BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

29 February 2012

From retailers' paradise to shoppers' strike: what lies behind the weakness in consumption? – speech by Martin Weale

In a speech delivered at Cass Business School, Martin Weale – External Member of the Monetary Policy Committee (MPC) – reflects on the relative weakness in consumption over the recent period of recession and stagnation. He discusses a number of factors relevant to consumption, including monetary policy, age effects, unemployment and social security reform, and quantifies the influence of some of these on consumption patterns. He concludes with some thoughts on the implications for monetary policy.

Weale begins by reviewing recent data and the relationship between income and consumption. If consumption is an indicator of future income, then recent data may point to further weakness in income to come. At the end of last year, real consumption per capita in the second half of 2011 was over 8 percent below its 2007 peak, and over 18 per cent below its pre-crisis trend. Weale reflects that the adjustment in consumption over the past few years has been more gradual than might have been expected and provides some possible reasons why this may be the case. First, that it has only become clear gradually how large the adverse shock to incomes has been since the financial crisis; secondly, people may continue to follow their habits and therefore not adjust their spending patterns initially; and thirdly, by rapidly cutting Bank Rate, the MPC encouraged consumers to replace future consumption by spending now. Weale also asserts that the Bank's asset purchases have provided support for consumption through their effects on asset values.

Weale then goes on to explore some of the factors weighing down on consumption. Age effects are addressed first. Weale discusses the fact that real wages of young adults have fallen more than those of people close to retirement since the crisis. He concludes that the crisis may affect the consumption of young adults more than that of old people; consumption by young adults depends mainly on current levels of and expectations of future wage income. In contrast, people close to or beyond retirement will expect to finance most of their subsequent consumption out of accrued wealth and will not find themselves affected as much by adverse movements in wage rates or employment opportunities.

Weale goes on to consider whether uncertainty could be a factor depressing consumption relative to income. In particular, Weale focuses on the risk of unemployment and the impact that risk might have on people's saving behaviour. He concludes that the effects of unemployment can be substantial but the influence of a

rise in unemployment fades over time. Once unemployment stops rising, the upward pressure on the savings rate from this source is likely to ease.

The state benefit system is likely to have a substantial impact on household savings behaviour, Weale asserts. First, the payment of state pensions to old people reduces the need to save for retirement; and secondly, the benefits system available to people of working age provides a back-up in the event of unemployment or ill health. Weale focuses on exploring the effects on savings behaviour of increases in the state pension age. Specifically, Weale analyses the short-term effect of an unanticipated announcement of an increase in the state pension age from sixty-five to the pattern of pension ages which emerged after the changes in 2011. His simulations show that such an increase has little impact on saving until people reach their early 40s. Overall, he states that one would expect to see savings rates around one percentage point higher than they would have been without the change. Whilst acknowledging that other factors will of course have an impact, Weale concludes that “changes to social security can have a non-trivial influence on saving and might lead us to expect a savings rate higher than we have seen in the past.”

Finally, Weale looks at housing, wealth and the availability of credit. He argues that both a tightening of the conditions on which credit is available and a fear that people will not be able to obtain credit in the event of an adverse shock to their income, will lead to an increase in saving. Tight credit has the effect of making consumption more sensitive to income and less sensitive to interest rates than it might otherwise be. However, looking at the Bank’s Credit Conditions survey Weale doesn’t think the tightness of credit has worsened since the early days of the financial crisis.

Weale concludes that his analysis of the various factors affecting private consumption “...represents a downside risk to the medium-term growth projections in our recent Inflation Report. Such a downside risk may not, of course, materialise, and does not automatically translate into a presumption that inflation will be markedly lower than the Report indicates.” Weale observes that recent indicators of economic activity have been positive and expresses concern about the persistence of inflation. Overall, he does not at present see any case for extending the asset programme further and notes that “the yield curve suggests that an increase in Bank Rate is not fully priced in until mid-2014. But, obviously, if the very real risks I see about inflation do materialise, then it is perfectly possible that the first rise will come earlier than that.”

Key Resources

From retailers' paradise to shoppers' strike: what lies behind the weakness in consumption?
http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech548.pdf
Full speech by Martin Weale