

UK ECONOMICS FOCUS

15th Jun. 2009



Editors: Roger Bootle and Jonathan Loynes

Why is retail spending so strong?

- **One of the puzzles of this recession is why consumer spending on the high street is so much stronger than spending off it.** The credit crunch driven nature of the slowdown appears to have played a key role in this. **But as the weakening labour market starts to have a broader impact on household incomes, we expect the weakness in consumer spending to become more widespread.**
- We think that there are four main reasons why retail sales growth is outpacing non-retail spending growth to such an unusual degree. (In previous recessions, they have slowed in tandem.) First, the published figures may be giving a misleadingly strong picture of high street sales. Second, retailers have cut prices particularly sharply relative to the non-retail sector.
- Third, the relative “cyclicality” of the retail and non-retail sectors may have changed. While a trip to the high street has become a staple part of everyday life, the share of non-retail spending that is discretionary – and vulnerable to cut-backs – has been increasing.
- **Fourth, and perhaps most convincingly, the credit-crunch driven nature of the slowdown seems to have affected non-retail spending particularly hard.** The simplest version of this argument is that tighter credit conditions have hit car sales – a key part of the non-retail sector. But non-retail spending has also been weak in other areas that have not been directly affected by the credit crunch.
- **Accordingly, the credit crunch may also have hit non-retail hardest because of how it has affected different types of people.** The economic uncertainty associated with the credit crunch may also have dented (primarily off-high street) purchases that require advance booking or instalment payments.
- **Looking ahead, it seems unlikely that such a big divergence between spending on and off the high street will persist.** The deteriorating labour market means that the slowdown is becoming far more than just a credit crunch phenomenon, implying that a broader range of people and sectors will soon start to be affected.
- **Admittedly, we would not rule out further high street resilience in the very near-term. But the big picture is that we expect *both* retail and non-retail spending to see a period of significant and prolonged weakness over the next couple of years.**

Vicky Redwood

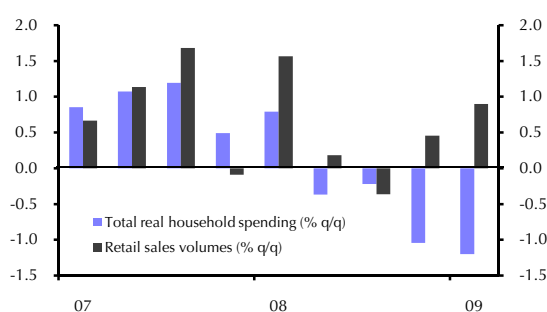
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Why is retail spending so strong?

A look at the high street suggests that consumers are still happy to spend. But while retail sales volumes rose by some 0.9% in Q1, total real consumer spending fell by 1.2%, the biggest drop since 1980. (See Chart 1.) Accordingly, spending off the high street appears to have been plummeting. In this *Focus*, we look at what is behind this divergence between spending on and off the high street. Is it usual in a downturn? If not, why is it happening this time? And will it continue?

CHART 1: REAL RETAIL SALES & TOTAL CONSUMER SPENDING (% Q/Q)

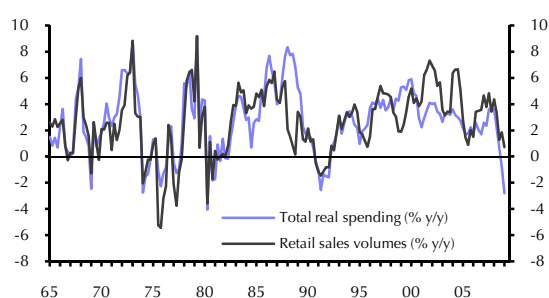


Source – Thomson Datastream

The puzzle

A look back at the past suggests that it is certainly not normal for retail sales to outperform overall consumer spending in this way.

CHART 2: REAL RETAIL SALES & TOTAL CONSUMER SPENDING (% Y/Y)



Source – Thomson Datastream

Chart 2 shows annual growth of real retail sales and overall spending and clearly illustrates how, in

previous recessions, the two slowed closely together. (Table 1 shows what makes up both retail spending and other spending.)

