

4 – The savings enigma: is the UK consumer already on the mend?

The most striking bit of news in the National Accounts for Q3 2009 was the fact that the household savings ratio rose to 8.6% in Q3 2009. This was up from its record low of -0.7% in Q1 2008 just prior to the start of the recession and actually now above its long-term historic average of 7.6% since comparable data began in 1963 (see Figure 4.1).

Is this dramatic rise in the household savings ratio an anomaly or a sign that the adjustment of household balance sheets is further advanced than realised, thus pointing to a rather healthier outlook for consumer spending going forward? To answer this question we need to:

- look in more detail at what has driven the rise in the savings ratio over the past year (Section 4.1);
- consider what lessons we can draw from trends in the savings ratio during the recovery phases of previous recessions during the last four decades, bearing in mind the similarities and differences between those past recessions and the current downturn in terms of trends in factors like earnings growth, employment and unemployment, house prices and financial wealth levels (Sections 4.2 and 4.3); and
- draw conclusions as to the likely strength of consumer spending growth over the next couple of years (Section 4.4).

4.1 – What has driven the recent rise in the household savings ratio?

The savings ratio is calculated by the ONS as the difference between available household 'resources' (post-tax disposable income plus an adjustment for the change in the net equity of households held in pension funds) and consumer spending, expressed as a proportion of available resources.

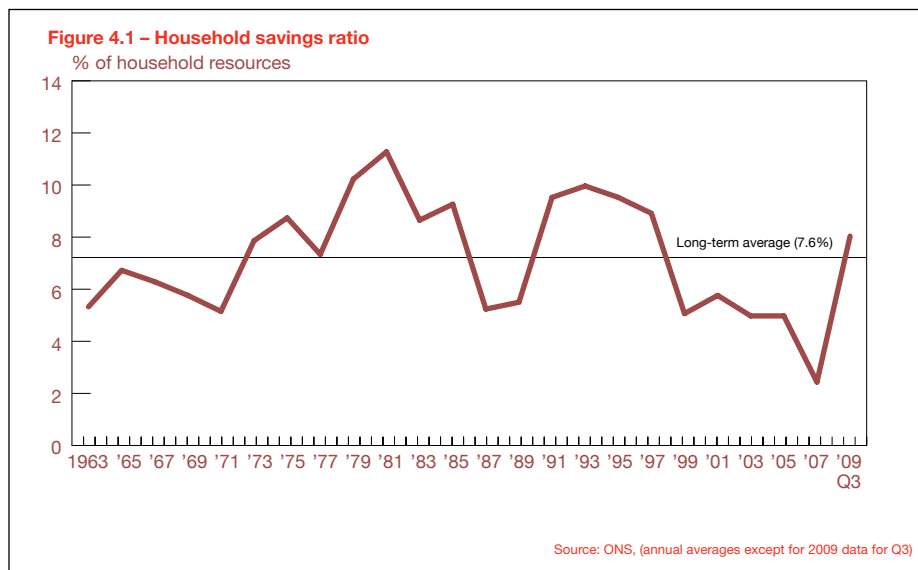


Table 4.1 – Drivers of savings ratio rise between Q3 2008 and Q3 2009

| Household income or spending category | % nominal growth in year to Q3 2009 |
|--|-------------------------------------|
| Wages and salaries | -1.3 |
| Household share of gross operating profits | -10.3 |
| Pre-tax earnings | -3.1 |
| Income tax paid | -8.4 |
| National insurance contributions paid (by workers) | -3.6 |
| Post-tax earnings | -1.1 |
| Social security benefits | +8.5 |
| Post-tax earnings and benefits | +2.0 |
| Net property income received (interest, dividends, rent etc) | +41.3 |
| Net current transfers (other than social security benefits) | +7.1 |
| Household disposable income | +6.5 |
| Change in net equity of households in pension funds | -16.7 |
| Available household resources | +5.9 |
| Household expenditure | -2.7 |
| <i>Memo: GDP at current market prices</i> | -3.5 |

Source: ONS quarterly national accounts (22 December 2009)

Table 4.1 shows how the key drivers of the ratio have moved over the year to Q3 2009, during which it increased from 0.9% to 8.6% (the change in the savings ratio being much more modest during the first six months of the recession). All year-on-year growth rates are measured in nominal terms, without adjusting for inflation (which averaged around 1.3% over this period based on the consumer expenditure deflator).

