Downtown Economics

Ideas for Increasing Economic Vitality in Community Business Districts

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Lessons and Strategies of a Recession - Consumer Choices

by Meghan O'Brien, Iowa State University

With the rash of recent retail bankruptcies, store closings, and increasingly vacant retail space, it is apparent the retail industry is facing tough times. Because retail is the second largest sector in the U.S. in number of businesses and employees and accounts for 8.3% of GDP, the implications of a retail recession are numerous and far reaching. Consumer spending also accounts for two-thirds of the national economy, giving us an indication of the relative strength of our economic times. As we have seen national retailers folding, it is natural to wonder what the impacts of a slowing economy will be on locally owned retail establishments and our overall retail landscape.

The following is from an Iowa State University report that presents data and analysis for decision makers, retail business owners, and concerned residents to determine the local impacts of tough economic times and offer solutions and means of adapting. This issue focuses on the recession as it relates to consumer behavior.

The Concept of Consumption Smoothing

The basic economic concept of consumption smoothing can help us understand how the current retail situation has developed and what we can expect next. Consumption smoothing refers to an individual's preference to maintain a certain standard of living over time. All things constant this means an individual will use savings as a tool to compensate when incomes are low or save more when incomes are high thus "smoothing" their consumption patterns. This doesn't mean that spending doesn't increase or decrease as incomes levels change, but rather that the peaks and valley's will be less dramatic.

The theory suggests that people won't spend one less dollar for every one less dollar that they earn, and vice versa. Evidence of this trend can be found in the proliferation of credit cards and their increased use in rough economic patches. Because a certain amount of people's consumption is fixed and doesn't vary with income, shortages are made up by dipping into savings or debt to maintain one's standard of living.

Use of Debt to Smooth Consumption

Financing personal consumption when income is decreasing comes down to a choice between debt and equity, and most recently with the historic rise in housing values we saw this framework altered. As housing prices were increasing, individuals had more paper wealth, triggering spending increases as though that paper wealth was a real stream of income. People, feeling wealthier, spent more money, fueling the tremendous consumer expansion simultaneous with the growth of the housing market.

In the infancy of the recent growth in these two sectors, individuals paid off credit card debt accumulated in the prior recession by refinancing their homes. Unfortunately, real incomes were not rising during this period and many people smoothed their new "wealthier" consumption levels with more credit card debt. Many households refinanced their homes more than once during this expansion, only to be faced with the dismal reality that home prices cannot continue to increase at the current rate and the equity in one's home does not have the same wealth effect of a liquid asset such as traditional savings.

Photo source: http://www.ocda.us/Calculator/calculator.htm

We are now in a period where many people have exhausted the safety nets that typically sustain a minimal level of consumer spending. In many cases, savings are exhausted and credit cards are maxed out forcing people to accept lower levels of consumption and a reduced standard of living. This response to economic times furthers the downturn, and increases its duration.

Substituting Goods to Smooth Consumption

While consumption smoothing explains the fundamental choices behind savings and spending for the consumer, it does not explain their specific spending decisions. During a recession, the typical consumer is forced to make difficult decisions and economic tradeoffs. In terms of consumption, we often see these choices manifested as substitution between goods. When budgets are constrained, the typical consumer will substitute down or choose an inferior good. An example of trading down would be substituting ground beef for steak. Other examples might be buying frozen fruit instead of fresh or purchasing the store brand rather than a name brand.

This trading down is a type of consumption smoothing allowing the consumer to get the same level of consumption but at a lesser quality per unit. This theory of goods substitution holds when there are inferior goods to trade down to and they are reasonably good substitutes for the more expensive good.

Another example of this goods substitution at work is in the consumer's choice of where to shop. While most retailers are experiencing sales declines, discount retailers are thriving as people trade down from expensive specialty and department stores to shop at discount and wholesale stores. These trends have great impacts on a retailer's strategy to survive a recession or downturn.

How Business Operators Can Respond

The author offers a few suggestions for retail and business owners related to the economics of consumer spending:

- Just as consumers shouldn't rely on debt to purchase items at a discount, neither should business operators. Financing unnecessary inventory with debt because it is being offered at reduced prices won't make money in the long run.

- To the extent possible, consumers should be offered lower price substitutes. Lower price point options may keep a consumer in a store and prevent them from shopping at a discounter.

- Business operators should not be afraid to have sales or specials to move inventory. Getting more people in the store or restaurant is the key to building long lasting customer relationships and repeat business.

- Businesses should not assume that raising prices will keep their revenue stream stable during a downturn. The price elasticity of the goods sold will determine whether prices can be increased. Price increases on highly elastic goods should be carefully monitored as this will reduce the quantity demanded dramatically.

- Businesses should know their inventory, what sells the most, and who the customers are. They should pay attention to their competition and the prices they charge.

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Contact: Bill Ryan, Center For Community & Economic Development, University of Wisconsin-Extension
610 Langdon Street, Madison, WI 53703-1104
PH: (608)265-8136; FAX: (608)263-4999; TTY: (800)947-3529; HTTP://WWW.UWEX.EDU/CES/CCED
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