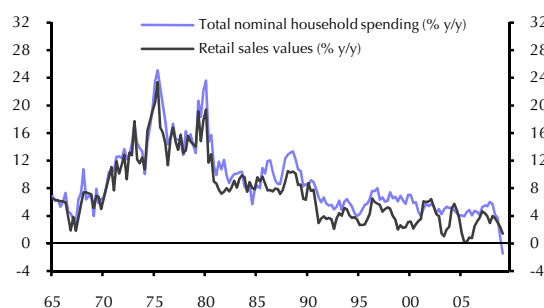
TABLE 1: RETAIL & NON-RETAIL SPENDING

Retail	% total spending	Non-retail	% total spending
Food & drink	9	Housing (rent, bills)	17
Alcohol & tobacco	4	Household services (e.g. cleaners)	<1
DIY goods	1	Health services	1
Furniture etc.	5	Car sales	5
Health goods	1	Transport	9
Phones	<1	Post & phone bills	2
Rec. goods (e.g. tvs.)	8	Rec. services (e.g. theatre)	4
Misc. (e.g. jewellery)	3	Education	2
		Hotels & rest.	12
		Misc. (e.g. fin. Serv.)	9
Total retail	37	Total non-retail	63

Source- Capital Economics & Thomson Datastream

Of course, what matter for firms' bottom lines is not real, but nominal spending. Yet Chart 3, showing both sales and overall spending in nominal or cash terms, paints a similar picture.

CHART 3: NOMINAL RETAIL SALES & TOTAL CONSUMER SPENDING (% Y/Y)



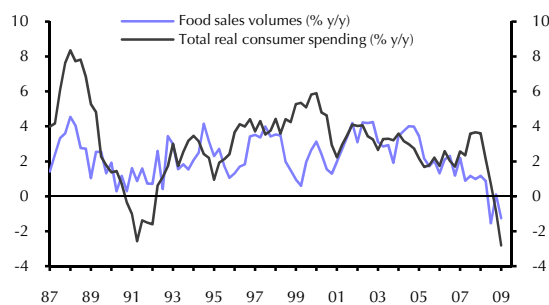
Source – Thomson Datastream

What's more, the strength on the high street has somewhat unexpectedly been driven by the non-food sector. Normally food is the part of the retail

sector that does relatively well during a recession, as people eat out less. And supermarkets have certainly been doing their best to make the most of this trend, with promotions such as “dine in for £10.” Indeed, they have recently been reporting pretty strong revenues growth.

However, revenues have been boosted by high food price inflation. In *volume* terms, food sales have actually been rather *weaker* than in previous recessions. (See Chart 4.) No doubt this is partly because people are responding to higher food prices by reducing the amount of food they waste.

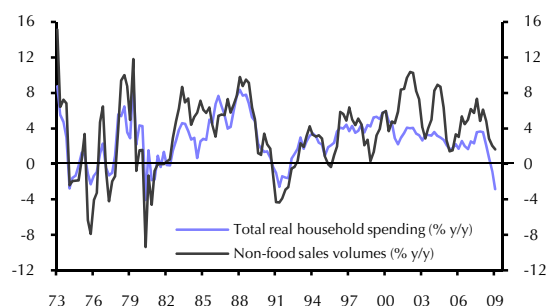
CHART 4: SALES IN FOOD STORES & TOTAL REAL CONSUMER SPENDING (% Y/Y)



Source – Thomson Datastream & Capital Economics

The result is that the gap between overall spending and *non-food* sales is even bigger than that with overall sales. As Chart 5 shows, in all of the past three recessions, non-food sales have fallen further than overall spending. This time around, however, they have actually kept *rising*, even as total spending has fallen.

CHART 5: SALES IN NON-FOOD STORES & TOTAL REAL CONSUMER SPENDING (% Y/Y)



Source – Thomson Datastream

As the year has progressed, each release of another strong figure has prompted suggestions of one or another temporary factor that might explain the strength in that month – from sunny weather to the later timing of Easter. But the fact that high street spending growth has now been outperforming for several months suggests that there is something rather more fundamental going on.

So what explains it?

So what is going on? There are four main factors that we can think of to explain this divergence between retail sales and the rest of consumer spending.

1. The published numbers are simply giving a misleading picture of the strength of the high street.
2. Retailers have been more aggressive than usual in cutting prices, relative to services sector firms.
3. Non-retail spending has become more discretionary over time, while retail sales have become less discretionary.
4. The credit crunch has disproportionately affected the non-retail sector.

We do not think that the whole story lies solely with any one of these explanations. But, taken together, we think that this combination of factors provides a fairly good explanation for why the high street has held up so well relative to the rest of spending.

1. The published numbers are misleading

Given the widespread suspicion regarding the reliability of the official retail sales figures, perhaps the most obvious explanation for the surprising resilience of sales growth is that the published sales numbers are giving a misleadingly strong picture of actual spending on the high street.