We can see that the rise in the savings ratio was driven primarily by a rise of 6.5% in household disposable income, rather than by a comparatively modest 2.7% fall in household expenditure over the year to Q3 2009 (less than the 3.5% fall in nominal GDP over the same period, which was driven to a significant degree by destocking and sharp cuts in capital spending). Even after adjusting for inflation, real household

1 The full quarterly national accounts for Q3 2009 were published on 22 December 2009 and include the latest available savings ratio estimates prior to finalisation of this report at the end of February 2010. Estimates for the savings ratio in Q4 will be published on 30 March 2010.

disposable income growth was 5.2% over the year to Q3 2009, which is around twice what might usually be expected based on trend GDP growth.

Why have household disposable incomes been so exceptionally strong during such a deep recession? It is not because pre-tax earnings have been strong because, as we can see from Table 4.1, these actually fell by 3.1% in the year to Q3 2009. Wages and salaries fell by 1.3% while the profits earned by the self-employed and small business owners fell by over 10%.

This fall in pre-tax earnings was offset in part by a marked fall in national insurance contributions (NICs) and, in particular, income tax payments (down 8.4%). This reflects the progressive, counter-cyclical nature of the tax system. But this is a temporary effect and will go into reverse gradually as the economy recovers and as higher rate income tax and NIC rates are raised from April 2011 to help bring the budget deficit back under control in the medium term (as has already been announced in the Budget and PBR).

Even after allowing for the cushioning effect of the tax system, however, there was still a 1.1% fall in post-tax earnings in the year

to Q3 2009. Had household disposable incomes fallen in line with post-tax earnings with the same consumer spending profile, the household savings ratio would only have edged up marginally from 0.9% in Q3 2008 to around 2% in Q3 2009. If this had been the case, then it would have still left a long way for the savings ratio to rise to return to long-term average levels of around 7-8%.

As Table 4.1 shows, however, household disposable income growth has been much stronger than post-tax earnings growth over the past year for two main reasons:

- as would be expected during a recession, **social security benefits** paid to households rose strongly by 8.5%, adding to the 'automatic stabiliser' effect of the tax system; but these cyclical benefit rises (bolstered by some often time-limited favourable decisions on indexation of benefits such as the basic state pension) will be temporary in nature and future governments may indeed need to take action to rein in benefits spending after the next election as part of the wider deficit reduction strategy; and
- **net property income**² rose very strongly by over 40% in the year to Q3 2009 due

both to the relative strength of dividend receipts and the low level of interest paid, although there are also some statistical oddities here in the precise way that interest payments and receipts are scored in the national accounts that may exaggerate this effect; the exceptionally rapid growth in net property income, as recorded in the national accounts, seems unlikely to persist for long, so this seems likely to dampen household disposable income growth somewhat over the next couple of years.

In summary, underlying trends in pre-tax earnings would not have suggested a significant rise in the household savings ratio, but this has been exaggerated by a number of special factors that seem likely to be largely temporary. Of course, as the recovery proceeds, one would also expect pre-tax earnings growth to resume, although probably not at a dramatic rate over the next year or two given that companies seem likely to remain cautious about hiring new workers and the public sector is likely to start cutting back on staff numbers as part of the deficit reduction strategy. Average earnings growth also seems likely to remain relatively subdued so long as there is a reasonable amount of slack in the labour market.

² Net property income is a technical national accounting term referring to net income from all kinds of assets not just physical property. It therefore includes items like dividend receipts on equities.

4.2 – Will the household savings ratio rise further? Lessons from past recessions

If this analysis is correct and household disposable income growth is going to slow markedly going forward, then any further rise in the savings ratio would need to come from consumer spending rising less strongly than even this much weaker growth in disposable income. But should we actually expect any such trend?

There is no easy answer to this question but the experience of previous economic cycles can offer some guidance. Table 4.2 summarises some key points of comparison in relation to the timing and magnitude of savings ratio movements during the last three recessions.

