Why consumer spending matters to the economy

By Rick Gross

There are a variety of factors that determine the strength of the U.S. economy, including government-spending levels, imports versus exports and currency values. Yet, the biggest factor in determining the health of the economy is based on consumer spending, which is the case in most developed countries.

According to statistics from the Federal Reserve (the Fed), expenditures from American consumers account for more than two-thirds of the nation's gross domestic product (GDP), the measure used to determine growth in the economy. While the role of the consumer has not always played such a dominant role in driving the economy, it has generally been responsible for 60 percent or more of economic activity dating back to the post-World War II era.

It is notable that consumers have played a more prominent role in recent decades. According to U.S. Bureau of Economic Analysis, a half century ago, in 1966, consumer spending accounted for 59 percent of total GDP. By 1991, the percentage had risen to 64 percent. Today, consumer spending represents 68.1 percent of GDP, and has been in a similar range since 2008.

What is the role of consumers?

Economists and market analysts often keep a close eye on trends related to consumer activity. If consumer spending is strong, it can be an indication that most Americans have a high level of confidence in the direction of the economy. The total amount of consumer spending isn't the only measure people keep an eye on. The types of expenditures can help determine how high consumer confidence may be at any given time. For example, if sales of luxury goods (expensive cars, jewelry) are lagging and people are putting more money into necessities like food, shelter and clothing, it may not reflect a strong vote of confidence about consumer expectations.

The data on spending plays an important role in how businesses and government agencies plan for the future. If consumers show a high level of confidence, businesses are more likely to boost spending as well to try to capitalize on the opportunity for increased sales. By contrast, if consumers are cautious about spending, businesses may invest less and government policymakers have, at times, chosen to provide stimulus through tax cuts or increased spending to help give the economy a boost.

Consumer spending trends also have a big impact on monetary policy, which is directed by the Fed. If consumer spending is lagging, the Fed can decide to reduce interest rates and take other steps to help jump-start household and business spending. If consumers are spending too much too quickly, it might signal that inflation could become a threat. The Fed may take steps, such as raising interest rates, to try and control economic growth.

What can we expect?

It’s difficult to predict what the future will hold for the markets and economy. One thing is for sure — economists and financial analysts will likely continue watching trends in consumer spending to gauge where the economy is headed.

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