UK: Credit Where It Is Due

- **The dominant theme for economic growth in the UK this year is likely to be slower consumer spending growth. More specifically, we expect sharply higher inflation to erode household real disposable income growth, in turn holding back the pace of consumer spending growth. However, that is only the starting point. We suspect that credit growth and tourist spending will provide some support, meaning that the downside for growth is less severe than most people are assuming.**
- **Our more optimistic view of the consumer reinforces our above-consensus forecast for UK GDP this year (1.6-1.7% y/y vs consensus expectations for 1.4% y/y growth).**

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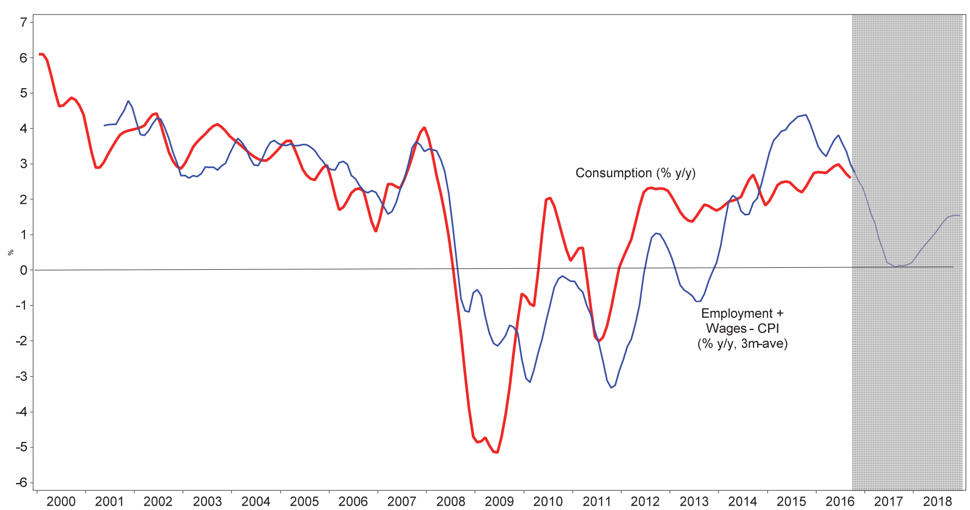
REAL DISPOSABLE INCOME GROWTH SLOWING

Pretty much everyone has downgraded their economic growth outlook for the UK since the Brexit vote. While a lot of commentary has focused on businesses shelving investment plans or freezing hiring, the most compelling reason for a slowdown is the surge in inflation. Chart 1 puts the situation into context. In very simple terms, the past year or so has seen close to 2% employment growth, coupled with 2% wage inflation, set against near zero CPI inflation. The net result has been real income growth of 4% y/y, which is roughly where consumer spending growth has been.

During 2017, we would expect employment growth to slow from 2% y/y to 1% y/y, wage inflation of around 2½% y/y, and inflation to continue rising from zero to around 3% y/y. The net result is that real income growth is virtually wiped out. In isolation, that would suggest that consumer spending growth should also be on a downwards glide path.

Chart 1: Real Disposable Income Proxy vs Household Consumption Growth



Source: Macrobond

However, this kind of framework is only a starting point. There have been a number of occasions in the past when the pace of disposable income growth and consumer spending growth have diverged. A good example was 2012-2013, when real income growth was negative, but consumer spending growth was maintained at a solid 2% y/y pace. This was possible at that time because the savings ratio fell (from over 9% down to just below 6%). In other words, consumers borrowed more (and/or saved less) in order to maintain the pace of consumer spending growth in excess of disposable income growth.

Clearly, it is possible that consumers will increase their borrowing over the coming year, helping to cushion some of the downside for spending growth. In addition, given the plunge in the GBP exchange rate, there is also the possibility that UK consumption growth will be augmented by a surge in inward tourist spending. We examine both below.