If Q3 2009 turns out to be the trough in the level of GDP in the current recession³, this historical evidence might suggest that the savings ratio should already have reached its peak by now. This would leave the peak level of the savings ratio some way below previous peaks, although this might be defended on the basis that the pre-recession trough was much lower in the current cycle than in previous cycles. The absolute increase in the savings ratio (9.3 percentage points since Q1 2008) is actually already larger than the increase in previous recessions, so it might be argued that enough has already been done.

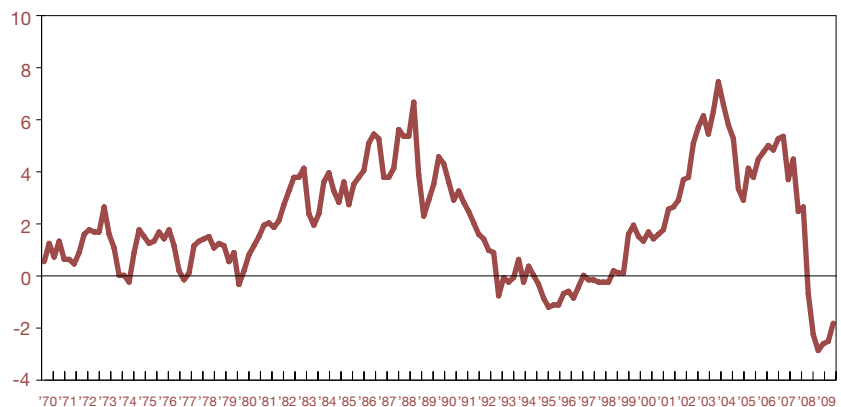
On the other hand, previous recessions saw GDP oscillate around its trough level for some time before moving decisively into its recovery phase and it could be that this will happen again (i.e. a U-shaped or W-shaped recession rather than a V-shaped one). In this case, the savings ratio could well still have further to rise before it peaks, or at least might remain at or around current levels for an extended period of time before falling back again.

Table 4.2 – Comparison of behaviour of UK household savings ratio in past recessions

| Key indicators | Mid 1970s recession | Early 1980s recession | Early 1990s recession |
|---|---------------------|-----------------------|-----------------------|
| Peak household savings ratio | 10.6% | 13.9%* | 12.2% |
| Timing of peak relative to GDP trough (quarters before/after) | -2 | -2 | -1 |
| Change in ratio in 2 years after GDP trough | -2.4% | -4.0% | -2.5% |
| Timing of return to ratio below historic average level (quarters) | +6 | +19 | +24 |

*Excluding an apparently anomalous spike in the ratio to 14.1% in 1979 Q4
Source: PwC analysis of ONS data

Figure 4.2 – Housing equity withdrawal as % disposable income



Source: Bank of England

Another important point to note here is that the rise in the savings ratio since early 2008 has been driven by reduced borrowing (particularly via mortgage equity withdrawal, which fell to record negative levels from mid-2008 as shown in Figure 4.2) rather than by increased financial asset accumulation.

The savings ratio is only likely to start to trend down again, excluding short-term volatility due to temporary factors, once borrowing picks up again, particularly for mortgages. This depends both on more confident consumers and more willing lenders. Higher house prices have helped

