EY ITEM Club Special Report on Consumer Spending

March 2017

EY
Building a better working world


SPRING
SUMMER
AUTUMN
WINTER
EY ITEM CLUB
You're Hired!
ECONOMICS
economics
SPECIAL REPORT

Contents

EY is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

Foreword

Mark Gregory

EY Chief Economist UKI
@MarkGregoryEY

Is the consumer growth engine running out of steam?

The end is in sight...surely?

For some time now, I have been expecting a slowdown in consumer spending growth. Headwinds have been strengthening, inflation has been ticking up and changes in the external environment should have dented consumer confidence. However, as the latest EY ITEM Club Special report on consumer spending shows, consumers have continued to push ahead with the result that their spending grew by 3.1% in 2016, the highest rate for 12 years.

Despite a strong 2016, the end of the consumer push is in sight. The EY ITEM Club expects that rising inflation will depress households' spending power, particularly when set alongside the continued weakness of pay growth, less scope for further gains in employment, and welfare cuts. While there may be some support from the strength of household balance sheets, strong growth in dividend income, and the prospect of tax cuts, these will likely accrue to richer households. There will be a consumer slowdown and this looks set to be disproportionately borne by the less well-off.

As the pressure on real incomes grows...

The key drivers of the EY ITEM Club consumer spending forecast are:

- CPI inflation of 2.8% in 2017;
- Modest acceleration in earnings growth from 2.4% in 2016 to 2.9% in 2017, not enough to offset the rise in inflation;
- Employment virtually stagnating in 2017 and the LFS unemployment rate ticking up to almost 5.5% by the beginning of 2018;
- Challenging conditions for non-wage income as 11.5 million UK households will continue to be affected by the cash freeze on many working-age benefits.

Overall, real household disposable income is forecast to drop by 0.3% this year, the first decline since 2013, with a rise of just 0.2% expected in 2018. As inflation starts to fall back, spending power will recover. However, forecast average real income growth of just 0.8% a year from 2018-20 will be less than half of the pace achieved in 2014-16.

...with differential impacts...

In terms of the outlook for different household groups, pressure on incomes and spending is set to be firmly regressive in the near-future. Alongside real-term cuts in working-age benefits, those at the lower end of income distribution will also suffer relatively more from increases in the price of essentials like fuel and food.

But gains from future income tax cuts will go primarily to better-off households, as will those from further increases in the National Living Wage. And the continuation of the pensions “triple-lock” means that pensioners will continue to gain relative to working-age households.

…creating a “perfect storm” for businesses…

Slowing consumer spending would create challenges for businesses at any time, but it comes at a particularly difficult moment. Rising inflation will not just impact real income growth, but it also increases the costs of doing business as inputs and resources become more expensive. With policies such as the Apprenticeship Levy and pensions auto-enrolment to deal with in an environment of uncertainty, businesses need a clear strategy.

…that requires a clear response

Businesses should, as a matter of urgency:

- Review their pricing, and consider what share of increased costs they can pass on. Drill down to understand the potential impact of the changes in the market at a segment level. It may make sense to allocate more resource to selling to higher end consumers and pensioners for example. Equally, introducing competitive offers at the lower end of the income scale could drive market share growth if the business is the first-mover.

- Assess the potential impact of changes in the economy on the workforce. Firstly, consider labour supply, and how this may change as welfare reform could potentially impact incentives to work for some groups, while the treatment of immigration in the run up to Brexit could cause a disruption in the supply of non-UK labour. These potential changes in the availability of labour could create increased demand for some skill sets in the changing labour market, with implications for wage levels. Understanding future labour market dynamics is critical.

- Analyse the scope to drive productivity improvements. This might be through investing in labour saving technology, but could also be achieved by changes to supply chains. If imports are more expensive due to the change in the value of sterling, now is the time to start sourcing more inputs locally. This might provide further insurance against a failure of the UK to agree a post-Brexit trade deal with the EU.

Overall, an integrated strategic response is required linking price to costs and capital and identifying the value maximising way forward.

Highlights

- Having seen a very strong 2016, consumer spending, while not heading for bust this year, faces the prospect of a sharp slowdown. Rising inflation will depress households' spending power, particularly when set alongside the continued weakness of pay growth, less scope for further gains in employment and welfare cuts. And while there may be some support from the strength of household balance sheets, robust growth in dividend income and the prospect of tax cuts, these will accrue overwhelmingly to richer households. The consumer slowdown looks set to be disproportionately borne by the less well-off.

- The consumer sector enjoyed what could reasonably be described as boom conditions in 2016. Real spending rose by 3.1%, a 12-year high. Solid growth in inflation-adjusted incomes, falling unemployment and record low borrowing costs were among the most important drivers.

- But this year will see household spending power hit by a sharp deceleration in real income growth as a result of a triple-whammy of rising inflation off the back of sterling's drop in 2016, stagnation in the jobs market and the corrosive effect of cuts in welfare spending on non-work incomes. Consumer spending is forecast to rise by 1.7%, the weakest since 2013.

- CPI inflation is expected to average 2.8% this year, a five-year high and we are pessimistic about the prospects of a pickup in wage growth to compensate. As a result, real earnings growth is forecast to slow sharply from 1.8% in 2016 to only 0.1% in 2017. There should be some improvement in 2018, as inflation begins to cool, but even then we anticipate real wage growth of just 0.7%. It is likely to be 2019 before workers begin to enjoy more 'normal' rates of real wage growth again.

- Meanwhile, the very success of the UK labour market in recent years has reduced the scope for further gains in employment. And the prospect of softer GDP growth this year will also take its toll on job opportunities. Our forecast sees employment virtually stagnating in 2017 and the LFS unemployment rate ticking up to almost 5½% by the beginning of 2018.

- Prospects for non-wage income are also looking more challenging. 11.5 million UK households will continue to be affected by the cash freeze on many working-age benefits. Higher inflation will exacerbate the real-terms cut, with the effect on consumer spending magnified by the tendency for low-income, benefit-receiving, households to consume a larger share of their incomes than the better-off. But on the plus side, the MPC's loosening of monetary policy in August 2016 has contributed to interest rates on mortgages and consumer credit falling to new record lows, cutting debt-servicing costs.

- Overall, real household disposable income is forecast to drop by 0.3% this year, the first decline since 2013, with a rise of just 0.2% expected in 2018. As inflation starts to fall back, spending power will recover. However, forecast average real income growth of just 0.8% a year from 2018-20 would be less than half of the pace achieved in 2014-16.

- On a more positive note, non-income drivers of spending are looking relatively buoyant. One is the historic strength of households' balance sheets. Households' net financial wealth represents almost four times the average household's income, the highest ratio since records began in 1987. This should ensure that the slowdown in spending growth is less abrupt than the weakening in real incomes. But with the squeeze on spending power intensifying through this year, we expect to see household spending growth of just 1.7% in 2017 and 0.4% in 2018. And there is likely to be a marked split between discretionary and non-discretionary expenditure, with spending on the former suffering relatively more from a more inflationary environment.

