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Economics Revision Focus: 2004

AS Economics

Consumer Spending and Saving

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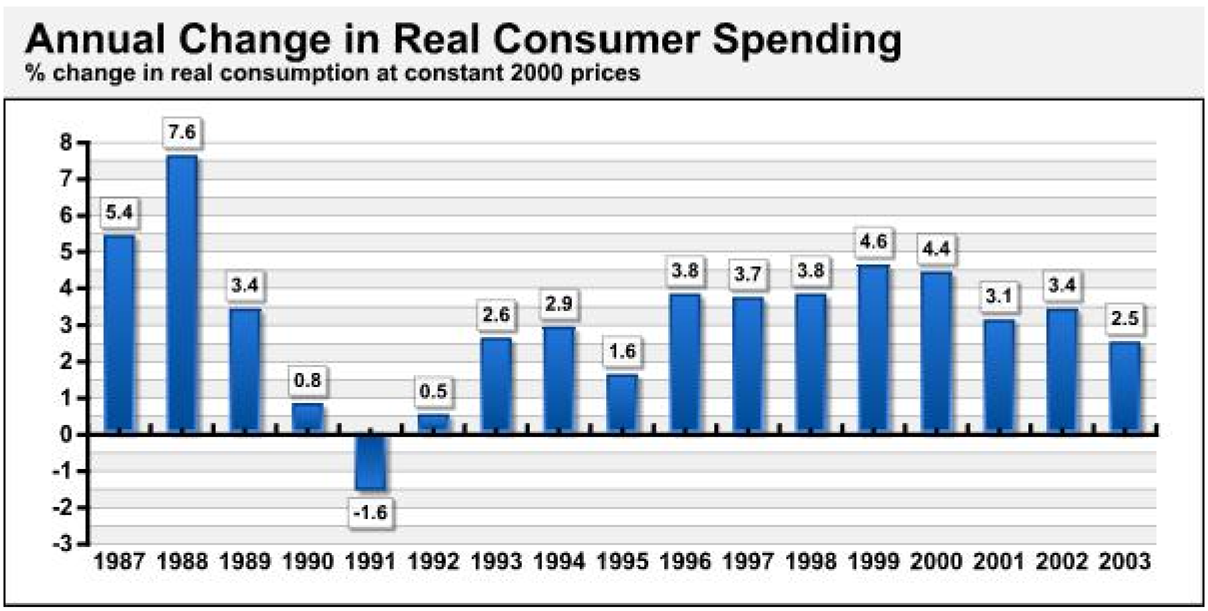
Revision Focus on Consumer Spending and Saving

AS Syllabus Requirements

Candidates should be able to explain and analyse the determinants of consumption as a component of aggregate demand. They should also be able to explain and analyse the determinants of savings

Consumer demand for goods and services

Consumption accounts for 65% of aggregate demand. There are many factors that affect how much people are willing and able to spend. It is important to understand these factors because changes in consumer spending have an important effect on the economic cycle.



John Maynard Keynes developed a theory of consumption that focused primarily on the importance of people's **disposable income** in determining their spending. A rise in real income gives people greater financial resources to spend or save. The rate at which consumers increase demand as income rises is called the **marginal propensity to consume**.

For example if someone receives an increase in their income of £2000 and they spend £1500 of this, the marginal propensity to spend is £1500 / £2000 = 0.75. The remainder is assumed to be saved – so the **marginal propensity to save** in this situation would be 0.25.

