Consumer Spending Drives the Economy?

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Consumer spending makes up more than 70 percent of the economy, and it usually drives growth during economic recoveries."

—"Consumers Give Boost to Economy,"

New York Times, May 1

Every quarter, when the government releases its latest GDP figures, we hear the familiar refrain:

"What the consumer does is vital for economic growth."

"If the consumer starts saving and stops spending, we're in big trouble."

"Consumer spending accounts for 70 percent of the economy."

The latter "fact" crops up regularly in the news reports from the Associated Press, the *Wall Street Journal*, and the *New York Times*.

The truth is that consumer spending is not the mainstay of the U. S. economy. Investment is. Business spending on capital goods, new technology, entrepreneurship, and productivity is more significant than consumer spending in sustaining the economy and a higher standard of living. In the business cycle, production and investment lead the economy into and out of a recession; retail demand is the most stable component of economic activity.

Granted, personal consumption expenditures represent 70 percent of gross domestic product, but journalists should know from Econ 101 that GDP only measures the value of final output. It deliberately leaves out a big chunk of the economy—intermediate production or goods-in-process at the commodity, manufacturing, and wholesale stages—to avoid double counting. I calculated total spending (sales or receipts) in the economy at all stages to be more than double GDP (using gross business receipts compiled annually by the IRS). By this measure—which I have dubbed gross domestic expenditures, or GDE—consumption represents only about 30 percent of the economy, while business investment (including intermediate output) represents over 50 percent.

Thus the truth is just the opposite: Consumer spending is the effect, not the cause, of a productive healthy economy.

This truth prevails in the marketplace: It's supply—not demand—that drives the economy. Savings, productivity, and technological advances are the keys to economic growth. This principle was discovered and developed by the brilliant French economist Jean-Baptiste Say in the early nineteenth century and is known as Say's Law. In fact, he invented the word "entrepreneur" to describe the primary catalyst of economic performance.

Is retail sales a leading economic indicator? Each month the Conference Board releases its Leading Economic Indicators for the United States and nine other countries. The ten U.S. leading indicators are:

- manufacturers' new orders
- building permits
- unemployment claims
- average weekly manufacturing hours
- real money supply
- stock prices
- the yield curve
- new orders for nondefense capital goods
- vendor performance
- index of consumer expectations

As you can see, almost all the indicators are linked to the early stages of production and business activity.

What about the Consumer Confidence Index that the media highlights every month? It turns out that the title is misleading. The questions asked consumers are more about business conditions than spending attitudes. Here are the questions consumers are asked to determine their "expectations":

1. Are current business conditions good, bad, or normal?
2. Do you expect business conditions to be good, bad, or normal over the next six months?
3. Are jobs currently plentiful, not so plentiful, or hard to get?
4. Do you expect jobs to be more plentiful, not so plentiful, or hard to get over the next six months?
5. Do you plan to buy a new/used automobile/home/major appliance [note: these are all durable consumer goods, not unlike durable capital goods] within the next sixmonths?
6. Are you planning a U.S. or foreign vacation within the next six months?

In other words, the much-touted "consumer" confidence index is more a forecast by consumers for business, employment, and durable goods than "retail sales" and consumer spending. It does not ask any questions about food, clothing, entertainment, and other short-term buying, because these expenditures seldom change from month to month.

The reality is that business and investment spending are the true leading indicators of the economy and the stock market. If you want to know where the stock market is headed, forget about consumer spending and retail sales figures. Look to manufacturing, capital expenditures, corporate profits, and productivity gains.

We hear so much about the consumer because the media and political pundits still live under the spell of Keynesian economics, which teaches that demand creates supply. Keynes's law is just the opposite of Say's law (supply creates demand). According to Keynesians, consumer spending drives the economy and saving is bad when the economy is in a short-term contraction.

In reality, increased savings can actually stimulate the economy, even if consumer spending is anemic. A recent study by the St. Louis Fed concluded that in the short run, "a higher saving rate in the current quarter is associated with faster (not slower) economic growth in the current and next few quarters" (Daniel L. Thornton, "Personal Saving and Economic Growth," *Economic Synopses*, St. Louis Fed, December 17, 2009).

How is this possible? When people save more, interest rates fall and businesses can afford to replace their old equipment with new tools, spend more on research and development, or develop new production processes. So while consumer spending may stay low, business spending can pick up the slack. Remember, in a dynamic economy the decision by businesses to spend more investment funds and hire more workers is a function of both current consumer demand and future consumer demand. And don't forget, during a recession corporate profits often recover first, without an increase in customer demand, because companies can boost profits by cutting costs and downsizing.

In the long run new business strategies and spending patterns increase productivity and lower prices to consumers, which in turn means the consumers' purchasing power increases. As the St. Louis Fed concludes, "A higher saving rate does mean less consumption [in the short run], but it could also result in more capital investment and, ultimately, a higher rate of economic growth. . . . [T]he growth rate of real GDP has been higher on average when the personal saving rate is rising than when it is falling."

Granted, the ultimate function of business activity and entrepreneurship is to fulfill the needs of consumers, and the most successful firms are those that satisfy their customers. But more important, who discovers the new, improved products that consumers desire? Who is the catalyst that determines the quantity, quality, and variety of goods and services? Did the consumer come up with the idea of personal computers, SUVs, fax machines, cell phones, the Internet, and the iPhone? No, these technological breakthroughs came from the genius of creative entrepreneurs and the savers/capitalists who funded their inventions.