- In terms of the outlook for different household groups, pressure on incomes and spending is set to be firmly regressive in the near-future. Alongside real-terms cuts in working-age benefits, those at the lower end of the income distribution will also suffer relatively more from increases in the price of essentials like fuel and food. But gains from future income tax cuts will go primarily to better-off households, as will those from further increases in the National Living Wage. And the continuation of the pensions "triple-lock" means that pensioners will continue to gain relative to working-age households.

'The King is dead. Long live the King'? The consumer was certainly king in 2016 in driving growth in the economy, something we anticipated in our last *Special Report* on consumer spending published in February 2016.[1] Low inflation supported households' appetite to spend, aided by another healthy year for the jobs market and continued low interest rates. Meanwhile, the Brexit vote in June (merely a gleam in the eye of posterity at the time of our last *Report)* has had no discernible impact on consumer spirits.

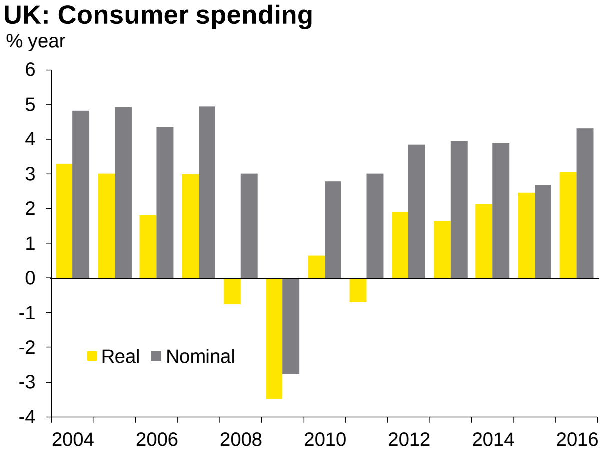
But our February 2016 analysis also suggested that the year would deliver one last hurrah for the consumer, with drags from gradually rising inflation and fiscal austerity starting to bite as we moved into 2017. These observations have proved perhaps a touch cautious in some respects, with the post-referendum drop in the pound delivering a sharper acceleration in inflation than expected and a new Prime Minister but little in the way of a new attitude to cutting the welfare bill. So there is little doubt that 2017 will deliver a more difficult year for the consumer sector. This *Special Report* considers just how much more difficult. It begins by looking at the factors that drove consumer spending last year, before considering prospects for wages and household incomes. It then examines likely developments in non-income drivers of spending before analysing what this all means for different household groups. The report concludes by setting out our overall forecast for consumer spending.

1. Recent trends in consumer spending

2016 as a whole delivered a fairly soft performance from the economy. GDP growth of 1.8% was below the 2.2% seen in 2015 and the annual average of 2% recorded since the last recession ended in 2009. But one area which surpassed expectations was consumer spending. Growth of 3.1% was the strongest since 2004 and accounted for the entirety of the rise in overall GDP. And with price pressures picking up, the strength of the consumer sector was a nominal, as well as a real, phenomenon. In cash terms, consumer spending rose by a nine-year high of 4.3% in 2016, compared to 2.7% in the previous year.

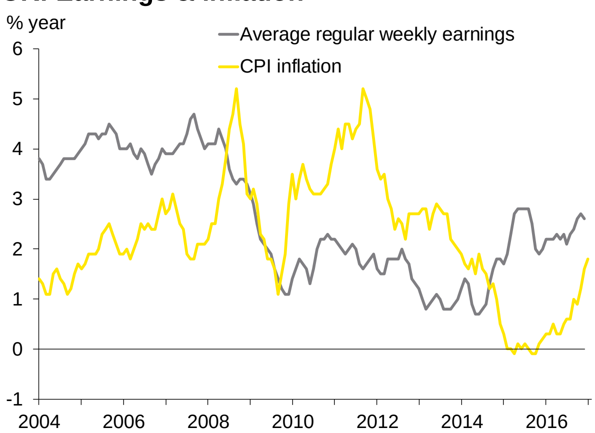
Four potential factors – two fairly convincing and two more debatable – lay behind this performance. The most important is likely to have been solid growth in real, inflation-adjusted incomes, boosting households' spending power. Consumer prices rose by a modest 0.6% in 2016. While this represented an acceleration on the 0.1% increase the previous year, it was less than one-third of the 2.1% rate averaged since 2000. But average weekly earnings increased by 2.4%. And overall household disposable incomes (which adds to wages income from social security benefits and interest savings, net of taxes and interest payments on debt) looks to have risen by around 1.8%, supported by a further rise in employment to a record high. So households in aggregate enjoyed a reasonable rise in real incomes, albeit at a pace which fell some way short of the growth in consumer spending.

UK: Consumer spending



Source : Haver Analytics

UK: Earnings & inflation



Source : Haver Analytics

Second, households' cash flow has continued to benefit from low interest rates, which fell further in the latter part of last year as a result of the Bank of England's decision to cut Bank Rate in August 2016.

[1] '*Special Report on Consumer Spending*', EY ITEM Club, February 2016. http://www.ey.com/Publication/vwLUAssets/EY_ITEM_Club_Special_Report_on_Consumer_Spending_February_2016/$FILE/EY-ITEM-Club-Special-Report-on-Consumer-Spending-February-2016.pdf

2016 began with the average mortgage interest rate at 2.96%. As of December, that had fallen to 2.67%, the lowest since records began in 1999. Of those responding to last September's Bank of England/NMG annual household survey, nearly a third said that the rate paid on their mortgage had fallen as a result of the Bank's action.[2] Low interest rates in turn appear to have encouraged households to borrow more, with consumer credit growth approaching the end of 2016 at an 11-year high. Structural changes in the financing of car purchases have helped to drive growth; close to half of the recent expansion in consumer lending has been accounted for by growth in dealership car finance, reflecting a shift towards so-called Personal Contract Purchase (PCP) deals and a rise in car registrations, which reached a record high last year. According to the Bank of England, around four-fifths of new cars were bought with dealership finance in 2015 compared with half in 2009.[3]

A third reason for strong spending growth mooted by some relates to consumers' expectations. Spending may have been boosted by shoppers bringing forward purchases to beat expected price rises flowing from sterling's depreciation last year, the bulk of which followed June's EU referendum. However, the evidence that consumers actually engaged in this behaviour is scant. A survey by Markit of 1,500 households in February 2017 found that 10% of respondents had pulled forward purchases of goods or services due to expected price rises this year. But 8% had delayed buying in the hope that prices would *fall*. The great majority of households had not adjusted their spending behaviour.[4]

And, fourth, could the Brexit vote itself have spurred greater spending among happy 'Leavers'? After all, a majority of voters, 17.4m people in total, chose the Brexit path. The answer seems to be probably not. The Bank/NMG survey actually found that a majority of households thought that Brexit would have no or a negative effect on the 'general economic situation'. That said, households on balance reported no intention to cut spending over the next 12 months as a result of the referendum's outcome and a majority viewed Brexit as a positive development when 'taking everything into account'.