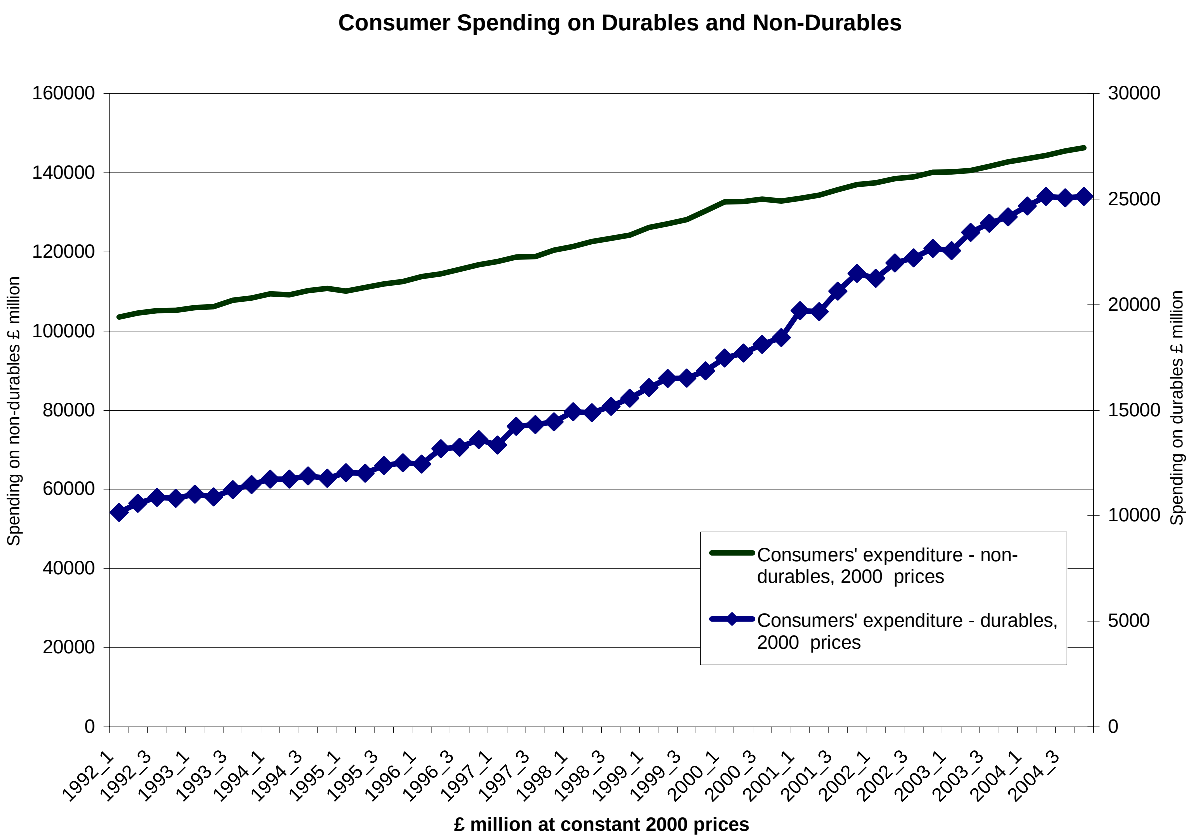
The marginal propensity to spend and save differs from person to person. Generally, people on lower incomes tend to have a higher propensity to spend. This has important implications when the government announces changes in direct taxation and the level of welfare benefits.

The key factors that determine consumer spending in the economy can be summarized as follows:

1. The level of real disposable household income
2. Interest rates and the availability of credit
3. Consumer confidence
4. Changes in household financial wealth
5. Changes in employment and unemployment

The strength of consumer spending has been one of the main reasons why the UK has avoided a recession in recent years – but at the same time, there are fears that household spending has been too high, and that much of it has been financed by a **surge in borrowing** leading to record levels of **household debt**. A large percentage of this demand has also fed into demand for imported goods and services, causing a sharp increase in the UK's trade deficit with other countries.

Spending on consumer durables and non-durables



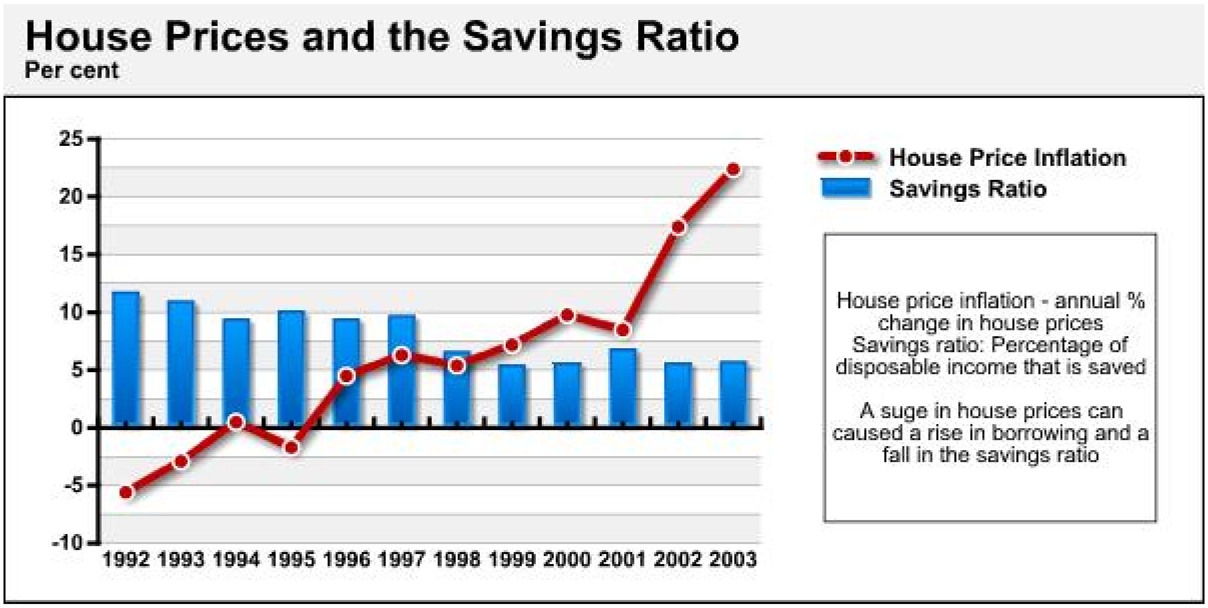
The chart above tracks the quarterly spending on consumer non-durables and durables. Non-durables include spending on food and drink, household services, transport, books and magazines etc. Durables include spending on new cars, household appliances, audio-visual equipment, furniture etc. The real level of spending on durables has surged in the last eight years.

