HEY, BIG SPENDERS

WILL THE CURRENT LEVEL OF HOUSEHOLD SPENDING CONTINUE, OR IS THE WELL ABOUT TO RUN DRY, ASKS JONATHAN LOYNES OF CAPITAL ECONOMICS.

Shop until you drop – that seems to be the motto UK households have lived by for the past five years and despite widespread expectations that households would eventually buckle under the weight of record levels of indebtedness, there are no signs of them dropping just yet. Even the first rises in interest rates for four years – and the threat of more to come – appear to have done little to deter them from spending every available penny, if not more. Does the continued strength of household spending mean that previous doubts over its sustainability were unfounded? Or does it mean that overstretched households are heading for an even harder fall than feared?

The arguments questioning the sustainability of the strength of household spending have been widely rehearsed, so I will summarise them fairly briefly here. Generally, household spending grows in line with the economy, but every now and then they diverge for a significant period, with spending outgrowing gross domestic product (GDP) or vice versa. Perhaps the most obvious example is the Nigel Lawson boom of the mid- to late-1980s, when household spending grew more rapidly than the rest of the economy for several years.

But even the 1980's boom has been eclipsed by the consistently rapid growth of spending in recent years. Although the gap between the rates of growth of household spending and GDP has not been as great in any particular year as it was then, the fact that the divergence has continued for much longer – since 1996 – means that the cumulative gap between spending and GDP is much greater.

For the current unprecedented gap to be closed, household spending would have to drop by more than 10% relative to the level of GDP. Worries that this adjustment might be sudden and destabilising have been fuelled by the rapid build-up of household debt, which has risen to record levels as a share of income.

HOUSEHOLD CONCERNS. So much for the scare stories. But despite these concerns, there are few signs as yet of the rapid growth of household spending coming to an end. Spending rose strongly in the last three quarters of 2003 and more timely information on retail sales suggests this momentum has continued into the early months of

2004. Even with a slowdown in the rate of growth during the rest of the year, household spending looks set to expand by at least 3% in 2004.

So what explains this resilience? Perhaps the first point to make is that the strength of spending appears less difficult to explain when compared with the growth of households' incomes than when compared with the growth of the overall economy. Between 1999 and 2001, for example, real disposable income grew at an average rate of 4.9% per year, more than accounting for the 4.1% average growth in spending. More recently, however, income growth has become much less supportive of spending.

Real household disposable income (RHDI) grew by just 1.6% in 2002 and this accelerated only modestly to 2.3% last year. Accordingly, while the strength of income certainly helped to explain the rapid growth of household spending until two years ago, it leaves a puzzle as to why spending has continued to grow so strongly as income growth has slowed. A second rationalisation lies in the distinction between volumes and values. Since the start of 1996, for example, nominal household spending has grown at an average annual rate of 5.6%, only a touch faster than the average rate of GDP growth of 5.4%. This is a much smaller gap than between the respective real rates of growth of 3.7% and 2.7%. In the past two years, household spending has actually grown more slowly than GDP in nominal terms. In 2003, it expanded by just 4.4%, the slowest rate since records began in 1958.

But while this certainly helps to explain the past strength of real spending growth, we do not think it necessarily precludes a major slowdown in the future. With household spending growing more rapidly than GDP in real terms, but at a similar rate, or recently more slowly, in cash terms, it follows that the prices paid by households must have been rising more slowly than those in the economy as a whole. To use the jargon, the household expenditure deflator must have been much lower than the GDP deflator.

CONTRIBUTING FACTORS. There is no guarantee that this pattern will continue, however. One important factor has been the strength of the exchange rate, which has helped to reduce import prices. An additional factor has been the rapid rise in prices paid by the public sector, which has contributed to the rise in the GDP deflator.

Admittedly, the exchange rate remains strong for now. But the continued deterioration of the external position supports the view that the pound is fundamentally over-valued and could fall sharply at some point. Meanwhile, it is likely that the public expenditure deflator will fall back as the growth of government spending slows.

A third argument, advanced by those who suggest that the strength of household spending is sustainable, is that the rapid build up of debt seen in recent years does not pose the risk that is commonly supposed. This is because the strong growth of borrowing in recent years has been broadly matched by sharp rises in saving, with the result that the net amount of borrowing by the household sector overall has been small and, contrary to popular perception, has provided little boost to household spending.

Again, however, I am not sure this is quite as comforting as it might initially seem. Once again, exactly the same observation could have been made at the peak of the Lawson boom, when strong borrowing was once again matched by strong saving. However, when borrowing subsequently fell back from 1990 onwards, saving fell back much more slowly, with the result that net saving rose sharply as a share of income and spending growth slowed. But many commentators would put one factor well ahead of these other considerations in terms of its importance as an influence on household spending, namely interest rates. Also, despite the rises of recent months, interest rates remain at extremely low levels by historical standards. The result is that the interest rate burden faced by households is also low, with the share of interest payments in income (otherwise known as income gearing) at roughly half the levels reached in the early 1990s.

Again, though, I am less confident. Partly because the simple measure of income gearing misses a large part of the costs of servicing debt by excluding repayments of principal. Plus, given the sharp rise in debt in recent years, these are likely to have risen substantially. Furthermore, provided that debt continues to rise more rapidly than income in the foreseeable future, which seems certain, debt servicing costs will continue to rise as a percentage of income, even if interest rates rise no further. In contrast to the common perception that households' debt servicing costs are low by historical standards, and are likely to remain so, they could be close to the peak levels seen in the early 1990s by the end of next year.

So the level of interest rates is perhaps not the strongly supportive influence on the growth of household borrowing and spending that it might seem – or at least it will not be for much longer. But there is, arguably, a danger of overplaying the importance of interest rates and the corresponding levels of debt-servicing costs anyway. After all, debt servicing costs were close to current levels in the early 1990s and yet household debt grew much more slowly. The implication is that, for a given level of interest rates, households' borrowing and spending behaviour can vary dramatically, depending on other influences and the wider economic environment.

Without doubt the single most important other influence on borrowing and spending in recent years has been the strength of the housing market, which has forced buyers to borrow more in order to purchase their houses and allowed existing homeowners to borrow against the rising value of their homes in the form of mortgage equity withdrawal. More generally, it has people, through an increase in their wealth, to save less of their income and spend more. But it seems very likely that the housing market will not be as supportive to borrowing and spending as it has been in recent years.

TAKING STOCK. Unravelling the influences on household spending is complicated. A number of factors help to rationalise the rapid growth of real spending in recent years and it is not impossible to envisage a situation – incorporating continued strength in house prices and the exchange rate – in which this carries on for a while. But neither of these influences looks to be sustainable. In nominal terms, there already has been a sharp slowdown in the growth of household spending, and when the housing market and the exchange rate weaken, real spending growth will slow sharply too. While household spending will post another strong rise of about 3% this year, I expect to see a significantly more modest gain of just 1% next year, and an even weaker performance is possible if our worst fears for the housing market are realised.

Predicting the general behaviour of an economy, or particular parts of it, is difficult enough, but getting the timing right is even harder. However, just because something did not happen when you expected it to does not mean it will not happen at all. The collapse of the dotcom boom and the drop in the dollar are just two recent examples of major economic adjustments that came later than expected, but came nonetheless. A sharp slowdown in the rate of household borrowing and spending in the UK could be the next.

Jonathan Loynes is Chief UK Economist at Capital Economics.
jonathan.loynes@capitaleconomics.com
www.capitaleconomics.com