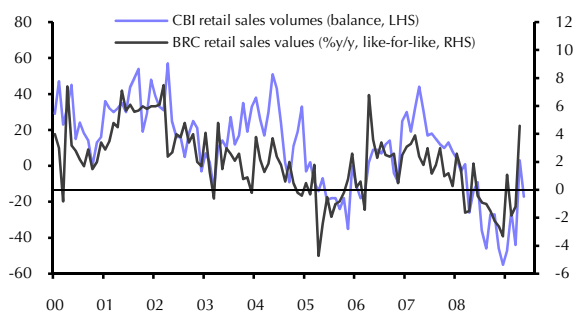
Retail analysts have long been sceptical of the official retail sales figures and, in particular, the way reported revenues are translated into seasonally adjusted, volumes estimates of sales.

And the resilience of the official sales figures towards the end of last year, when anecdotal evidence was dire, only increased this suspicion.

What's more, the ONS has done itself no favours more recently. First, it cautioned in January against the reliability of its seasonal adjustment process. And then in May it revised down its previous estimates of sales volumes due to a change in methodology. **We would therefore not be surprised at all if, in the future, we saw further downward revisions to previous estimates of sales growth.**

That said, we do not think that this is the whole, or even a major part of, the story. After all, alternative measures of high street spending, such as the retail surveys published by the BRC and CBI, have also suggested that the trend in sales growth has picked up (even accounting for Easter distortions). Admittedly, the BRC survey measures sales values, which will have been boosted by high food price inflation. However, its measure of non-food sales, which it has recently started to publish, has also picked up. And the CBI survey, which measures sales volumes, has also improved. (See Chart 6.)

CHART 6: BRC & CBI MEASURES OF RETAIL SALES (% Y/Y)



Source – Thomson Datastream

Accordingly, the divergence between retail and non-retail spending may not be quite as big as the official figures suggest, but it certainly still exists.

2. Price-cutting by retailers

Assuming, then, that the resilience of high street spending is more than just a statistical mirage, it

could reflect the fact that retailers, at least in the non-food sector, have been quicker than firms in the rest of the consumer sector to cut prices. Chart 7 shows the gap between the non-food retail sales deflator and overall CPI inflation. This has been on a generally widening trend since the late 1990s, but the trend clearly accelerated once the economy began to slow at the start of last year.

CHART 7: NON-FOOD RETAIL SALES DEFLATOR MINUS CPI INFLATION



Source – Thomson Datastream

That said, the gap has narrowed again since the start of this year. Even assuming that it might take some time for consumers to adjust their spending to a change in relative prices, the narrowing in relative prices should surely have affected spending patterns by now. What's more, there is no reason why consumers necessarily had to respond to relatively cheaper prices on the high street by buying more retail goods. They could just have used the money saved to spend away from the high street or to buy financial or housing assets. In other words, it does not explain why retail sales values have also been growing strongly.

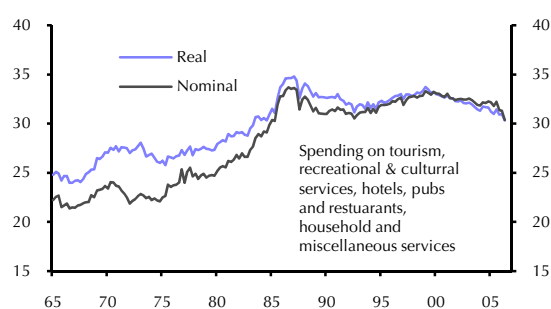
3. Retail has become less cyclical & non-retail has become more cyclical

An alternative reason which might explain why the high street has performed so much better than non-retail spending is that the relative cyclicity of the two sectors has changed. In other words, the retail sector has become *less* responsive to the economic cycle, while non-retail spending has become *more* responsive.

For a start, it is possible that retail spending has become less cyclical. This might be because a trip to the high street is seen as more of a staple part of everyday life than a luxury experience which we cut back on. Indeed, this might explain why retail sales growth outpaced overall spending growth during the “good times” between 2000 and 2005. (See Chart 2 again.) Although part of this was related to the housing boom – which boosted household goods – and so was only likely to be temporary, it is notable that other sectors like clothing saw unusually strong sales growth too.

At the same time, the non-retail sector might have become more cyclical. As we get richer, we tend to spend more of our extra money on services, rather than high street goods (although this trend came to halt during the retail boom in the past few years). Chart 8 shows that, over the past twenty years, the discretionary parts of spending off the high street have increased from 25% of all non-retail spending to 30%. This therefore means that there is perhaps more scope than in previous recessions to cut back on non-retail spending when times get tough.