2. The outlook for household incomes

To what extent will these factors help or hinder spending over the next few years? The bad news is that while 2016's consumer boom is unlikely to turn to bust, a fairly sharp slowdown seems likely. Overall household spending power will be hit by a sharp deceleration in real income growth as a result of a triple-whammy of rising inflation, stagnation in the jobs market and the corrosive effect of cuts in welfare spending.

Rising inflation will take its toll on real pay…

Average weekly earnings rose by 2.4% in 2016. This was unchanged from 2015's rate and below the post-2000 average of 3%, despite the LFS unemployment rate falling to an average of 4.9% from 5.4% in 2015. In real terms, the end of 'no-flation' mean that the year saw a slowdown in the pace of real pay growth, from 2.4% to 1.8%. Nonetheless, with inflation-adjusted average pay having fallen in each full year from 2008 to 2014, the direction in 2016 was at least the right one.

But the annual figures mask what was a sharp deterioration through 2016, with the ONS measure of annual real pay growth slowing to just 0.2% in December 2016. And these pressures are likely to intensify this year, with inflation set to increase further on the back of last year's large fall in sterling. Consumer price inflation reached 1.6% at the end of 2016 and is expected to average 2.8% this year, a five-year high. The culprits are rising commodity prices and the boost to import prices from sterling's sharp post-referendum fall in 2016. In dollar terms, a barrel of Brent crude ended February at $55, $23 or 75% up on the level a year earlier. But magnified by the 15% drop in the pound last year, the increase in sterling terms was even bigger at almost 90%. As a result, petrol prices were almost 20% higher in February than a year earlier. Meanwhile, the cost of imported goods increased by close to 10% in the year to December 2016, while the cost of inputs used by manufacturers rose at an annual rate of 20.5% in January, the fastest for more than eight years.

[2] Bank of England/NMG household survey data, https://issuu.com/bankofengland/docs/qb16q4article3?e=22693371/42014313
[3] '*Inflation Report*', Bank of England, February 2017.
http://www.bankofengland.co.uk/publications/Documents/inflationreport/2017/feb.pdf
[4] '*Limited evidence of households buying ahead of expected price rises*', Markit Household Finance Index, 15 February 2017, https://www.markiteconomics.com/Survey/PressRelease.mvc/1860822d834b46c39ffd5206fd9764bd

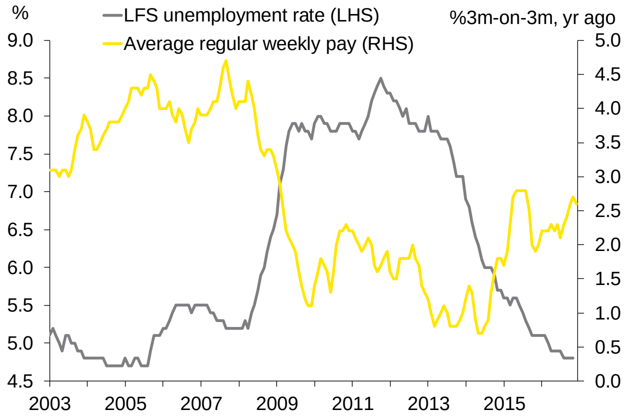
These cost pressures will increasingly feed through to prices in the shops. Although there is uncertainty over what the precise pass-through will be, we expect annual CPI inflation to climb to close to 3% in the second half of this year, the highest rate since 2012. And though we expect the spike in inflation to prove temporary, at 2.3% our forecast for inflation in 2018 is some way above the experience of very low rates of price growth which have been such a boon to consumer spending in recent years.

Growth in cash earnings unlikely to compensate for higher inflation

Granted, three developments could potentially support faster growth in cash pay, so compensating workers for increased price pressures. The first is the scope for apparent tightness in the labour market to embolden employees to push for bigger pay rises. As of the end of 2016, the LFS unemployment rate of 4.8% had rarely been lower at any point in the last 40 years, the employment rate for those aged 16–64 stood at a post-1971 record high of 74.6% and, with vacancy levels close to a historical peak, there were just over 2 unemployed people for every job vacancy, well below the long-run average of 3.4.

But growth in cash pay has shown strikingly little response in the last few years to what, on the face of it, has been an increasingly healthy jobs market. Although a 2.6% annual rise in earnings in the three months to December 2016 was up on the 1.9% recorded a year earlier, it represented a slowdown on what had been seen earlier in the year. Moreover, the last time the jobless rate was so low, in 2005, pay was rising at close to 5% year-on-year, almost double the recent rate.

UK: Unemployment & earnings growth

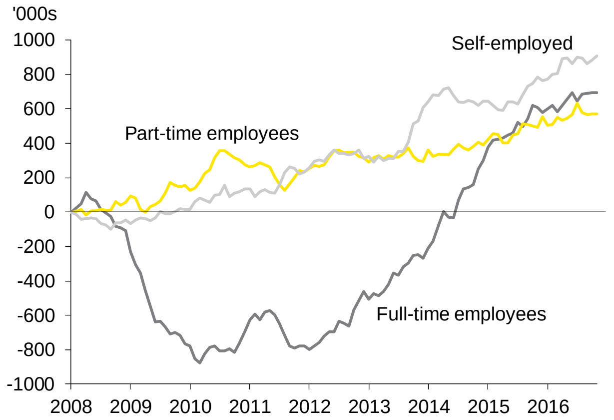


Source : Haver Analytics

In explaining this apparent paradox, the headline numbers may understate the true amount of slack in the jobs market. For example, the number of people who come under the rubric of what we might term 'frustrated workers' – the officially unemployed, individuals classed as inactive but who say they wish to work and part-time workers who would prefer a full-time job – stood at just over 4.9m at the end of 2016, three times the official jobless measure. And if the Bank of England is correct in believing that the UK's 'equilibrium' rate of joblessness is now around 4.5% (which it reduced from a previous estimate of 5% in February's *Inflation Report*), the UK still is someway from full employment even on the standard measure of joblessness.[5]

Changes in the nature of employment may also have played a role in dampening pay growth, with a shift towards less secure and, on average less well-paid, jobs.[6] Almost a third of the rise in employment in the two years to the end of 2016 reflected growth in self-employment with another fifth corresponding to a rise in part-time work. While this movement may in part reflect an increased preference among workers for flexibility and autonomy, it could also stem from cost-cutting by employers. Employing workers on a part-time basis saves on national insurance contributions, while using self-employed contractors avoids the need to pay the minimum wage.

