 to Q1 2007.

1 The EC survey asks a series of questions on household finances, the general economic outlook and so on. Four of these questions are aggregated to form an overall consumer confidence measure. The four questions are: (1) how do you expect the general economic situation to develop over the next twelve months?; (2) how do you expect the financial position of your household to change over the next twelve months?; (3) how do you expect the number of people unemployed in this country to change over the next twelve months?; and (4) how likely is it that you save any money over the next twelve months? The overall consumer confidence measure aggregates – by a simple average – the net balances for the four questions.

position (see Chart B). Households' expectations about their personal financial positions have been less upbeat in the last two years and more in line with the relatively muted consumption profile in that period. This box explores some alternative explanations for the recent developments in consumer confidence and considers the possible implications for private consumption.

Interpreting consumers' assessments of their financial position

In principle, households should base their consumption decisions on the income they expect to receive during their lifetime, taking into account current and expected income. Household perceptions of their financial position are likely to be influenced by similar economic determinants – the correlation with growth in households' real disposable income growth is high (see Chart B). Since 2004, despite a pick-up in overall economic activity and rising employment in the euro area, growth in households' real disposable income has been relatively weak.² Moreover, with wage growth remaining moderate, unlike past cycles, much of the growth in disposable income has been driven by non-labour income. Typically, households appear to react more immediately to developments in labour income: confidence moves more closely with changes in labour income and households typically have a higher propensity to consume out of this category of income. As a result, consumers have recognised improvements in the general economic situation – in particular employment prospects – but they have been less positive about developments in their own financial position and household spending has been more moderate than in past recoveries.

While developments in confidence appear to be largely explained by income growth, other factors may also have affected household confidence. One possibility is that consumers' confidence about personal finances has remained relatively low because a larger part of the recent employment gains have been in temporary work than in the past. Between 2003 and 2006 the proportion of temporary jobs within total employment increased by around two percentage points. Ultimately, greater labour market flexibility benefits households, translating into increased employment opportunities and both a lower rate and duration of unemployment. However, in the short term, as households adjust to the new environment, they may feel more uncertain about their income prospects. Consequently, for a given income level, their assessment of their personal financial position may have been less optimistic, precautionary saving higher and consumption weaker than in previous upturns. Indeed, Chart C suggests that, at the moment, those countries which have experienced the largest increase in temporary employment in recent years are also those in which households register the biggest gap in confidence between the labour market developments and their personal finances.

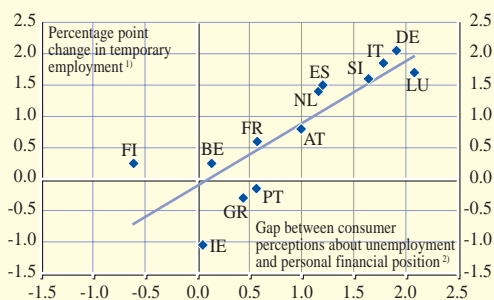
Another potential explanation is that households harbour growing concerns about demographic changes, increased longevity and the sufficiency of retirement income. Until very recently, the confidence breakdown by age group shows an increasing gap between the confidence of younger and older respondents relative to the past – with the young progressively more confident than the old – perhaps confirming that concerns about social security provision are increasingly relevant at the current juncture for the latter group (see Chart D).³ Since older

² For more detail on recent developments in household income, see Box 9 entitled "Recent developments in the household and corporate sectors: information from new quarterly euro area sector accounts", in the June 2007 issue of the Monthly Bulletin.

³ The EC survey separates responses into four age groups: 16-29, 30-49, 50-64 and over 65. The split by age group is provided by only a subset of countries.

Chart C Temporary employment and consumer confidence

(percentage points; standardised confidence balances)



Sources: Eurostat, European Commission Business and Consumer Surveys and ECB calculations.

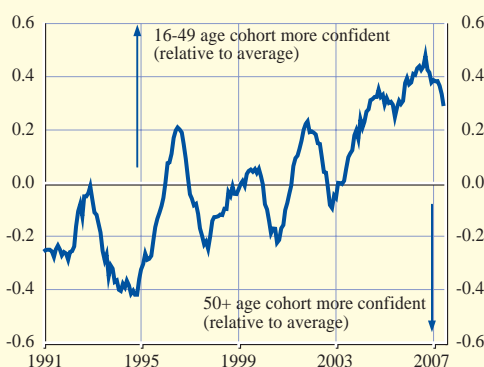
Note: Standardised confidence balances calculated as difference from series mean scaled by standard deviation.

1) Change in proportion of temporary employment within total employment between the average in 2003 and 2004 and the average in 2005 and 2006 (percentage points).

2) Average gap between unemployment and personal financial situation consumer confidence balances (expressed as standard deviations from series mean) in the first half of 2007.

Chart D Generation gap

(12-month moving average of standardised confidence balances for personal financial situation; 16-49 age cohort versus 50+ age cohort)



Sources: European Commission Business and Consumer Surveys and ECB calculations.

Note: Standardised confidence balances calculated as difference from series mean scaled by standard deviation.

members of the population typically have a higher propensity to spend, this may partly help to explain the relatively subdued consumption profile during the recent economic upturn.

Overall, there seem to have been a range of factors at work which have contributed to a discrepancy between consumer confidence and consumption. Looking ahead, as labour market conditions improve further, household income – in particular labour income – is expected to strengthen. One indication of this is that in 2006 a larger part of the employment gains was in the form of permanent jobs. That should support household confidence and consumption. Indeed, the judgement of consumers regarding their personal financial situation has improved in the last few months, although it remains low relative to other components of consumer confidence (see Chart A).