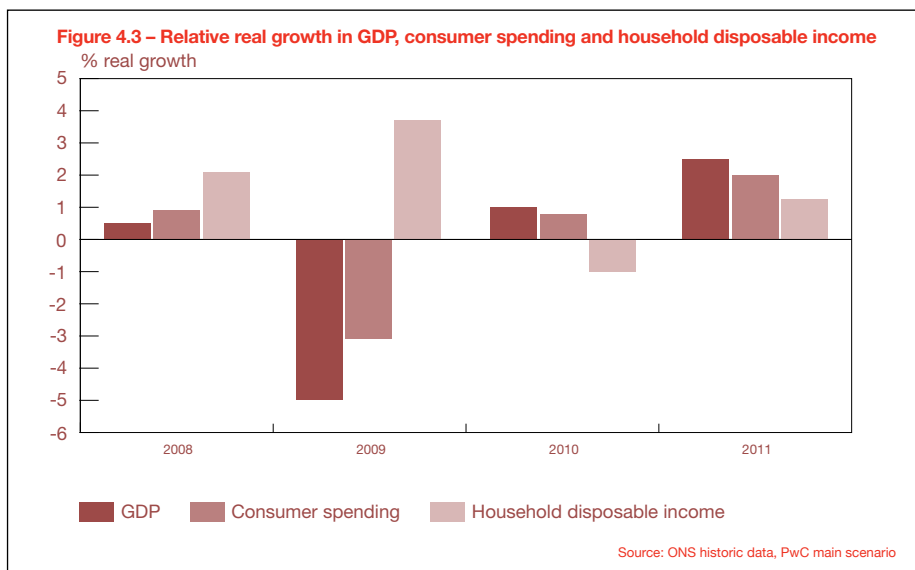
to generate a modest revival in mortgage borrowing recently, but the sustainability of this housing market revival remains to be proven.

4.3 – Key factors underlying prospects for the savings ratio and consumer spending

Another way to look at this is to consider prospects for the key factors such as earnings growth, employment and asset prices relative to past recessions. Broadly speaking, the current downturn has been characterised by:

³ GDP troughs for the previous three recessions are estimated to occur in Q3 1975, Q2 1981 and Q2 1992 based on latest ONS estimates for real GDP.

- more subdued average earnings growth than in previous cycles, which is expected to continue according to consensus forecasts of average earnings growth of only 2.2% in 2010 and 2.8% in 2011; furthermore, higher taxes and national insurance contributions will mean that post-tax earnings growth is likely to be considerably slower than this, particularly from April 2011 when many of the pre-announced tax rises come into effect and bearing in mind the probable need for further tax increases over and above those already announced (as discussed in Box 2.1);
- a less marked fall in employment and a smaller rise in unemployment than in past recessions, perhaps reflecting the greater flexibility of the labour market; this has been a positive so far for consumer spending, although it remains possible that this will mean that employment has less far to bounce back when the economy recovers than was the case in past cycles, which will dampen disposable income growth and so consumer spending;
- house prices have bounced back earlier than in the early 1990s recession, which may have supported consumer confidence and spending to some degree over the past year; there are doubts as to how far this house price recovery will be sustained as the supply of houses for sale picks up to meet increased buyer demand and, looking to 2011 and beyond, as base rates and mortgage interest rates move back up again to normal levels; if house prices stall or start falling again, people may no longer see house price appreciation as 'doing their saving for them', so resulting in a rise in the savings ratio; and
- stock market prices have also recovered strongly during the last nine months of



2009, although this also tended to be the pattern in past recessions and may not have that large an impact on household spending and saving given that much of this equity price effect will be reflected via pension fund values that most households may have little awareness of in practice. Share prices also fell back in early 2010, although it is too early at the time of writing to assess whether this will be a blip or a more sustained correction.

4.4 – Conclusions: implications for consumer spending growth

Our key conclusion is that the rise in the savings ratio has been driven to a significant degree by temporary factors boosting measured household disposable income growth well above post-tax earnings growth over the past year. Over the next year, our main scenario is that real disposable income growth will be negative as these temporary factors are reversed, with only a very modest recovery in 2011 (see Figure 4.3). This is likely to imply a fall in the headline household savings ratio in 2010 and

possibly also 2011, even if the underlying ratio is stable or rising.

There have been some more positive influences on consumer spending in relation to recent trends in asset prices and employment, which have been generally more favourable than in previous recessions. However, it is not guaranteed that these positive trends will continue and there are likely to be significant adverse headwinds from subdued earnings growth and the expected fiscal squeeze following the general election.

In summary, while the worst of the fever may be over for UK consumers, it will be some time before they are fully back on their feet. The recovery process is likely to be slow and uneven, with our main scenario being for consumer spending to lag behind GDP growth in 2010-11 (as shown in Figure 4.3). In these circumstances, policymakers will have to be careful not to take the patient off medication too quickly and risk a major economic relapse. Given the clear need to tighten fiscal policy in the medium term, this suggests that monetary policy may need to remain relatively loose throughout the next few years.