# Deeper impact

## The importance of real disposable incomes

Trevor Williams considers if slowing the economy now could have a bigger impact going forward

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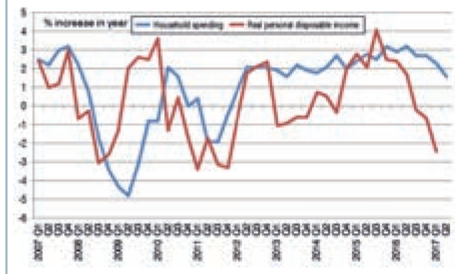
Real personal disposable income figures sometimes do not get the attention they deserve. After all, the data are critical to how much is left – after income is adjusted for inflation and tax – for households to spend or to save. And consumer spending is by far the most significant component of the expenditure measure of the UK's Gross Domestic Product (GDP), a key measure of economic growth.

In 2016, consumer spending accounted for 66% of this version of GDP, far outstripping government spending of 19% and gross fixed capital formation (investment) of 16.5%. Thus, this primary determinant of consumer spending – household income, and in particular what households have left over to spend in real terms – is often not given the attention it deserves.

**Chart A** illustrates the point that it is real personal disposable income that drives consumer spending. When real personal disposable income growth slows, consumer-spending growth slows, and vice versa. When real personal disposable income growth turns negative, i.e. income falls in real terms, then typically consumer-spending growth either slows sharply or falls outright. The chart shows that consumer spending followed real personal disposable income into negative territory in the recession of 2008's second quarter and the fourth quarter in 2009.

**Chart A:** UK real personal disposable income drives consumer spending



When real personal disposable income dropped again between 2010's second quarter and 2011's final quarter, consumer spending also followed it into negative territory. And yet, the negative signal sent by the fall in real incomes between the first quarter of 2013 and the final quarter in 2014 was ignored by consumers, who continued spending.

### Negative territory

Now, real personal disposable income growth is negative again and has been since the third quarter of 2016, just three months after the EU referendum. For the fourth time since 2007 therefore consumer-spending growth has been negative. Will consumer spending follow it into negative territory this time?

As has been said, while it appears accurate that at times of weak growth in real disposable income people can still maintain spending by cutting back on saving or selling assets, that can only go on for so long and depends on the buffer that savings offers people to maintain spending. In other words, if savings rates are high people may have enough in the kitty to run them down for some time before cutting back on spending, but eventually if real disposable income keeps falling people will have no recourse but to cut, especially at the aggregate level.

The disaggregated analysis seems to show that some people have more savings than others

and so not everyone will have enough savings to draw on if incomes fall. Many people are highly dependent on what they earn each week or month to maintain their spending. Indeed, some estimates suggest that up to 50% of those in work have little or no savings to fall back on if incomes are stressed.

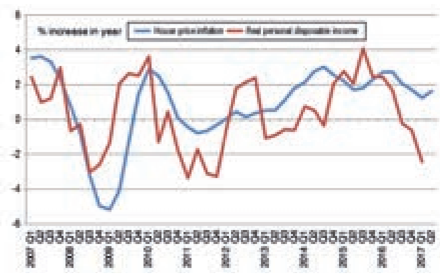
## Avoiding an economic stall

Why is real personal disposable income of particular importance now? The reason is that with the Bank of England monetary policy committee (MPC) on the cusp of raising interest rates, real personal disposable income is sending something of a warning sign against doing too much. The economy has expanded by 0.3% in each of the first two quarters that we have data for so far this year, and evidence suggests that something similar may be in store for quarters three and four. If consumer spending were to fall, then the economy could stall.

One reason that a fall in real personal disposable incomes is significant is because it has a broader impact on the economy than just the direct link to consumer spending.

It could lead to a fall in house prices, which in turn could hit consumer confidence and so lead to more caution in cutting back on saving to maintain spending, thus amplifying any economic slowdown from the direct impact on incomes. **Chart B** shows just how closely house prices and real personal disposable incomes are linked.

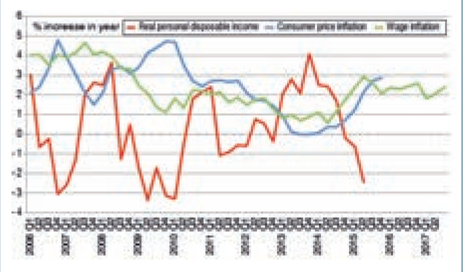
**Chart B:** Real personal disposable incomes also drive house prices



It is also important to note that with wage inflation slowing to 2% a year, as price inflation is peaking at about 3%, the current negative growth of real personal disposable income will likely persist into 2018. **Chart C** highlights that whenever wage inflation falls below price inflation, real personal disposable income growth tends to become negative or decline. This is what is occurring now.

Next year, price inflation will ease back as the fall in the exchange rate drops out of the annual comparison. And though this will result in a rise in real personal disposable income, the decline in the economy in the interim that could arise from an increase in interest rates this November could mean that the move was unnecessary. The risk is that by slowing the economy more than otherwise – by raising borrowing costs and hitting incomes – it could make the eventual fall back in inflation even more pronounced, raising questions about the judgment of the Bank of England and whether rates should be cut in 2018. ■

**Chart C:** The relationship between incomes, wages and prices



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