UK: Change in employment since 2008



Source : Haver Analytics

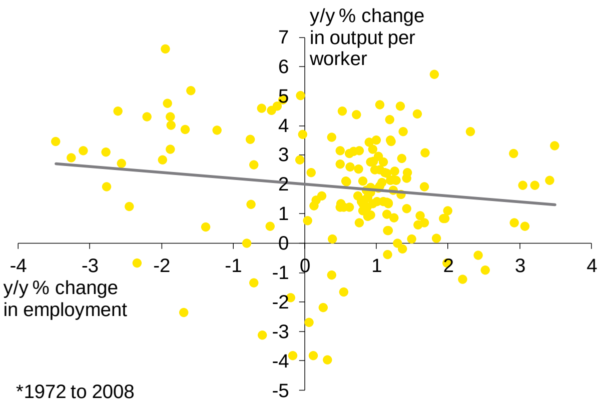
A second potential source of stronger pay growth is the impetus provided by rising inflation itself, as workers seek to preserve the purchasing power of their incomes. During 2015, when inflation fell into

[5] Bank of England, '*Inflation Report*', February 2017.
http://www.bankofengland.co.uk/publications/Documents/inflationreport/2017/feb.pdf
[6] See '*The income of the self-employed*'. Department for Business, Innovation and Skills, February 2016.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500317/self-employed-income.pdf

negative territory, the Bank of England's Monetary Policy Committee occasionally speculated that the absence of price pressures was a contributing factor in explaining weak pay rises.[7] So the reverse might be expected in a world of higher inflation. However, there is little statistical evidence to support a connection between inflation and pay growth.[8] The last episode of elevated inflation in 2010-11 did not see wage settlements increase in response, although in fairness the jobs market then was much less healthy then than it has been of late.

Third, could a recovery in productivity give firms the resources to pay more? 2016 looks to have delivered a rise in output per worker of 0.8%, a marginal acceleration from growth of 0.6% in the previous year. But while productivity growth appears to at least be on an upward trajectory, 2016's rise was less than half of the average increase seen prior to the financial crisis (growth in output per hour averaged 1.8% from 1997 to 2007). However, before 2008 at least, periods of slowing employment growth (which we anticipate this year, see below) tended to be accompanied by faster productivity growth, perhaps because a tougher economic environment incentivises firms to seek efficiencies. Indeed, we expect output per worker to rise by around 1.3% this year, accounting for almost the entire rise in GDP. So, all else equal, firms will have the resources to pay more, although in a tougher market for workers, whether employers will feel compelled to use those resources to fund higher pay is a moot point.

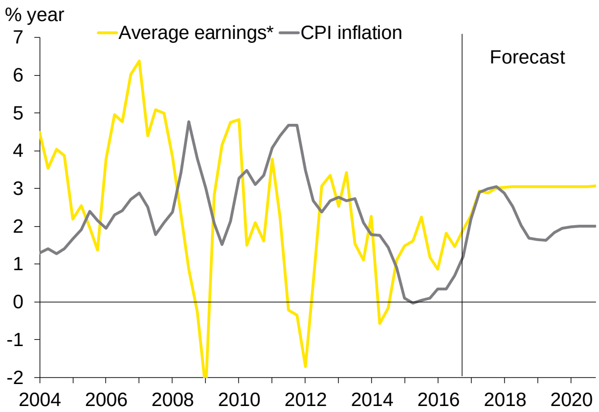
UK: Employment & productivity growth*



Source : EY ITEM Club/Haver Analytics

Beyond the actions of workers and firms, an increase in the national living wage in April from £7.20 to £7.50 will provide a state-directed rise in incomes for individuals on low wages. And there is a good chance of further sizeable increases in future years, with the Government keen to move the national living wage closer to the median wage. But there are also legislative forces working in the opposite direction. Employers face rises in non-wage labour costs from the introduction of the apprenticeship levy this April, ongoing auto-enrolment into workplace pensions (the employer minimum contribution will rise from the current 1% to 2% in April 2018 and 3% a year later) and the levying of National Insurance contributions (NICs) on termination payments from April 2018.

UK: Average earnings & inflation



Source : EY ITEM Club *National Accounts measure

All in all, we expect annual growth in average cash earnings to run at 2.9% this year, a modest progression from 2.4% in 2016. But higher inflation means that, in real terms, average pay growth is set to slow sharply from 1.8% to only 0.1%. There should be some improvement in 2018, as inflation begins to cool, but even then we anticipate real wage growth of just 0.7% and it is likely to be 2019 before workers begin to enjoy more 'normal' rates of real wage growth again.

…while weaker employment growth will dampen overall household incomes…

In terms of growth of overall household incomes, an important driver in recent years has been burgeoning levels of employment. As of the end of 2016, the number of people in work was 303,000

[7] For example, see '*Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 9 December 2015*' 10 December 2015. http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2015/dec.pdf
[8] See '*The labour market*'. Speech given by Michael Sanders, External MPC Member, Bank of England, 13 January 2017, page 5. http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech953.pdf

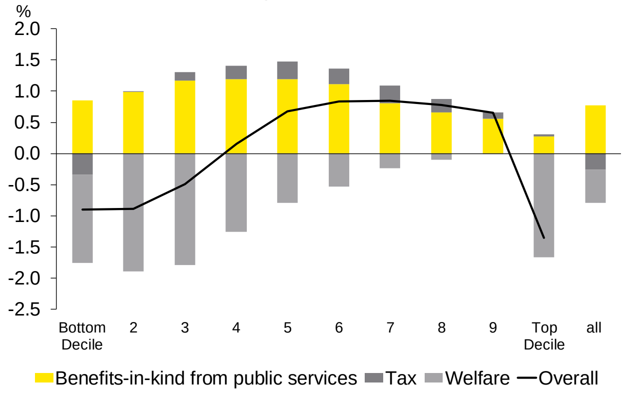
higher than a year earlier and 2.8m up on mid-2009, the point at which employment troughed following the last recession. But the economy may now be on the cusp of a change in this respect. Employment growth saw a slowdown over the course of last year, decelerating from around 1.5% in early 2016 to 1% at the end of the year. This represented a marked weakening on the 2-3% increases seen over much of 2014 and 2015. Given that momentum in economic activity picked up a touch though the course of 2016, a slowdown in hiring probably more reflected the greater difficulty and cost of finding new workers in a world of low joblessness and some recovery in productivity than anything ominous.