CHART 8: DISCRETIONARY NON-RETAIL SPENDING (AS A % OF ALL NON-RETAIL SPENDING)



Source – Thomson Datastream

4. The impact of the credit crunch

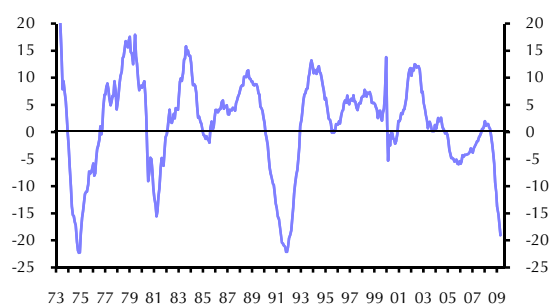
The last, and perhaps most convincing, explanation for the divergence between spending on and off the high street is the different nature of this downturn compared to those in the past. In particular, this recession has been driven by an unprecedented tightening of credit conditions.

The simplest version of this argument is that tighter credit conditions have meant that demand for big-ticket items has been disproportionately affected. And cars – a key part of spending off the high street – are the biggest-ticket items of all, with around 50% of new cars bought on finance. New car registrations in the private sector were falling at an annual rate of 45% at their low-point in November.

However, this does not seem to be the whole story. For a start, significant parts of the retail sector – such as sales of white goods – are dependent on the availability of finance too. The credit crunch should also have had *indirect* effects on the retail sector, via its impact on the housing market and thus demand for household goods. Accordingly, the credit crunch should not have left the high street unscathed.

Secondly, car sales are always very cyclical and in fact do not seem to have been affected any worse than in previous recessions. Chart 9 shows the three month average of the annual growth rate of total new car registrations (we do not have long run data on the private market, so the chart includes company and fleet cars). Registrations have recently been falling at a rate of 20%. But they fell even more in the mid-1970s and early 1990s. This could be because the sharp rises in interest rates in previous downturns had pretty much the same effect in choking off demand for cars as the recent tightening of credit conditions.

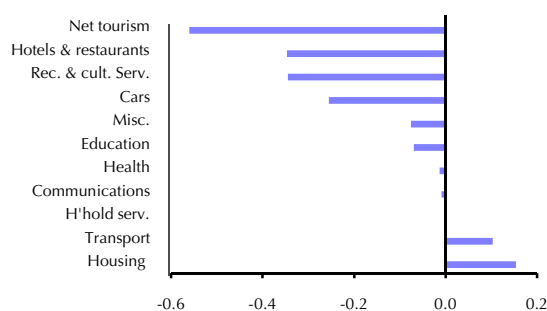
CHART 9: TOTAL NEW CAR REGISTRATIONS (% Y/Y)



Source – Thomson Datastream

Lastly, cars account for only 5% of overall spending anyway. To explain the weakness of total non-retail spending, other sectors must have played a role too. Indeed, Chart 10 shows the contribution of different sub-sectors to the 1.4% drop in real off-high street spending in Q4. (We do not yet have the breakdown of spending in Q1.) Net tourism, hotels and restaurants and recreational and cultural services (e.g. theatres, gyms) actually each accounted for more of the drop in spending than car sales. And these sectors have clearly not been affected *directly* by the credit crunch.

CHART 10: CONTRIBUTIONS TO 1.4% DROP IN REAL NON-RETAIL SPENDING IN Q4 (% POINTS)



Source – Thomson Datastream

The direct impact of tighter credit conditions on consumer spending therefore does not seem to be a particularly convincing reason for why non-retail has performed so much worse than retail spending. However, the credit crunch could also have had a couple of more subtle effects.

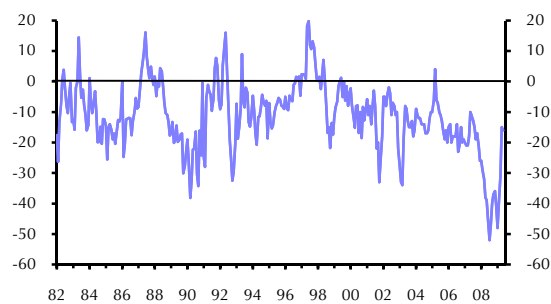
First, the credit crunch-driven nature of the downturn could mean that the types of people who have been worse affected are those who spend a greater share of their income off the high street. Meanwhile, those people who have been relatively unaffected – or are even better off as a result of falling inflation and mortgage rates – might be more inclined to spend cash on the high street.

Admittedly, it's hard to find data either to prove or disprove this point. Nonetheless, it seems plausible that the relatively well-off middle-class households who tend to spend a relatively high share of their

income on services have had their confidence disproportionately dented by falling house prices and reduced access to equity withdrawal. Meanwhile, young people who are waiting to get on the property market and are made better off by house price falls (although they now need to save more to get a high enough deposit) might feel better off. And they generally spend a high share of their income on clothing and gadgets, areas of the high street which have been doing well.

