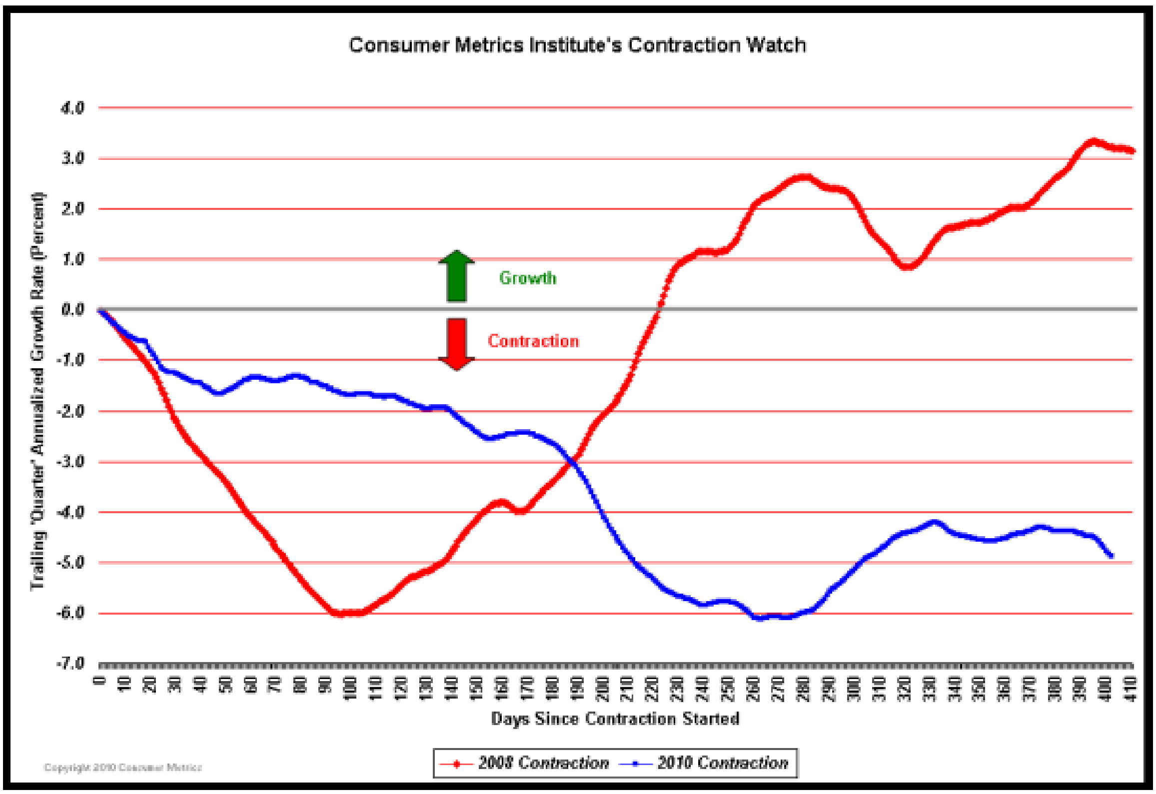
Consumer Metrics Institute Members News

February 16, 2011: Our Current Outlook and Bastiat's Broken Window

Our measurements of on-line consumer demand for discretionary durable goods continue to show an overall economic weakness that is still not reflected in reports coming from the U.S. Bureau of Economic Analysis (BEA) and the Bureau of Labor Statistics (BLS):



In the above chart the day-by-day courses of the 2008 and 2010 contractions in our Daily Growth Index are plotted in a superimposed manner with the plots aligned at the left margin on the first day during each event when our Daily Growth Index went negative. The plots then progress day-by-day to the right, tracing out the changes in the daily rate of contraction in consumer demand for the two events. The 2010 contraction event is now more than 13 months old, dating back to January 15, 2010.

It is important to remember a few things about our data when comparing it to data from either the BEA or the BLS:

-- Our data is intrinsically inflation neutral (or arguably "real" as opposed to "nominal"). This avoids the kinds of problems present in recent retail sales gains that completely disappear when adjusted for price movements.

-- Our data is largely free from aberrant seasonal adjustments, since it reflects daily year-over-year changes (using a 364 day "year", with only minor timing adjustments to reflect calendar shifts in the Easter and Thanksgiving holidays). It is also impervious to those dreaded storms that are handy explanations for unfavorable surprises.

-- We only track on-line demand for discretionary consumer durable goods. As a consequence the dynamics in our data may be amplified relative to the entire consumer economy.

-- The consumers that we track are demographically different from the aggregate profile of the "U.S. Consumer." Our consumers are (generally) younger, better educated and less culturally diverse than the entire U.S. population. Those same characteristics may have caused our consumers to be effected by the recent recession in ways that diverge from the population as a whole.

-- We have chosen to use as a baseline year for our weightings the same year (2005) that the BEA uses for its NIPA tables. One of the consequences is that our weightings still assume that residential real estate and healthy employment levels are relevant to the economy.

