United Kingdom – Real wage recovery to offer consumers limited respite

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7 JUNE 2018

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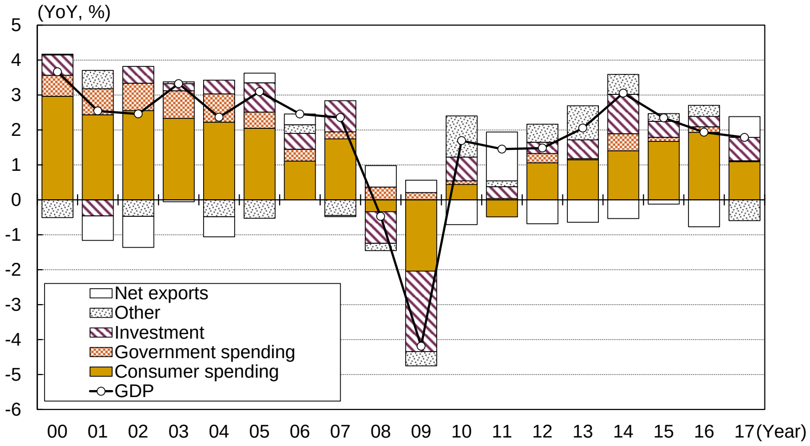
1. Introduction

The consumer is central to the UK economy. Between 2000 and 2007 UK GDP growth averaged 2.8% YoY with an average contribution to this from consumer spending of 2.2pp (Chart 1). But there are now some worrying signs. Retail sales figures have been disappointing and credit growth seems to be slowing. The latest GDP growth figure was weak at 0.1% QoQ. While inclement weather played a part, the ONS downplayed it and said that there was a "longer-term weakening… in the more domestic consumer-facing industries". With consumer spending so important to the UK economy and signs that the global upswing may be losing some steam, this is concerning.

In this report we look at the causes of this weakness as well as the medium-term outlook for consumer spending.

Chart 1: Contributions to Real GDP Growth



Source: ONS, MUFG Bank Economic Research Office

2. Current trends

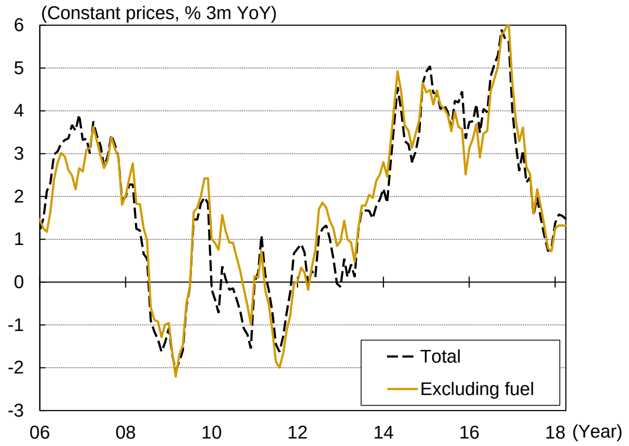
(1) Recent developments

UK consumer spending growth has been trending downward. Domestic household expenditure grew by an average of 2.4% YoY between Q2 2012 and Q1 2017. It has declined sharply since: 1.8% in Q2 2017, 1.3% in Q3 and just 1.2% in Q4. With the latest figure for Q1 2018 just 1.1% the pattern seems clear.

We note that there were some special circumstances in the first quarter. There were extended periods of heavy snow across much of the country in both February and March. This may have been countered somewhat by a boost to spending from the early Easter. Even so, the downward trend seems clear. Retail sales growth averaged 4.4% YoY in 2015-2016. This fell to just 1.9% in 2017 (Chart 2)