So the very success of the UK labour market reduces the scope for further gains. But the prospect of softer GDP growth this year will also take its toll on job opportunities. Our forecast sees employment virtually stagnating in 2017 and the LFS unemployment rate ticking up to almost 5½% by the beginning of 2018. So 2017 is set to see the contribution of employment growth to rises in household incomes and spending disappear. That said, there are some upside risks here. Employment growth has consistently surprised on the upside in recent years. And while the UK's employment rate is high by the standards of many other major economies, the UK still has some way to go to match the 80% or so rates seen in Switzerland and some Scandinavian countries.

…as will continuation of benefit cuts

Turning to non-wage income, prospects here are also looking more challenging. In particular, around 11.5 million UK households will continue be affected by the cash freeze on many working-age benefits which began in April 2016 and is not due to end until 2020-21. Higher inflation will exacerbate the real-terms cut to benefits received, with the effect on consumer spending magnified by the tendency for low-income, benefit-receiving, households to consume a larger share of their incomes than the better-off. The Institute for Fiscal Studies estimated that under the OBR's March 2016 inflation forecast, the freeze represented a 4% cut in benefits relative to previous plans, resulting in 11.5m families losing an average of £260 per year and saving the Government £3.0bn in 2019-20.[9] But in analysis conducted last October, using what was then the latest inflation forecast from the IMF (which predicted CPI inflation of 1.9% in 2017), the IFS estimated that the policy represented a 6% cut to affected benefits, costing the same 11.5m families an average of £360 per year, but delivering savings of £4.2bn to the Exchequer.

UK: Cumulative impact of tax, welfare and public service changes in 2019-20



Source: EY ITEM Club/HM Treasury

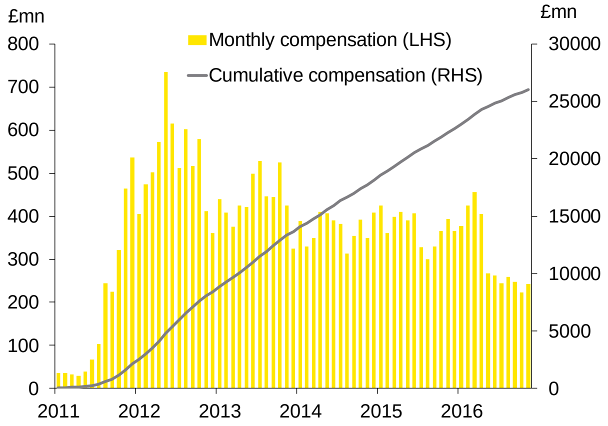
Last November's Autumn Statement saw some modest action to soften the blow. The rate at which Universal Credit is tapered as income rises was reduced from 69% to 67%, allowing claimants to keep an additional 2p for each extra pound earned (although large cuts in the amount that can be earned before the taper begins were maintained). But according to the Resolution Foundation, this change only reverses 7% of the planned welfare cuts.[10] Under our latest inflation forecast, which expects the CPI measure to hit almost 3% by the end of the year, the total real-terms hit to households is likely to be close to £5bn or almost £450 per household by the end of the decade.

Offering some mitigation, although hardly doing much to reduce inequality, is a better picture for households' dividend income. The fall in sterling has boosted the overseas profits of UK corporates and this is translating into bigger pay-outs for shareholders. According to Capita Asset Services, total UK dividends rose to almost £85bn in 2016, £5.2bn or 6.6% up on the previous year. More than 90% of the £5.2bn increase was estimated to arise from the pound's weakness. Capita forecasts dividends will rise a further £5.9bn this year with two-thirds of this down to the effect of the weaker pound.[11]

[9] Institute for Fiscal Studies, '*Falling sterling, rising prices and the benefits freeze*', 18 October 2016. https://www.ifs.org.uk/publications/8699
[10] '*Bending the rules: Autumn Statement response*', Resolution Foundation, November 2016. http://www.resolutionfoundation.org/publications/bending-the-rules-autumn-statement-response/
[11] '*UK dividends hit record after pound devaluation*', Financial Times, 23 January 2017. https://www.ft.com/content/e063be40-df13-11e6-9d7c-be108f1c1dce

And while the crisis which afflicted the banking sector is now looking like a long time ago, compensation for mis-sold Payment protection insurance (PPI) continues to offer some support to household budgets, although less so than in the past. Payouts totalled £3.8bn in the year to November 2016 compared to £4.5bn in the same period in 2015 and a peak of £6.5bn in 2012. The Financial Conduct Authority has proposed set a deadline for compensation claims of August 2019, so there PPI compensation is set to continue flowing for some time.

UK: PPI compensation payments



Source : FCA

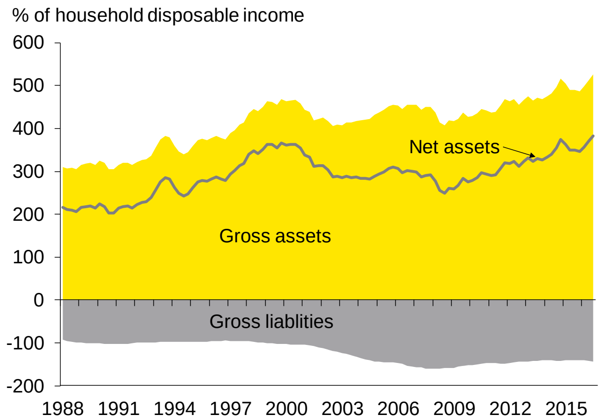
But overall, these modest fillips will not be enough to compensate for the major headwinds facing households this year. The latest available data, covering the third quarter of 2016, showed annual real disposable income growth slowing to just 0.3%, the weakest for two years and well behind the pace of consumption growth (2.9%). And we expect that weakness to continue; this year, real incomes are forecast to see the first decline since 2013, dropping by 0.3%, with growth of just 0.2% expected in 2018. As inflation starts to fall back, spending power will recover. However, with real incomes growth set to average just 0.8% a year from 2018-20, this is less than half of the pace achieved in 2014-16.

3. Non-income drivers of consumer spending

Household balance sheets are in an unprecedentedly strong position…

So a downbeat picture for household incomes. But looking beyond income growth, the factors influencing consumers' ability to spend are not all negative. In fact, non-income drivers of spending are looking relatively buoyant. One is the historic strength of households' balance sheets. Rising equity prices in 2016 contributed to gross household wealth increasing at what is likely to have been the fastest pace in 11 years. And as of the third quarter of 2016, households' *net* financial wealth (including bank deposits, equities and money invested in pension funds and deducting financial liabilities) was up by 12.5% on a year earlier, reaching £4.9tr, or £180,000 per household. This represented almost four times the average household's income, the highest ratio since records began in 1987.