But even with those caveats in mind, the above chart is clearly signaling that something is amiss with the consumer economy -- something that neither the BEA nor the BLS has yet reported. Our data suggests that their aggregate measures of the economy fail to capture share changes among the different socio-economic, age, gender, racial or cultural demographics. In effect, this may not be a rising tide -- but rather a selectively benevolent crane operator who is lifting favored boats back to sea.

Some external evidence of demographic divergences was observed within the February University of Michigan consumer sentiment data by Dave Rosenberg. Although the headline number of 75.1 beat expectations (and was the highest level since June), Dave noted that:

"all the gains in consumer confidence in the past month were concentrated in the high income segment   soaring to 88.2 in February from 80.7, which is the best reading since December 2007. That is a sure sign of how the equity wealth effect has taken over, at least among the folks that own stocks. But sentiment among the lowest income group actually tumbled from 72.1 to 67.7, a three-month low, and that may reflect the unintended consequence of QE2, which was to send the prices of food and fuel sharply higher."

"YouTube" Video Links

A number of our members have reported that at least some copies of our last e-mailed commentary contained mangled links to the "YouTube" videos that help explain what we do. Trying again, with fingers crossed, those links are:

Economic Data for the 21st Century - Part 1 (Duration 7:35)

and

Economic Data for the 21st Century - Part 2 (Duration 11:35)

Hopefully this time the e-mail gods will smile more favorably on the transmission.

Mortgage Delinquencies and the "Broken Window Fallacy"

We have received a number of thought provoking responses to our back-of-the-envelope calculations about the impact of mortgage delinquencies (and so-called "strategic defaults") on consumer spending. One such correspondence has been with Jeff Harding at The Daily Capitalist. Jeff correctly pointed out that our calculations ignored the offsetting damages that the defaults were inflicting on banks, making the spending gains that we calculated a present-day example of Bastiat's "Broken Window Fallacy."

For those unfamiliar with the "Broken Window Fallacy", in 1850 Claude Frédéric Bastiat published an essay containing an economic parable that illustrated the hidden costs associated with destroying the property of others. Bastiat imagined a situation where a shopkeeper's son carelessly breaks a window in the shop. The fallacy centers on subsequent comments by onlookers -- who offered that "it is an ill wind that blows nobody good. Everybody must live, and what would become of the glaziers if panes of glass were never broken?" The onlookers (and by extension most casual economic observers) sense that the shopkeeper's loss is the glazier's gain, a zero-sum game.

Bastiat asserted that the onlookers completely missed the macro-economic loss of the previously productive window. If the shopkeeper had not needed the replacement window, he might very well have used those same funds to purchase new shoes from the cobbler. When you include the cobbler's lost sale, it is no longer a zero-sum game. Ultimately the economy is net poorer by the amount of the capital lost when the window was broken.

Although our perspective of the economy is limited to what on-line consumers are doing, Jeff has persuasively argued that Bastiat would ask: "What would the banks have done with the money? Most likely lend more, create more credit for the economy, replace the store of real capital, pay salaries to employees, make profits ... What the economy needs now is not (consumer) spending, but savings."

We agree that more pain for the banks probably does not bode well for the economy down the road. And however unsympathetic the character of some banks may be, at some fundamental level large-scale defaulting on debt contracts is a defacto violation of the rule of law that is essential to any desirable society.

The Broken Window Twists

There are, however, some interesting twists to the present-day incarnation of the parable. In no particular order:

1) The sainted John Maynard Keynes would disagree that there is any fallacy involved at all. He was so focused on what he mis-labeled as a "Paradox of Thrift" that he literally felt that the ultimate goal of governmental stimuli was simply to spend, however wasteful that spending may be. He would have lauded the shopkeeper's son for stimulating the economy.

2) In Bastiat's parable the fallacy is fundamentally based on the fact that there is a net macro-economic loss: the broken window is itself a loss of productive capital for the economic collective. It is not a zero-sum game. In the case of present-day mortgage defaulters, however, the sums are somewhat more muddled. In many (if not most) cases the ultimate economic loss will be shouldered by Fannie Mae or Freddie Mac; i.e., the American taxpayers. This means that most of the $90 billion per year in delinquency "found money" is ultimately coming from Mr. Bernanke. The sainted John Maynard would love it.

3) Again, in the parable there is an implication that the loss was neither natural nor inevitable, but rather a case of third-party carelessness -- for which the shopkeeper is blameless. It is hard to see how bankers, Fannie Mae, Freddie Mac and politically motivated HUD administrators are blameless for the present-day debacle. Would Bastiat still see a fallacy in his parable if the glazing had failed because of the shopkeeper's bad maintenance decisions?

It is probable that in the end a large portion of the $90 billion per year in delinquency/default "found money" will simply be a transfer of taxpayer funds to the most financially stressed subset of American consumers -- in some regards not at all that functionally different from extending unemployment benefits. And while the banks are hardly blameless shopkeepers, it may also be hard to find taxpaying Americans that didn't benefit to at least some extent from the same asset bubble that eventually blew out the window. The ultimate collective loss from this particular incarnation of Bastiat's parable may lie in the memories of the rewards reaped by those institutions that have most egregiously abused moral hazards, and the wealth transferred to those individuals who have successfully shirked debt. The real losses may be in the sanctity and innocence of credit obligations.