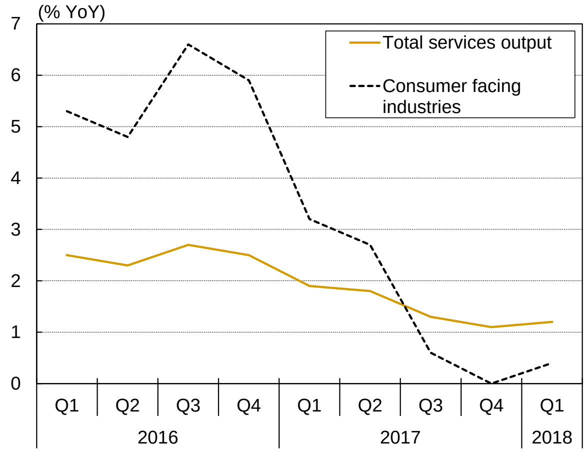
In fact, the effect of the weather may not be especially significant which makes the weak start to the year more concerning. In the preliminary release for Q1 GDP (a below-expectations 0.1% QoQ) the ONS wrote that "services industries were broadly unaffected by the snow". The BoE, meanwhile, estimated that the impact of snow on retail sales was a drag of 0.04pp to quarterly GDP growth – and the total drag from bad weather was just 0.12pp. So, with better weather we may have been looking at growth of around 0.2% QoQ. This would still be disappointing and a lot of the weakness stems from consumer spending. The ONS highlighted the plight of consumer facing industries in particular since mid-2016 (Chart 3).

Chart 2: Retail Sales



Source: ONS, MUFG Bank Economic Research Office

Chart 3: Services Output



Source: ONS, MUFG Bank Economic Research Office

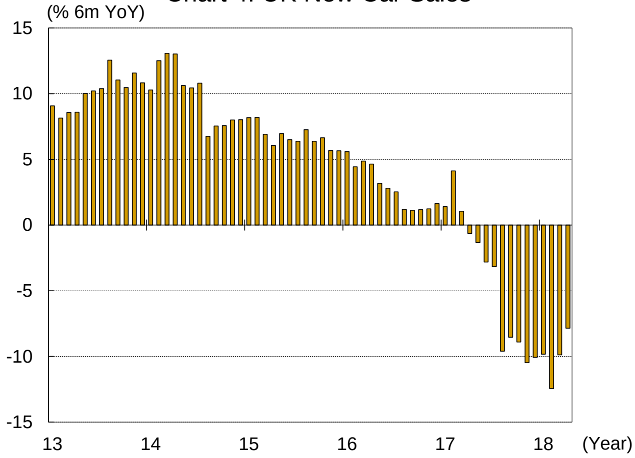
There are few signs of a pick-up in consumer spending in Q2 despite the sunnier weather. Retail sales did bounce in April but the three-month-on-three-month growth was just 0.1%. Other data is gloomier still. The British Retail Consortium (BRC) monitors sales from participating retailers that account for around 60% of the sector by turnover. In April, total sales fell by 3.1% YoY, the sharpest fall in the 23-year history of the series. On a like-for-like basis, which strips out the effect of new store openings, sales fell by 4.2% YoY. This was partly due to the early Easter in March, but the BRC noted that "even once we take account of these seasonal distortions, the underlying trend in sales growth is heading downwards" as "consumers' discretionary spending power remains under pressure".

(2) Reasons behind the slowdown

The European Commission's consumer confidence gauge is markedly weaker than its 2013 to mid-2016 average, if not quite at the low seen in the immediate aftermath of the EU referendum. There is a similar picture in the GfK consumer confidence gauge of the general economic situation over the next 12 months. September 2016 aside, it has remained weak since the referendum. This could point to increasing recognition that the UK has underperformed relative to its peers since the Brexit vote, but we think that softer confidence figures are more likely to be a symptom of wider issues facing consumers.

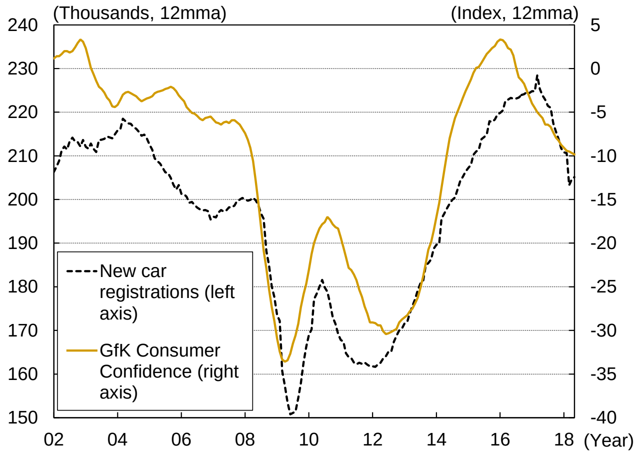
It is worth looking at certain bellwether sectors to shed more light, starting with new car sales. Data here tend to be very volatile on a monthly basis but when smoothed the trend is concerning (Chart 4). New car sales may reflect confidence in employment prospects and earnings and therefore can be a useful indicator for wider consumption patterns. Indeed, as Chart 5 shows, new car sales correspond closely with overall consumer confidence.