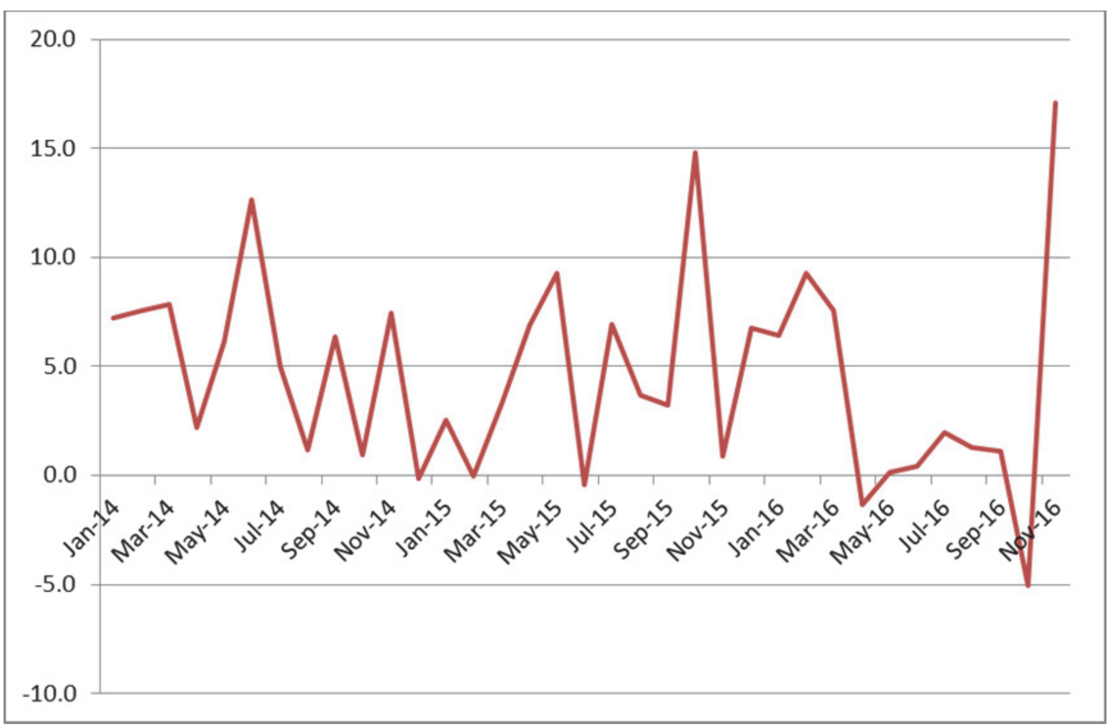
TOURIST SPENDING

One kneejerk reaction to the news that the Pound has weakened by 15-20% is that the UK will be inundated with overseas tourists. Similarly, the weakness of the pound 'should' make it less attractive for UK residents to want to travel abroad because it is 15-20% more expensive. We suspect that there is truth to both these assertions, but all in good time.

In practical terms, there is more than one reason to visit the UK from overseas. The official tourism statistics from the ONS show around 36 million individuals entered the UK over the past 12 months. Of those, around one third did so for holiday, a quarter for business and almost a third for visiting friends and relatives. Clearly, gyrations in the exchange rate can influence all three. Our assumption is that the effect would primarily affect holiday flows and visits to friends / relatives, while business trips are more likely to be linked to the buoyancy of the economy. Secondly, planning an overseas trip (especially a holiday) is not necessarily something that swathes of tourists are going to arrange within the blink of an eye.

Indications of what has happened to tourist flows since Brexit have been mixed. Chart 2 shows the % y/y growth rate of overseas visitors into the UK. Despite the anecdotal reports of overseas tourists flocking to the UK to snap up expensive watches, the growth rate of tourist flows was virtually stagnant for most of 2016 and, if anything, on a downward trend. However, the latest data for November showed a massive acceleration to over 17% y/y. It is yet to be seen whether that was a one-off or temporary. We suspect that a more sustained increase in tourist flows will become more obvious around summer-2017.