UK: Household financial balance sheet



Source : EY ITEM Club/Haver Analytics

Admittedly, this wealth is heavily concentrated among higher income households. According to the ONS' most recent survey, in 2012 to 2014, the wealthiest fifth of households owned 62% of all private financial wealth. But the bottom quartile owned only 1.5%.[12] Moreover, households' financial assets are in large part not very liquid, particularly the half or so locked up in pension funds. But the evidence does point to a modest 'wealth effect', with the boost to sentiment from rising wealth feeding through to higher consumer spending. Research by the Bank of England concluded that a 10% rise in financial wealth ultimately boosts consumer spending by 0.6%.[13] So the buoyancy of households' balance sheets should provide some prop to spending this year.

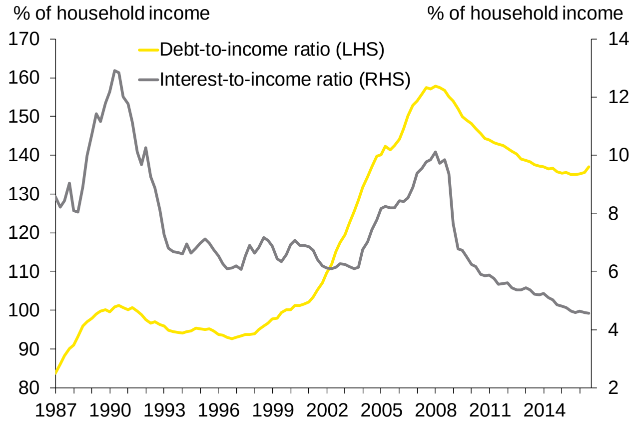
[12] '*Extended Analyses, Wealth in Great Britain, 2012 to 2014*', Office for National Statistics, http://webarchive.nationalarchives.gov.uk/20160105160709/http://www.ons.gov.uk/ons/dcp171776_428643.pdf
[13] '*Wealth and consumption: an assessment of the international evidence*', Vincent Labhard, Gabriel Sterne and Chris Young, Bank of England Working Paper No. 275, October 2005.
http://www.bankofengland.co.uk/archive/Documents/historicpubs/workingpapers/2005/wp275.pdf

…while the affordability of debt is at a record low

Meanwhile, action taken by the MPC in August 2016 to loosen monetary policy has contributed to interest rates on mortgages and consumer credit falling to new record lows, cutting debt-servicing costs. For example, January saw the average interest rate on a new mortgage drop to only 2.05%, down from 2.49% a year earlier and less than half the rate payable just before the financial crisis. Over the same 12-month period, the interest rate on a typical £10,000 personal loan fell from 4.29% to 3.68%.

As a result, household interest payments as a share of gross disposable incomes remained at 4.6% in Q3 2016, the joint lowest since records began in 1987. And for much of 2016, households appeared to be prepared to take advantage of lower interest rates by borrowing more. As of the end of 2016, consumer credit (consisting mainly of personal loans and borrowing on credit cards) was rising at close to 11% on an annual basis, having maintained double-digit rises throughout most of last year. This was a pace of expansion not seen since 2005, with the monthly level of net unsecured lending also at an 11-year high.

UK: Household debt & interest ratios

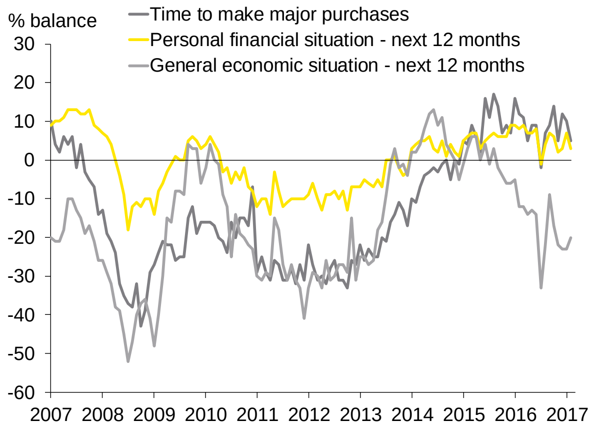


Source : Haver Analytics

The importance of consumer credit in driving consumer spending shouldn't be exaggerated – the net rise in outstanding unsecured loans in Q4 2016 equated to less than 1% of nominal consumer spending in that period. And while extra borrowing did contribute to a rise in the ratio of household debt to income from 135% at the beginning of 2016 to 137% in Q3 of last year, this was still 20 percentage points lower than the peak ratio reached in 2008. So although the household saving ratio fell to an eight-year low of 5.6% in Q3 2016, that consumers as a whole might be willing and able to countenance a further drop doesn't seem implausible. This was certainly the key assumption behind the Bank of England's surprisingly upbeat forecast for the economy this year in its most recent *Inflation Report*.[14] In particular, the Bank pushed up its forecast for consumer spending growth in 2017 to 2% from the 1¼% expected last November. But this was conditioned on the saving ratio dropping over the next two years to the lowest since records began in 1963 and we would see this as an upside risk to the forecast, rather than a likely outcome.

The strength of overall household balance sheets may go some way to explaining recent developments in gauges of consumer confidence. According to GfK's monthly survey, the second half of 2016 saw a marked divergence between consumers' confidence in their own financial prospects and their perception of the outlook for the economy as a whole. While the balance relating to the former fully made up the drop seen immediately after the EU referendum and has since been fairly stable, that relating to the general economic outlook has been falling in recent months towards the low seen last July. Intuitively, personal circumstances are likely to be a more important driver of households' willingness to spend than the rather nebulous concept of the 'economy'. So that some components of overall confidence are looking gloomy need not be too negative a harbinger of future spending.

UK: GfK consumer confidence survey



Source : Haver Analytics

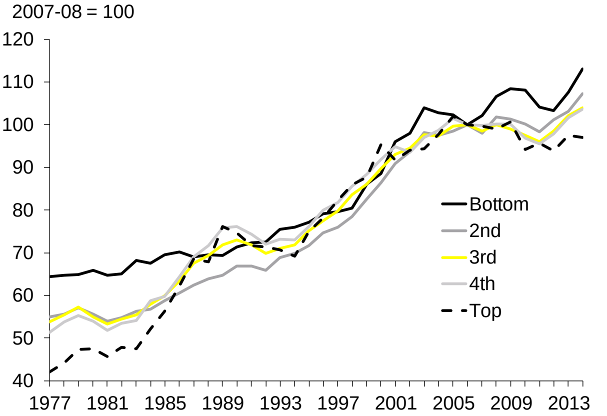
[14] See footnote 4.

4. The outlook for different household groups

Consumption has probably been supported by fall in income inequality...

As outlined in Section 1, in recent years consumer spending has been supported by reasonable growth in real household incomes. And who has been receiving that growth has also probably supported spending, with changes in the distribution of incomes shifting in a spending-friendly direction. Lower-income households (who tend to spend rather than save a larger fraction of earnings compared to the better-off) have seen relatively stronger income growth than higher-earning households.