Chart 4: UK New Car Sales



Source: SMMT, MUFG Bank Economic Research Office

Chart 5: New Car Sales and Consumer Confidence

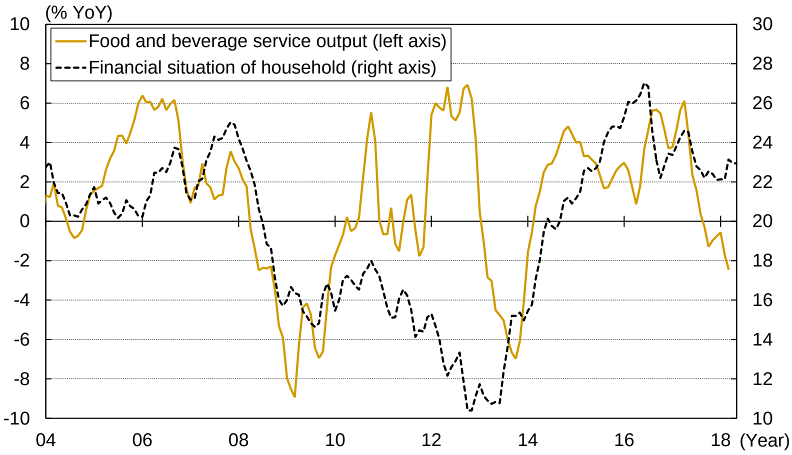


Source: GfK, SMMT, MUFG Bank Economic Research Office

We do note, though, that there are wider trends in the automobile sector such as the shift from diesel following the government's tax changes and the increasing popularity of car clubs and ride-hailing apps. In its recent Inflation Report, the BoE highlighted the fading effect of the structural shift in car finance which had made it easier to purchase new vehicles. The sterling depreciation is also likely to have contributed to higher vehicle prices.

Another worrying sign is the decline in food and beverage services output. This type of 'discretionary' spending, which is easily avoided, can indicate how comfortable households feel about their disposable income. Chart 6 shows how food and beverage services output has fallen over the last year. Numerous restaurant chains have reported difficulties as consumers try to improve their finances. This is affecting the sector. Even in the best of times, the share of food and drink service activities in company insolvencies (firms that enter liquidation or other rescue processes) is typically higher than its gross value added share of around 3% – but it has been increasing. In England and Wales it was over 10% in Q1 2018, the highest for a year.

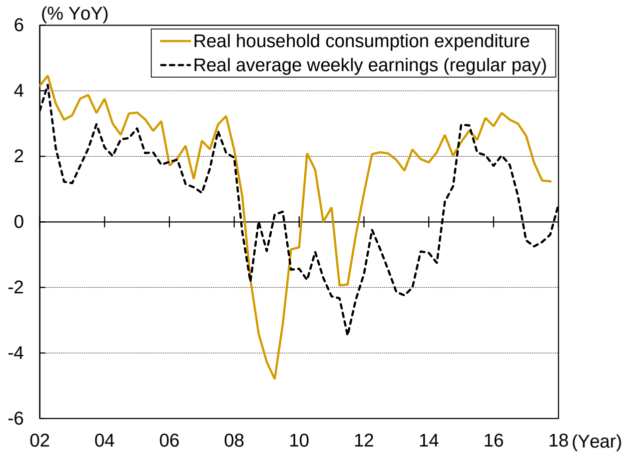
Chart 6: Hospitality Output and Household Finances



Source: ONS, EC, MUFG Bank Economic Research Office

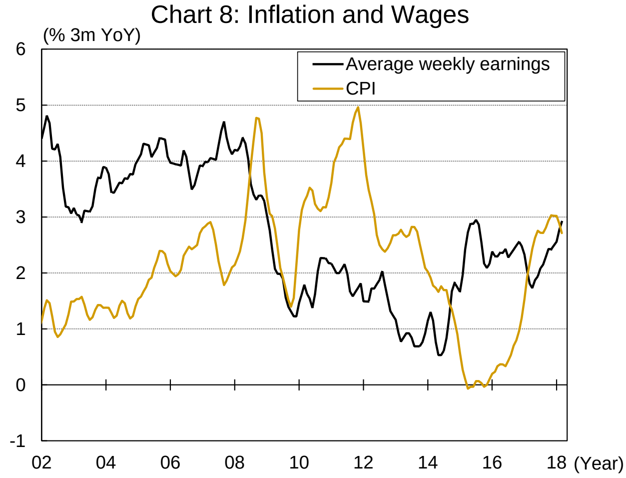
To our minds, lower discretionary spending and the broader recent weakness in consumer spending can be explained in large part by sluggish pay growth. Real wage growth is the main driver of consumer spending (Chart 7). As Chart 8 shows, nominal wage growth has been well below the pre-Global Finance Crisis (GFC) average, and inflation then spiked following the EU referendum sterling depreciation. Overall, looking at regular pay, real wages fell by 0.6% YoY in 2017. In addition, the BoE note that net taxes and benefits have also weighed on real income growth since 2016.