Chart 2: Number of Overseas Visits to the UK (% y/y)



Source: ONS

Figures from the ONS show earnings from overseas residents' visits to the UK over the past 12 months have amounted to almost GBP22bn. These too were on a downwards trend until the latest data for November. We could go on and on about the relationships between the exchange rate or the business cycle and gyrations in tourist spending and where in the UK that money gets spent. But at the end of the day, earnings from inward tourist spending represents less than 2% of nominal consumer spending. The non-business (potentially exchange rate sensitive) components of that are probably only half that amount. The point is that there would have to be a massive increase in inward tourist flows and spending to have a material impact on the official consumer spending data. So when it comes to deciding whether to aim higher or lower than the real disposable income growth relationship suggests, we are minded to aim higher because of increased tourist flows, but not by much at all.

CREDIT GROWTH

The latest consumer credit data attracted a number of headlines because the growth rate exceeded 10% y/y. The growth rate has been on an upwards path since 2010 (when growth was almost zero) and has now reached the highest since late-2005. Within that total, credit card loans outstanding grew by 8.7% in the past 12 months, while other loans grew by 11.6%. So clearly households are already supporting their spending growth via increased borrowing. The question over the coming year or so is whether consumer credit growth:

- will rise further, helping to maintain the pace of consumer spending growth and offsetting the impact of slowing real income growth;

- decelerates; reinforcing the impact of slowing real income growth and representing an even bigger blow to consumer spending growth;

- remains about the same; meaning that the path of real disposable income growth is still the best guide to the future path of consumer spending growth.

To be clear, these figures refer to unsecured consumer credit. Total lending to individuals is currently growing by a less elevated 4% y/y, with lending secured on dwellings growing by 3.1% y/y. However, this category of borrowing tends to be most heavily linked to turnover in the housing market, rather than a desire to finance current expenditure. Clearly mortgage equity extraction has been a source of support for consumer spending growth in the past, which we discuss below. To put the figures into context:

Consumer credit as a proportion of total lending to individuals:

- Total outstanding lending to individuals is GBP1,516bn

Of which

- Total lending secured on dwelling is GBP1,323bn (87% of total lending)
- Total unsecured consumer credit outstanding is GBP193bn (13% of total lending)

Consumer credit as a proportion of household spending:

- The level of consumer credit outstanding is equivalent to 16% of nominal consumer spending over the past 12 months.
- That is 0.5% points higher than over the prior 12 month period.
- So of the 2 percentage point acceleration in nominal consumer spending growth in the past year, one quarter of that could be attributed to the rise in unsecured consumer credit.

Big moves in consumer credit in the past:

- The biggest 1-year drop in consumer credit in recent memory happened during 2009.

- At that time, the level of credit fell by GBP15bn, or 7.4%.
- That GBP15bn fall in the level of consumer credit represented 1.6% of total nominal consumer spending.
- The point is that if the level of consumer credit were to suffer a similar sized setback, it would be likely to subtract between 1 and 2 percentage points more from consumer spending growth (above and beyond the subtraction implied by the fall in household real disposable incomes).
- By contrast, if the growth rate of consumer credit is maintained at close to the current pace, this would represent GBP15bn–GBP20bn additional cash on top of household disposable income.

What the above illustrates is that the consumer credit avenue could easily exacerbate or ameliorate the impact of the decline in real income growth on consumer spending. The current growth rate of just over 10% y/y may look high, but is still some way short of the near 15% y/y average growth rate that prevailed in the decade prior to the financial crisis. We suspect that there are amber warning lights flashing within the Bank of England regarding double digit consumer credit growth and some action will be taken. However, we doubt that this will come soon enough to lead to an abrupt deceleration in the pace of credit growth. Hence from the consumer credit perspective, we are inclined to aim higher for consumption growth this year than the indication given to us from real disposable income growth.

