Consumer Sentiments and its determinants*

Nithin.M[†1], XYZ[2], pqr[1, 2]

[1] Department of Humanities and Social Sciences, IIT Kharagpur
[2] University of Hyderabad

Abstract

The extant literature have already examined the excess sensitivity of consumption, and the validity of the permanent income and life cycle hypothesis (PIH) for the developed countries. India is a big country with a significantly large cross sectional heterogeneity than the developed countries. It provides a rich information content to the micro level Indian data, which is nicely captured in the longitudinal dataset for the Indian households, given by CPHS, CMIE. Using this rich dataset, and inspired from Souleles (2004), this paper is the first genuine attempt to examine the excess sensitivity of consumption to sentiments, and the validity of PIH for India through an Euler equation framework. We find - (i) the excess sensitivity of consumption to sentiments exists, and PIH does not hold for India, (ii) since, sentiments mostly captures the perception household's uncertainty about their own financial condition, and the overall business conditions, precautionary savings motive holds for the Indian households, and (iii) the excess sensitivity of consumption to sentiments exists even after controlling for the household specific forecast errors about their own financial conditions.

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†Corresponding author.
Email: `write2nithinm@iitkgp.ac.in`

1 Introduction

Domestic household consumption is an important macroeconomic aggregate and accounts for about 60 per cent of national expenditure[1]. Consumer Sentiments contain information about potential future changes in consumer spending and hence is of paramaount importance in business cycle research (Curtin, 2007; Katona, 1951). Consumer sentiments is an important indicator of business conditions of the economy and is often closely monitored by researchers and policy makers alike. Ever since the time series data on consumer sentiments have become available, here has been a prolonged interest in the power of consumer sentiment to predict business cycle fluctuations, and aggregate consumption growth (Matsusaka & Sbordone, 1995; Mishkin et al., 1978). Using US data from 1953-1988, Matsusaka & Sbordone (1995) finds that all recesions were preceeded by a fall in confidence and all major falls in consumer sentiments were followed by a recession. It can be thought of as consumers correctly forecasting a fall in output or a fall in consumer confidence causing a fall in output. Despite the widespread attention given to surveys of consumer confidence, the mechanisms by which household attitudes influence the real economy are less well understood (Ludvigson, 2004).

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[1] See MSOPI