Chart 7: Consumption and Average Earnings Growth



Source: ONS, MUFG Bank Economic Research Office

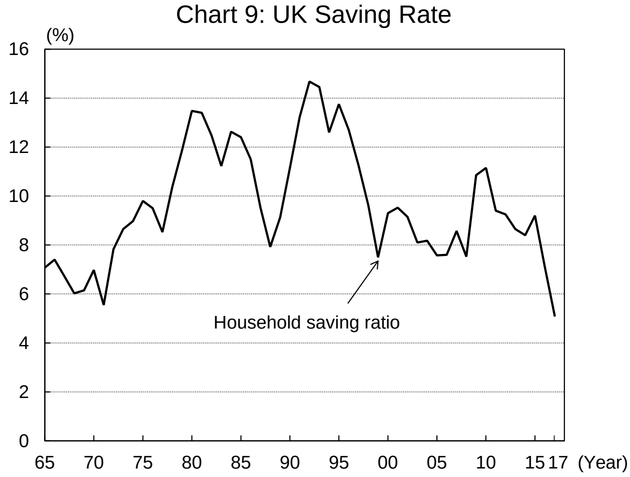
Chart 8: Inflation and Wages



Source: ONS, MUFG Bank Economic Research Office

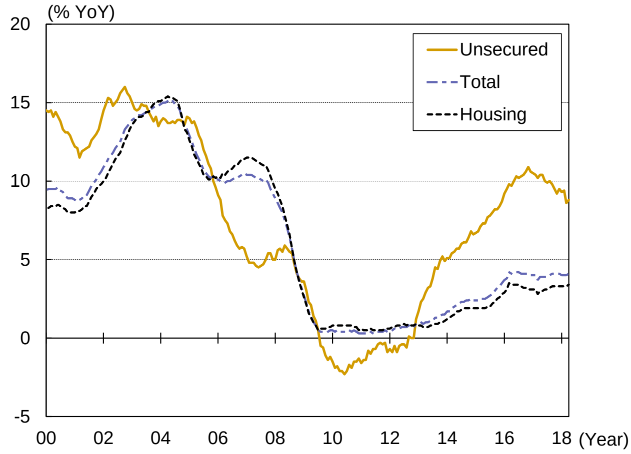
Households can take some time to adjust to lower real income growth as savings or credit can be used to smooth consumption. Chart 9 shows how the saving rate fell to just 5.1% last year. This was the lowest since records began in 1963. At the same time, with supportive financial conditions, consumer lending has increased markedly since 2012 (Chart 10). Drawing from savings or taking out loans can support consumption over the medium term but eventually these approaches become unsustainable. This may partly explain the slowdown in consumption over the past six months – quarterly saving numbers suggest that the rate has picked up from the long-term low. Meanwhile, there was a pronounced decline in unsecured consumer borrowing growth in March, and scant improvement in April. This may help ease concerns about the sustainability of household debt but it does also point to a decline in consumer spending driven by a changing risk appetite.

