

UK ECONOMICS UPDATE

15th Aug. 2011

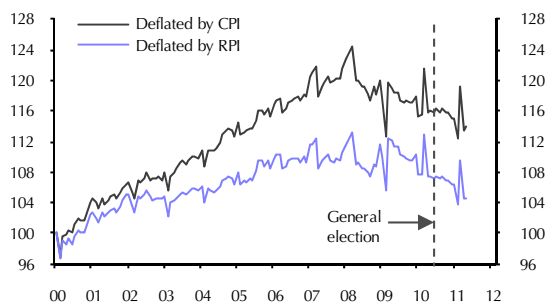


What consumers need most is lower commodity prices

- It is often assumed that the fiscal squeeze is driving the current weakness of consumer spending and that government measures – such as a VAT cut – are all that are needed to get the consumer recovery back on track. But real pay began to fall long before the austerity measures kicked in. The bigger squeeze on real pay over the past few years has come from rising food and energy prices, suggesting that what consumers need most of all is a sustained fall in commodity prices.
- Admittedly, the austerity measures have been building up. January's VAT rise was largely passed on by retailers and has cost consumers about £7bn. The 150,000 or so fall in public sector employment has knocked about £2.5bn off incomes. The public sector pay freeze has reduced pay by about £1bn since April and the tax and benefit changes introduced at the same time have knocked off another £0.6bn.
- In total, the fiscal squeeze has probably cost consumers just over £10bn since the coalition got into power a year or so ago. **But this is no more than the cost to households over the last year of the rises in commodity prices.** We think that rising petrol prices have cost consumers about £4bn, utility price rises about £1.5bn and food prices a further £5bn or so. On top of that, higher commodity prices will have had a wider impact on the costs and prices of other goods and services (such as restaurant meals).
- **What's more, the deterioration in real incomes began, not at the start of this Parliament, but three or four years ago.** Real gross average earnings have fallen by 2% since last June. But since their peak at the start of 2008, they have fallen by some 8.5%. (See Chart 1.)
- Fiscal tightening measures introduced by Labour explain some of the earlier fall in disposable incomes. The 50% income tax rate and removal of the personal allowance for high earners in April 2010 cost households about £2bn. **But the bigger impact has come from rising commodity prices.** (See Chart 2.) We estimate that higher petrol prices have cost consumers an extra £12bn since they started to rise in 2007. Over the same period, utility price rises have cost them £13bn and food price rises about £25bn.
- Commodity price rises are also likely to be the more immediate concern for consumers over the next few months. The utility price rises just announced will cost households an extra £6bn or so a year.
- **What consumers really need, then, is for commodity prices to drop sharply and permanently.** This has the scope to do incomes far more good for than a temporary VAT cut – which might not be passed on by firms anyway. Food, utilities and petrol account for about 20% of consumer spending. **Other things equal, then, a sustained 10% drop in food and energy prices would boost real income growth by about 2%** - more than offsetting the 1.5% or so drag on real incomes from the fiscal squeeze this year. In this light, the drop back in oil prices over the last fortnight has been moderately encouraging.
- **That said, even a recovery in real pay might not help spending to rebound. Households have still made only limited progress in deleveraging and raising their saving. If any rise in income is channelled into repairing balance sheets, spending might take rather longer than incomes to recover.**

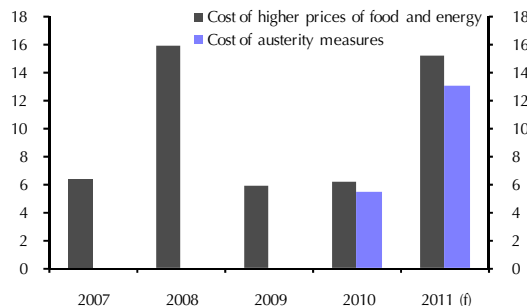
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Chart 1: Real Average Earnings (Jan. 2000 = 100)



Source – Thomson Datastream

Chart 2: Cost to Households of Commodity Price Rises vs. Austerity Measures (£bn, relative to previous year)



Source – Thomson Datstream