UK: Average real disposable income by quintile



Source : EY ITEM Club/ONS

Data released by the ONS at the beginning of this year showed that average household disposable incomes for the population outside the richest 20% were all higher in real terms in 2015-16 than before the 2007-08 financial crisis. But the biggest relative gains had gone to the less well-off. Incomes of the households in the bottom 20% were 13% higher than in 2007-08, while those in the middle of the income distribution were about 5% up, both reflecting higher wages and higher employment levels among these income groups. But the richest 20% of households had seen average real incomes *fall* by 3.4% since the financial crisis, with the ONS attributing this to lower income from employment.[15] As a result, the Gini coefficient of income inequality, which measures perfect equality as 0 and maximal inequality as 100, fell to 31.6 in 2015-16, the lowest level since late 1986 and down from a post-1977 peak of 36.1 in 2001.

...but that development is now set to reverse to the detriment of spending

But looking forwards, pressure on household incomes is set to be firmly regressive, to the detriment of consumer spending growth. At first glance this might sound a little odd, given what we know about Government policy. The Government intends to see the National Living Wage reach 60% of a typical worker's hourly wage by 2020, which should mean further large increases over the next few years. And plans to increase the tax-free personal allowance to £12,500 by the end of the parliament would also appear to favour those towards the lower end of the income distribution. Indeed, the fruits of these policies are seen in our forecasts of take-home pay (see table below), which show those in the bottom two wage deciles enjoying the largest increases over the next few years while those towards the middle are squeezed. Interestingly, the other beneficiaries of Government policy are set to be the top decile, which is the only group in this analysis to benefit from the commitment to raise the 40% income tax threshold to £50,000 by the end of the parliament.

[15] *'Household disposable income and inequality in the UK: financial year ending 2016'*, Office for National Statistics, 10 January 2017.
https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/householddisposableincomeandinequality/financialyearending2016

Take-home pay
Annual % change

	Income percentiles								
	10	20	30	40	Median	60	70	80	90
1997-2007	4.0	3.8	3.7	3.7	3.7	3.8	3.8	3.9	4.1
2008	4.6	3.6	4.1	4.5	5.1	5.6	5.9	6.2	3.4
2009	3.9	3.7	3.2	3.2	2.9	2.7	2.7	2.4	3.4
2010	-2.2	-1.2	-0.6	-0.2	-0.4	-0.1	0.0	0.2	0.2
2011	-3.4	0.4	0.9	0.6	0.8	0.6	0.6	1.0	-0.1
2012	5.0	3.7	3.2	2.9	2.6	2.1	1.7	1.6	1.2
2013	4.2	4.5	3.7	3.5	3.1	3.2	2.9	2.4	1.9
2014	0.7	1.1	1.3	1.5	1.7	1.3	1.3	1.2	1.3
2015	4.9	3.6	2.7	2.4	2.1	2.1	1.9	1.6	1.5
2016	5.1	3.7	3.3	3.2	2.9	2.5	2.5	2.7	2.5
2017 (f)	4.3	4.1	2.5	2.5	2.7	2.9	2.9	3.0	3.2
2018 (f)	5.6	4.8	2.2	2.2	2.2	2.3	2.4	2.5	2.7
2019 (f)	5.4	4.8	2.2	2.2	2.2	2.3	2.4	2.5	2.7
2020 (f)	5.3	4.8	2.2	2.2	2.2	2.3	2.4	2.5	2.6

Source: EY ITEM Club

However, the situation begins to look a little different when the analysis is widened. First of all, those at the lower end of the income distribution will suffer relatively more from rising inflation, particularly from increases in the price of essentials like fuel and food. For example, petrol pump prices have recently been surging – the cost of a litre of unleaded increased rose by 11p per litre or 10% in the six months to February of this year. In January food prices rose on an annual basis for the first time in just over two years and the recent growth in the price of imported food (up by 5% year-on-year last December) suggests that food price inflation is likely to accelerate further over the coming months. And with three of the 'Big Six' energy firms having announced price hikes to take effect in March, energy prices are likely to be soon making positive contributions to inflation once again.

Consequently, differences in spending patterns between income groups mean that having worked in favour of the less well-off in recent years, inflationary trends are now set to punish this part of the population. In 2015-16, the bottom two income deciles spent an average of 24% of disposable income on food, motor fuel and energy bills. But this share was only 12% for the top 20% of households by income. The higher propensity to consume out of income of lower income households means that the rising price of essentials is set to exert a disproportionate drag on discretionary spending.

UK: Spending on food, energy & petrol

Source : ONS

Thus, when the different inflation rates facing our wage groups are accounted for, the sizeable gap between the performance of the lowest two deciles and the rest is eroded somewhat (see table below). And those earning just above the National Living Wage are set to see a modest decline in their real take-home pay both this year and next.

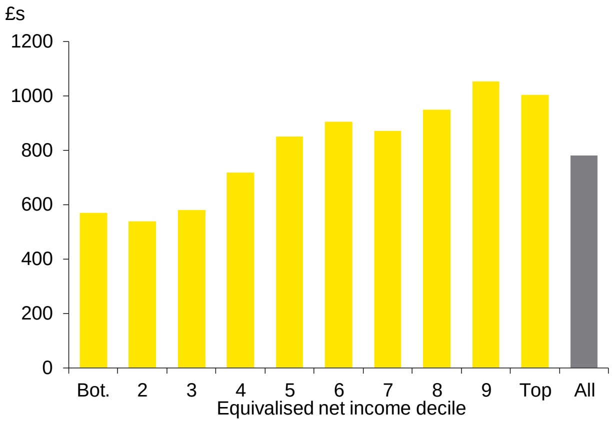
Real take-home pay Annual % change									
	Income percentiles								
	10	20	30	40	Median	60	70	80	90
1997-2007	2.3	2.1	2.1	2.1	2.1	2.1	2.2	2.3	2.5
2008	0.5	-0.3	0.2	0.6	1.2	1.8	2.2	2.5	-0.2
2009	1.3	1.2	0.8	0.8	0.6	0.5	0.5	0.3	1.3
2010	-5.0	-4.2	-3.7	-3.3	-3.6	-3.4	-3.2	-3.1	-3.1
2011	-7.6	-3.9	-3.4	-3.8	-3.5	-3.7	-3.7	-3.4	-4.4
2012	1.9	0.6	0.2	0.0	-0.3	-0.7	-1.1	-1.2	-1.5
2013	1.3	1.6	0.9	0.8	0.5	0.6	0.4	-0.1	-0.6
2014	-0.9	-0.6	-0.2	0.0	0.2	-0.1	-0.1	-0.2	-0.1
2015	4.8	3.5	2.8	2.4	2.1	2.1	1.9	1.7	1.5
2016	4.6	3.2	2.8	2.6	2.3	1.8	1.9	2.0	1.8
2017 (f)	1.6	1.3	-0.2	-0.2	-0.1	0.0	0.1	0.2	0.4
2018 (f)	3.0	2.3	-0.2	-0.2	-0.2	0.1	0.1	0.3	0.4
2019 (f)	3.2	2.7	0.2	0.2	0.3	0.6	0.6	0.7	1.0
2020 (f)	2.9	2.6	0.0	0.1	0.1	0.3	0.4	0.5	0.7