Chart 9: UK Saving Rate



Source: ONS, MUFG Bank Economic Research Office

Chart 10: Lending to Individuals



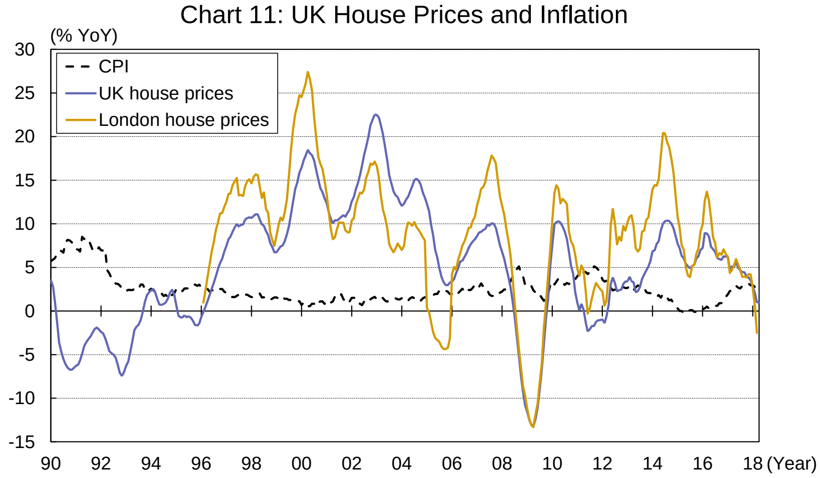
Source: BoE, MUFG Bank Economic Research Office

The housing market also matters. House purchases can reflect confidence in future earnings and employment, and in the economy more generally. The strength of the market can also be important for consumer spending through more indirect channels. Numerous studies have shown the significance of house price wealth effects in the UK for both consumption and labour supply[1]. Increasing paper wealth tends to make home owners more likely to leave the labour market and more likely to spend more. This is especially true for older people who are less likely to want to "move up the ladder" and save for their next home. Wealth effects may well have contributed to the UK's outsized share of consumption in the economy (and high prices are probably a drag on investment in other sectors).

[1] This paper from the Institute for Fiscal Studies for example: www.ifs.org.uk/uploads/publications/wps/WP201425.pdf

The relatively steady growth in Chart 10 of lending for house purchases, which makes up the bulk of credit to individuals, disguises weakening sentiment about the housing market. There has been a long term trend of increasing house prices in the UK. Chart 11 shows how UK house price growth has tended to outpace the rate of inflation over the past twenty years. Deflated by CPI, house prices have risen by almost 26% since 2011. Recent data suggest a shift. The Halifax house price index fell by 3.1% MoM in April in nominal terms, the largest monthly fall in nearly eight years. A bounce of just 1.5% MoM in May did little to allay concerns.

Chart 11: UK House Prices and Inflation



Source: Acadata, ONS, MUFG Bank Economic Research Office

House price indices can be volatile on a monthly basis but there is a clear trend across all the major sources: nominal house price growth is lower, and perhaps even negative in real terms (there are various house price indices which paint slightly different pictures). The market looks especially weak in London.

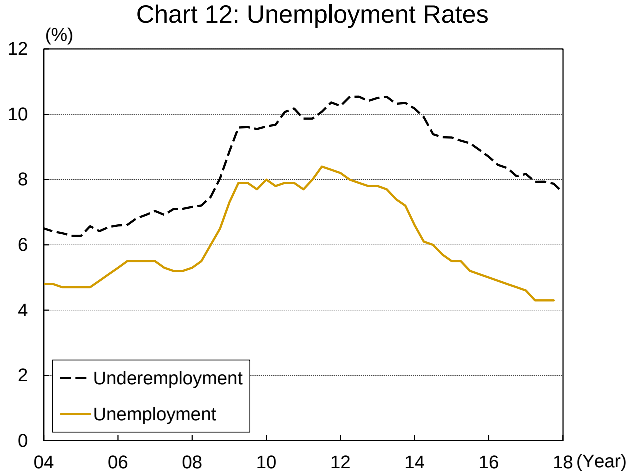
3. The outlook for consumer spending

(1) Labour market and real wages

There are already some signs that real wage growth is returning to positive territory. The referendum-induced sterling effect on inflation is fading and nominal wage growth is edging up.