Second, the unprecedented nature of the credit crunch and, in particular, worries about the solvency of the banking system, have prompted an unusually sharp drop in consumer confidence in the past few months. For a while, there was speculation that we were heading for another *depression*, with confidence in the economic outlook over the next 12 months plunging well below the levels seen in the 1990s recession. (See Chart 11.)

CHART 11: CONSUMER CONFIDENCE IN THE ECONOMIC OUTLOOK (NET BALANCE)



Source – GfK/NOP

This uncertainty could have disproportionately affected the non-retail sector, where purchases are more likely to involve a long-term finance agreement (e.g. cars), instalment payments (e.g. gym membership or satellite television subscription) or booking in advance (e.g. holiday and travel). In contrast, high street sales are just a one-off purchase and so require less certainty in the future.

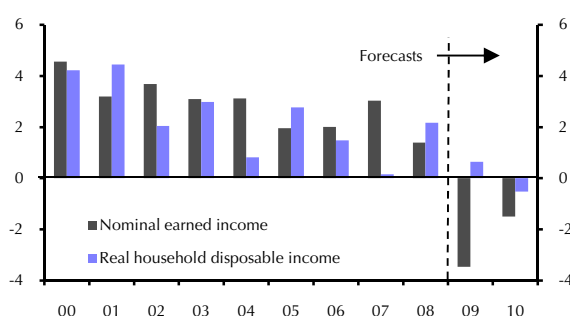
Shape of the consumer downturn to change

Of course, when it comes to whether the recent wedge between retail and non-retail spending growth persists, what matters is what happens to these factors going forward. And given our conclusions so far, **we think there's good reason to think that the gap could, if not narrow fully, come pretty close to it.**

For a start, the high rates of import price inflation mean that retailers could find it hard to keep cutting high street prices aggressively. Although imported *food* price inflation is now on a downward trend, inflation of other imported consumer goods has yet to fall much. While we expect overall core inflation to ease over the next couple of years, there is no reason why that should not be driven primarily by weakening inflation in the less import-intensive services sector.

But perhaps more importantly, what was initially a credit-crunch and housing driven downturn is now evolving into a more "typical" consumer downturn. The key aspect of this looks likely to be a severe squeeze on households' incomes. Part of this will be due to the weakening labour market, in terms of both rising unemployment and slowing pay growth. But also important further ahead will be the major fiscal consolidation that is looming. Whether that is achieved through higher taxes or lower public spending (affecting the average pay of the public sector or the numbers employed), the result will clearly be lower household incomes.

CHART 12: REAL HOUSEHOLD DISPOSABLE INCOME (% Y/Y)



Source – Thomson Datastream

As a result of these factors, we expect real household incomes to fall next year for the first time since 1977. (See Chart 12.) **All of this suggests that a much wider range of people and sectors will soon start to be affected by the recession.**

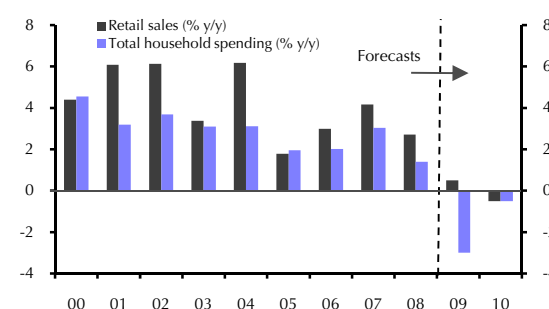
In addition, we still think that the household saving rate has further to rise. The saving rate has already risen from around zero to 4.8% in Q4 and possibly higher since then. However, we think that eventually it will get into double digits. And while the rise has so far been driven by a slowdown in borrowing growth (and housing equity withdrawal in particular), a rise in conventional saving into financial assets is likely to play an increasing role – again perhaps encompassing a wider set of people.

Conclusions

The upshot is that we remain pretty pessimistic about the outlook for all of consumer spending. (See Chart 13.) The strength so far this year means that retail sales are unlikely to fall as sharply as the 3% drop we expect to see in overall real consumer spending. In fact, it is not inconceivable that sales volumes *rise* in 2009 as a whole.

But next year could look rather different. We expect total consumer spending to fall again in 2010 by around 0.5%. (As part of the revisions we made to our GDP forecasts last week, we revised up our forecast of spending in 2010 from -1.5% to -0.5%). And we think that retail sales will fall by a similar amount – or possibly even more. **After a temporary respite for the high street, tougher times lie ahead.**

CHART 13: REAL CONS. SPENDING & RETAIL SALES (% Y/Y)



Source – Thomson Datastream