WEALTH EFFECTS

Not so long ago, the only thing you needed to know in order to forecast consumption growth in the UK (and ultimately overall GDP growth) was whether the housing market was trending up or down. Projecting the pace of real household disposable income growth was an afterthought.

More specifically, if the housing market (prices and turnover) was on a sharply rising trajectory, consumption growth would typically be accelerating (and more rapidly than disposable income growth) and vice versa. One mechanism which helped to facilitate this kind of behaviour was mortgage equity withdrawal (MEW). Essentially, when a property had risen substantially in value, the owners could tap into that capital gain by borrowing more. This increase in borrowing was used for a variety of purposes including paying off unsecured credit, buying cars, improving the home and so on.

So what has changed? The housing market crash of 2009 initially shut off access to this form of borrowing since home values dropped by 10–20%. More cautious behaviour by lenders, both of their own accord as well as in light of a more prudent regulatory system crimped this behaviour further. Indeed, some lenders are now only willing to facilitate mortgage equity extraction if the money withdrawn is used to improve the dwelling which is being borrowed against.

Last but not least, the housing market has been far less volatile. Past cycles saw house price inflation swing from double digit increases, down to double digit declines and back again. By comparison, house price inflation has been far more stable of late. Rather like the path of house price inflation, the profile for MEW has been far more stable in recent years. In the boom years, MEW represented as much as 4% of post-tax disposable income. When the housing market crashed in 2009, this exacerbated the slowdown in consumer spending growth, subtracting up to 4% of disposable income. That was an 8% swing in less than a year!

In the past 4 years, MEW has been negative, implying that households have (on average) been repaying mortgage debt. That may have been a response to super-low mortgage rates or rapid real disposable income growth, giving the opportunity for households to reduce their debt overhang. On average, MEW has been around GBP10bn per year. That is equivalent to almost 1% of nominal household consumption.

Faced with the dive in real disposable income growth that most forecasters anticipate, there is certainly scope for MEW to move from negative territory to at least zero. This would enable consumption growth to outpace real disposable income growth, at least temporarily. While we think that this will soften the blow to the consumer, we would be loath to assume that it completely offsets the headwind of rising inflation. In particular, house price inflation is likely to be on a downwards glide-path through 2017 given the indications from upstream indicators such as the RICS survey. Secondly, the tightening in credit standards implemented since the financial crisis suggests that this source of support for consumer credit is unlikely to boom back to life.

At the margins, it is also possible to argue that the buoyant performance of the equity market could also provide support for consumer spending growth. Indeed, during 2016, the FTSE all-share index rose by around 15%. That wealth gain could easily be used to supplement disposable income and maintain current consumption. However, that 15% y/y gain followed a double digit decline the prior year. Furthermore, we find that swings in equities have tended to have a pretty low correlation with overall consumption growth. The rationale is likely to be that equity investment tends to be for the longer run, rather than providing a buffer to smooth short-term fluctuations in disposable income.

The bottom line is that given the scope for the drop in MEW to come to an end, we are also minded to aim higher for consumption growth this year than the indication given to us from our real disposable income outlook.

CONCLUSION

Everyone has the same forecast for the UK economy, which typically means that things will not pan out exactly as expected. We expect the thrust of the forecast to be right, namely that the surge in inflation erodes household disposable income growth and hence consumer spending growth decelerates throughout this year. However, while a simplistic projection for real disposable income growth might suggest that consumer spending growth will grind to a halt this year, we are inclined to be a little more optimistic. We expect consumer credit growth to remain positive, helping consumers to maintain spending growth in excess of disposable income growth. Mortgage equity extraction has been negative in recent years. That represents paying down debt, which could be temporarily put on hold while disposable income growth suffers this year. Last but not least, while we expect tourist spending in the UK to increase, it represents a very small share of overall consumption and hence is unlikely to change the big picture.

Our more optimistic view of the consumer reinforces our above-consensus forecast for UK GDP this year (1.6-1.7% y/y vs consensus expectations for 1.4% y/y growth).

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