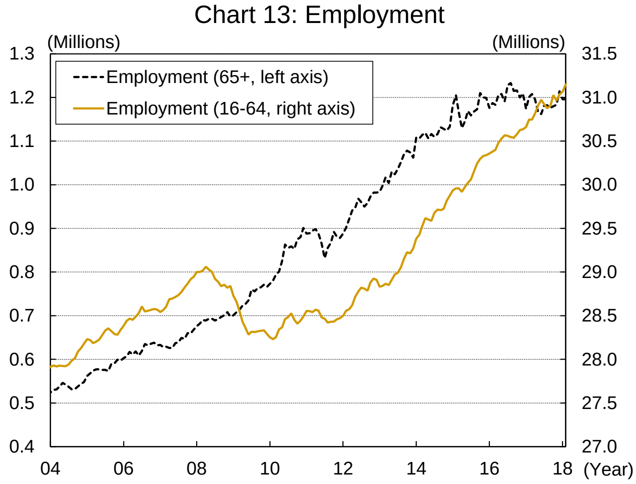
Looking ahead, we expect nominal wage growth to average around 3% in 2018. Wage settlements will be conducted on the back of 2.7% annual inflation in 2017 which was significantly higher than in the two previous years. The government's 4.4% increase to the minimum wage in April this year will also help. Over the medium-term, though, we do not expect a sharp pick-up in nominal income. On the face of it the labour market is very tight. Unemployment is at a long-term low of 4.2% and employment is at a record high. However the pressure on wages has been limited so far. Underemployment, a measure of those who have a job but wish to work more hours, remains stubbornly high compared to its pre-GFC average, suggesting there is still some slack (Chart 12). Employment may continue to improve, but at a more moderate pace. The number of working people aged over 65, which has been supporting the overall figure, seems to have flattened already (Chart 13).

Chart 12: Unemployment Rates



Source: ONS, MUFG Bank Economic Research Office

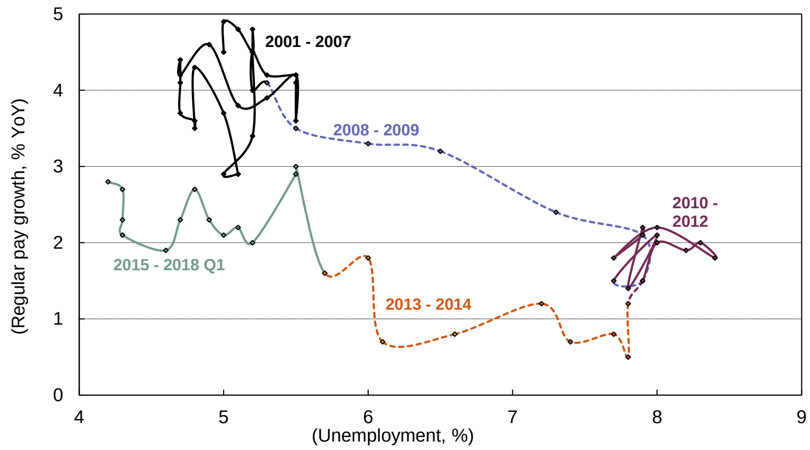
Chart 13: Employment



Source: ONS, MUFG Bank Economic Research Office

Overall, any shift in the wage Phillips curve back (Chart 14) toward the pre-crisis relationship does not appear imminent. With this in mind, we expect nominal wage growth to average 3% in 2018. This may rise to 3.3% in 2019.

Chart 14: UK Wage Growth and Unemployment

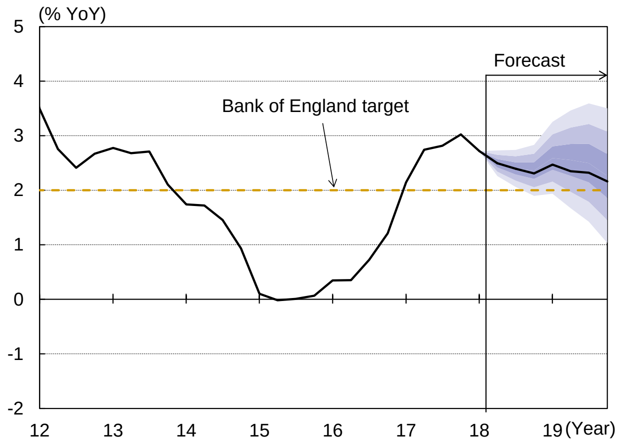


Source: ONS, MUFG Bank Economic Research Office

Turning to inflation, CPI is likely to remain above the BoE's 2% target for the time being as we discussed in our report released in February this year[2]. The out-turn so far has been slightly below our previous central projection but higher oil prices (which are already feeding into weekly fuel prices) and a weaker pound lend support to our view. We expect CPI inflation to average 2.5% YoY in 2018 and 2.2% in 2019 (Chart 15).

[2] See here: www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-UK20180219.pdf

Chart 15: UK CPI Inflation Forecast



Note: Based on the BoE's fan chart style (introduced in their May 2002 Inflation Report). Here, the chart shows how likely various outcomes are for CPI inflation in 2018. The darkest band includes the central projection which covers 10% of the probability. Each successive pair of bands covers a further 10% of probability, reaching 30% of the distribution.