Source: EY ITEM Club

The situation looks bleaker still when we broaden the analysis from workers to households in general. As we pointed out in our last consumer *Special Report*, for those workers gaining from the NLW, a proportion of the increase in earnings will be lost through lower benefit entitlements. And because many workers on the NLW are households' second earners, a significant proportion of the cash gains in *household* income from the NLW are set to accrue to the top half of the income distribution. The OBR put the proportion at around half.[16]

Furthermore, the real-terms cut in most working-age benefits, discussed in Section 2, will also be an important factor. These payments go overwhelmingly to the relatively low-paid, so this will further add to the pressure on lower income groups.

UK: Average annual gain from NLW in 2020



Source : EY ITEM Club/OBR

Pensioner households will continue to be protected

Meanwhile, the ONS data cited earlier also showed a stark division between retired and working-age households. While the former saw incomes grow by 13% in real terms since 2007-08, incomes of those in work in 2015-16 were still 1.3% below the pre-crisis level. And a recent report by the Resolution Foundation found that after adjusting for housing costs, typical pensioner incomes are now higher than those of a typical working-age household.[17]

These observations seem unlikely to shift anytime soon. Despite discontent from some politicians, including the House of Commons Work and Pensions Committee, the Government remains committed to

[16] See Box 3.2 of the '*Economic and Fiscal Outlook*', Office for Budget Responsibility, November 2015.
http://budgetresponsibility.org.uk/docs/dlm_uploads/EFO_November__2015.pdf
[17] '*Living Standards 2017: the past, present and possible future of UK incomes*', Resolution Foundation, February 2017.
http://www.resolutionfoundation.org/publications/living-standards-2017-the-past-present-and-possible-future-of-uk-incomes/

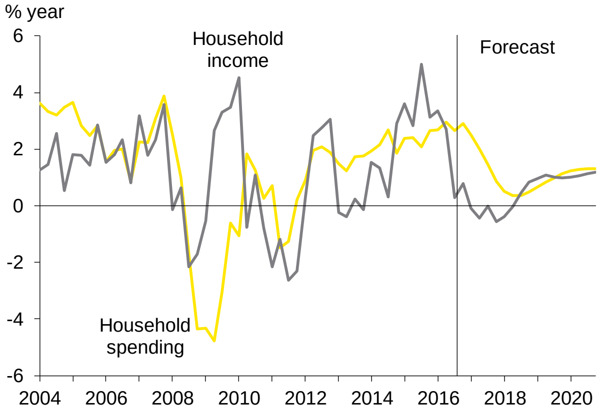
preserving the pensions 'triple-lock' (guaranteeing that the state pension rises annually by whichever is the highest out of average earnings, the consumer price index, or 2.5%) until at least 2020.[18] In a world where inflation is rising, but pay growth is unlikely to follow suit to any great extent, the divergence between pensioner and working-age households is set to continue widening.

5. Forecast for consumer spending growth

2017 set to see consumer spending growth slow to a four-year low

Overall, it is not difficult to see that the balance of forces working for and against the consumer is set to shift in favour of the latter this year. Forecast growth of 1.7% would represent a sharp slowdown on 2016's 12-year high of 3.1% and deliver the weakest rise in spending since 2013.

UK: Real household income and spending



Source : EY ITEM Club

Rising inflation will be the key pressure dragging down growth. Admittedly, if inflation peaks at close to 3% as we expect, this would be some way from the 5%+ rates seen in 2011, the last time the UK experienced a bout of elevated inflation, and a very long way from the double-digit rates that were the norm in the 1970s and early 1980s. But with pay growth seemingly little-responsive to low unemployment and lower-income households hit by continued efforts to reduce the welfare bill, an unfavourable gap between rises in prices and rises in incomes will open. With income growth set to be very constrained and inflationary pressures becoming particularly apparent in the price of essentials like energy and fuel, discretionary spending is set to be the fall guy as consumer spending growth slows.

That said, the availability of cheap credit and the ability of households to draw on what in aggregate, are plentiful savings, should mean that growth in consumer spending slows at a gentler pace than real incomes, in this year at least.

With inflation expected to accelerate as this year progresses, the worst of the squeeze on spending power is likely to come around the turn of 2017/18. As such, this is likely to have a depressing effect on spending growth for 2018, with growth of just 0.4% forecast. We do expect to see real income growth stage a modest recovery from 2018, as the inflationary effects of sterling's drop fade, though households' purchasing power will remain under pressure from the ongoing freeze in most working age benefits. receives some further support. However, we expect annual growth in household incomes to average only a modest 0.8% from 2018 to 2020, less than half the 1.8% averaged from 2000 to 2015. Growth in consumer spending is expected to be marginally stronger over the same period, at 0.9%, implying some stability in the household saving ratio, albeit at historically low levels. But as with real incomes, this would be a very disappointing rate by historical standards – since 2000, the annual norm for consumer spending growth has been 2%.

[18] BBC News, '*State pension triple-lock should be scrapped, say MPs*', 6 November 2016. http://www.bbc.co.uk/news/business-37871681

6. Conclusion

Having enjoyed what could reasonably be described as boom conditions in 2016, consumer spending, while not heading for bust this year, certainly faces the ingredients for a sharp slowdown. Inflation will be the key culprit, cutting off what has been an all-too-brief revival in real pay growth and continuing the dismal picture for earnings, historically speaking, seen since the financial crisis. And what has been an important prop to income and spending growth – rising employment – is set to largely disappear.

Admittedly, the squeeze on spending compared to the last time the UK experienced a period of elevated inflation in 2010-11 is set to be much less. In that period, VAT increased by 5 percentage points in the space of just over two years and the price of oil was well over $100 per barrel, contributing to CPI inflation breaching 5%. And non-income factors, such as rising household wealth, should ensure that the slowdown in spending growth is less abrupt than the weakening in real incomes.

But support from factors such as rising wealth and dividend payments will overwhelmingly accrue to the better-off. Lower paid households will be disproportionately hurt by rising inflation and welfare cuts while rises in the NLW will support this group by less than appears at first sight. So as things stand, it is a downbeat outlook for the consumer sector and particularly gloomy prospects for those toward the bottom of the income distribution.

EY | Assurance | Tax | Transactions | Advisory

Ernst & Young LLP

www.ey.com/uk

About EY

About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. ITEM's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

Uniquely, ITEM can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.