The Great Debt Scare

By Robert J. Shiller
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NEW HAVEN – It might not seem that Europe's sovereign-debt crisis and growing concern about the United States' debt position should shake basic economic confidence. But they apparently have. And loss of confidence, by discouraging consumption and investment, can be a self-fulfilling prophecy, causing the economic weakness that is feared. Significant drops in consumer-confidence indices in Europe and North America already reflect this perverse dynamic.

We now have a daily index for the US, the Gallup Economic Confidence Index, so we can pinpoint changes in confidence over time. The Gallup Index dropped sharply between the first week of July and the first week of August – the period when US political leaders worried everyone that they would be unable to raise the federal government's debt ceiling and prevent the US from defaulting on August 2. The story played out in the news media every day. August 2 came and went, with no default, but, three days later, a Friday, Standard & Poor's lowered its rating on long-term US debt from AAA to AA+. The following Monday, the S&P 500 dropped almost 7%.

Apparently, the specter of government deadlock causing a humiliating default suddenly made the US resemble the European countries that really are teetering on the brink. Europe's story became America's story.

Changes in public confidence are built upon such narratives, because the human mind is very receptive to them, particularly human-interest stories. The story of a possible US default is resonant in precisely this way, implicating as it does America's sense of pride, fragile world dominance, and political upheavals.

Indeed, this is arguably a more captivating story than was the most intense moment of the financial crisis, in 2008, when Lehman Brothers collapsed. The drop in the Gallup Economic Confidence Index was sharper in July 2011 than it was in 2008, although the index has not yet fallen to a lower level than it reached then.

Most confidence indices today are based on survey questions that ask respondents to assess the economy today or in the near future. George Gallup, the pioneer of survey methods and creator of the Gallup poll, created a confidence index in 1938, late in the Great Depression, when he asked Americans, "Do you think business will be better or worse six months from now?" He interpreted the answers as measuring "public optimism" and "the intangible mental attitude which is recognized as one vital element in the week-to-week fluctuations of business activity."

But it hardly seems likely that big changes in people's confidence (the kind of confidence that affects their willingness to spend or invest) are rooted in expectations over so short a time horizon.

When George Gallup wrote, almost nine years after the Great Depression began, a sense of ultimate futility – a belief that high unemployment would never end – was widespread. That sentiment probably held back consumption and investment far more than any opinions about changes in the next six months. After all, consumers' willingness to spend depends on their general situation, not on whether business will be a little better in the short term. Likewise, businesses' willingness to hire people and expand operations depends on their longer-term expectations.

The Consumer Sentiment Survey of Americans, created by George Katona at the University of Michigan in the early 1950's, and known today as the Thomson-Reuters University of Michigan Surveys of Consumers, has included a remarkable question about the reasonably long-term future, five years hence, and asks about visceral fears concerning that period:

"Looking ahead, which would you say is more likely – that in the country as a whole we'll have continuous good times during the next five years or so, or that we will have periods of widespread unemployment or depression, or what?"

That question is usually not singled out for attention, but it appears spot-on for what we really want to know: what deep anxieties and fears do people have that might inhibit their willingness to spend for a long time. The answers to that question might well help us forecast the future outlook much more accurately.

Those answers plunged into depression territory between July and August, and the index of optimism based on answers to this question is at its lowest level since the oil-crisis-induced "great recession" of the early 1980's. It stood at 135, its highest-ever level, in 2000, at the very peak of the millennium stock market bubble. By May 2011, it had fallen to 88. By September, just four months later, it was down to 48.

This is a much bigger downswing than was recorded in the overall consumer-confidence indices. The decline occurred over the better part of a decade, as we began to see the end of debt-driven overexpansion, and accelerated with the latest debt crisis.

The timing and substance of these consumer-survey results suggest that our fundamental outlook about the economy, at the level of the average person, is closely bound up with stories of excessive borrowing, loss of governmental and personal responsibility, and a sense that matters are beyond control. That kind of loss of confidence may well last for years.

That said, the economic outlook can never be fully analyzed with conventional statistical models, for it may hinge on something that such models do not include: our finding some way to replace one narrative – currently a tale of out-of-control debt – with a more inspiring story.

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