Source: ONS, MUFG Bank Economic Research Office

Lastly, as is often the case, productivity is important. Theory suggests that firms are willing to hire to the point that real wages equal the marginal product of labour. That is, the additional output per worker, per hour. With this in mind, there had been encouraging signs in productivity growth in H2 2017. But the low GDP figure and increase in hours in the first quarter of this year point to a relapse. Unless there is a sharp upturn in productivity then a similar boost to real wages is unlikely. We have argued that there may be data issues – productivity in services, especially during periods of technological advancement, is hard to measure – but the fundamental issue of low investment, both public and private, is likely to endure. This would drag on real wages.

Overall, we expect real wage growth of around 0.6% this year, increasing slightly above 1% in 2019 as inflation slips back further. The return to positive territory will be welcome. But how much support it will offer to consumption remains to be seen. 0.6% would still be below the average since 2001. Before the GFC, real wage growth of 2% YoY or more was common.

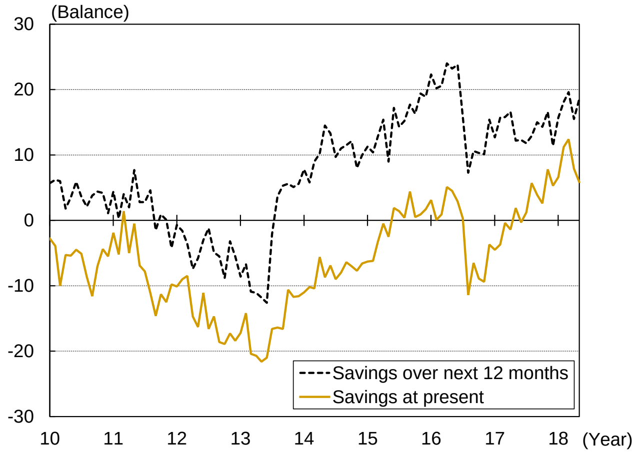
(2) Household finances

If real wage growth is sluggish, will households continue to rely on credit to support spending? It seems unlikely. If anything, households could opt to save any boost to income rather than spend it. The BoE had talked up a rate hike in May then had to backtrack in the face of softer data. Taking a wider view it has managed to successfully steer interest rate expectations higher over the medium term. 55% of households expect a UK rate hike in the next six months according to the latest IHS Markit household finance index release. With this in mind, households may well anticipate that savings rates could increase and borrowing costs will rise.

Indeed, there are already signs that households are saving more. The saving rate is volatile on a quarterly basis but has increased from just 3.9% in Q1 2017 to 5.3% by the end of the year. Looking ahead, the European Commission's consumer survey for saving expectations over the next 12 months has trended upwards since mid-2017 (Chart 16). The number of respondents saying that it is a good time to save has also increased. We also note that internet searches for "savings account" in the UK seem to have taken off since mid-2015.

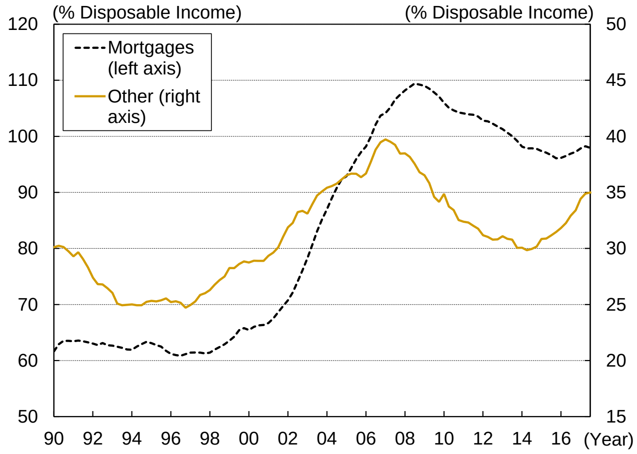
Turning to borrowing, the BoE wrote in the latest Inflation Report that lending conditions are "projected to remain relatively accommodative and supportive of consumption growth" – but also note that there is "some evidence of a tightening in consumer credit conditions". Loan demand already appears weak. Households may well be concerned about high debt levels. Debt-to-income is not quite as high as it was pre-GFC, but has been increasing – especially non-mortgage debt (Chart 17).

Chart 16: Consumer Judgement on Savings Outlook



Source: European Commission, MUFG Bank Economic Research Office

Chart 17: Household Debt-to-Income



Source: BoE, MUFG Bank Economic Research Office

Against this background, growth in unsecured borrowing has looked increasingly soft. It slowed sharply in March from 9.4% YoY to 8.6%, and remained subdued at 8.8% YoY in April. Reducing household indebtedness may make sense for many individual households but on a macro scale it could be cause for concern.

We also note that the extended period of low interest rates has pushed home-owners to re-mortgage onto fixed rate deals (just 27.5% of mortgages were on fixed rate terms in Q2 2012, this rose to over 60% by the end of 2017). Both lower interest payments and easier budgeting are likely to have been supportive of consumption growth. Mortgage rates now seem to have bottomed out, however, and any boost to consumption is likely to fade.

(3) The housing market

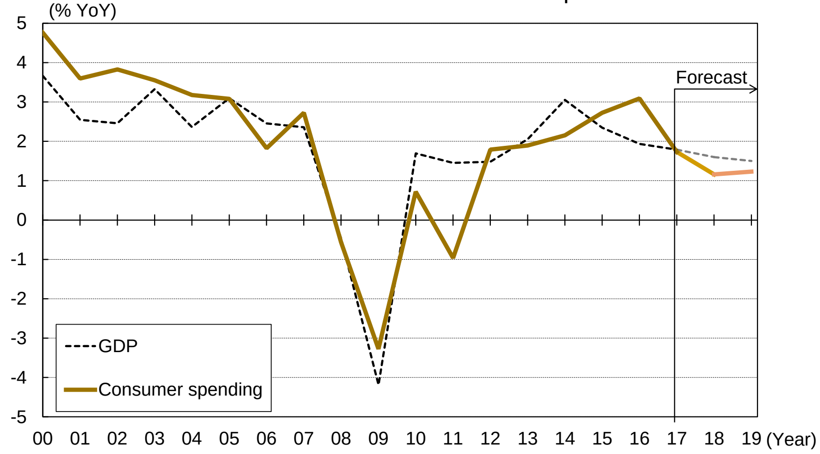
As mentioned above, nominal house price growth is slowing but prices still remain high relative to income. Looking ahead, we expect house prices will continue to rise nationally in nominal terms – but may struggle to keep pace with inflation. The issue of housing affordability has become increasingly political and the government is under considerable pressure to increase housing supply. On top of this, expectations of interest rate rises, Brexit uncertainty and a trend of lower immigration are likely to be headwinds. This may mean that negative wealth effects will weigh on consumption in real terms, but some sort of correction in house prices seems overdue. And if home ownership does become more accessible to younger generations – the current house price to income ratio for first time buyers in London is 9.8 – then consumption of white goods and furnishing may increase. This would be a longer term factor, though, and any effect over the next two years is likely to be negligible.

4. Conclusion

The outlook for consumer spending seems mixed. On the one hand, the labour market is likely to remain supportive. Combined with lower inflation, it leads us to anticipate a sustained return to positive territory for real wages. But a return to the pace of real wage growth before the GFC is very unlikely. Low productivity growth is likely to persist despite encouraging figures at the end of 2017, and some slack in the labour market remains despite low unemployment. Meanwhile, overextended households are poised to save more and borrow less over the coming months. The slowdown in credit in particular bodes badly for the economy. We may also see negative wealth effects as house price growth cools nationally and perhaps reverses in London. Overall, consumer spending is likely to remain subdued over 2018 and 2019. Our forecast is 1.2% YoY for both years. We see little scope for significantly faster growth rates.

The BoE seems to agree. It expects consumer spending to average just 0.25% QoQ (1.0% annualised) over the rest of 2018. However, at a recent press conference, Governor Carney talked about a “rotation in demand towards net trade and business investment and away from household consumption”. This could mitigate the damage from slower consumer spending, but, to our minds, sounds a bit hopeful. Almost two years on from the referendum there has been scant evidence so far of any meaningful rebalancing of the economy towards exports. Any sharp acceleration in private investment seems unlikely until we get more clarity about the UK’s future relationship with the EU. For us, in the consumer-driven UK economy, slower consumption growth is likely to go hand-in-hand with slower overall GDP growth (Chart 18).

Chart 18: Real GDP and Consumption



Source: ONS, MUFG Bank Economic Research Office