Among the explanations are (i) falling prices for many durable products – arising from rapid advances in production technology and the effects of globalisation (ii) low interest rates which have encouraged people to spend more on "big ticket items" and (iii) pretty strong consumer confidence and borrowing levels. The demand for consumer durables is more **income elastic** than for non-durables which are usually staple items in people's monthly budget.

The Wealth Effect

Wealth represents the value of a stock of assets owned by people. For most people the majority of their wealth is held in the form of **property** (housing), **shares** in quoted companies on the stock market, **savings** in banks, building societies and money accumulating in **occupational pension schemes.**

There is a **positive wealth effect** between changes in financial wealth and consumer demand for goods and services. For example when house prices are rising strongly, consumer confidence grows and home-owners can also borrow some of the equity in their homes to finance major items of spending. In 2003, **mortgage equity withdrawal** surged to over £57 billion.



The Savings Ratio

Saving represents a decision to **postpone consumption** by saving out of current disposable income.

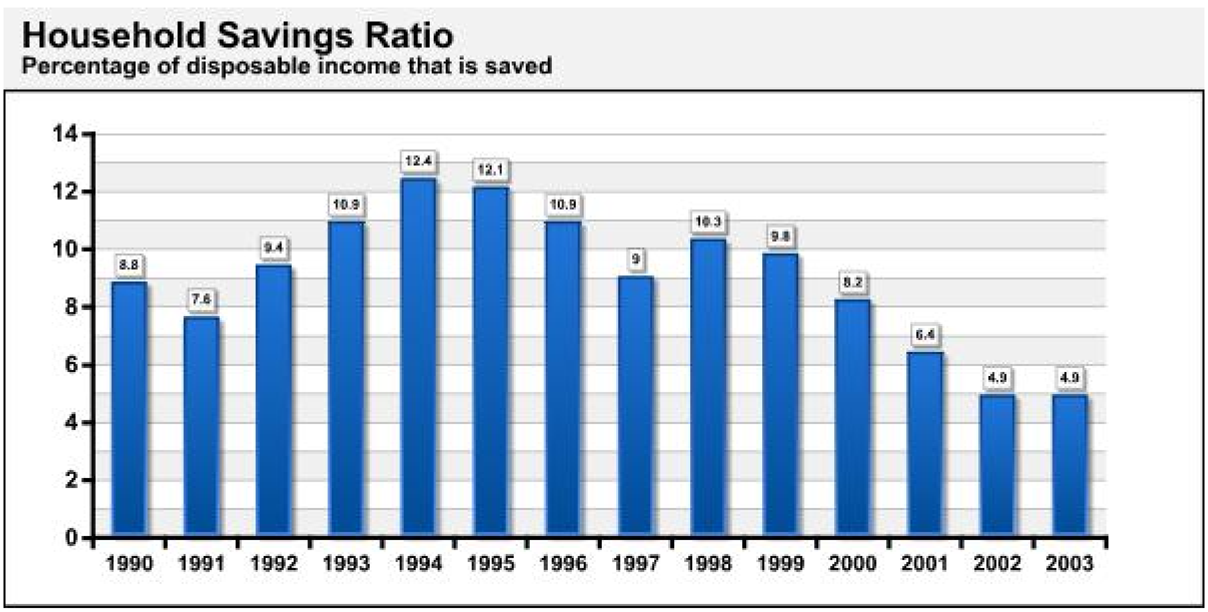
Why do people choose to save their incomes? There are many motivations for saving:

1. **Precautionary saving**: For example people save more because of a fear of being made unemployed. A nest egg of savings allows people to smooth their monthly and annual spending levels even when incomes are fluctuating
2. **Building up potential spending power**: Saving more now and defer spending today in order to finance major spending commitments in the future (e.g. saving for the deposit on a mortgage, a new car or a wedding). People are also becoming increasingly aware of the need to save in order to build up assets in occupational pension schemes
3. **Interest rates and saving:** There might be a greater incentive to save because of the incentives of high interest rates from banks, building societies and other financial institutions
4. **Inheritance**: Many people have a desire to pass on bequests to future generations
5. **Saving and the life-cycle of consumers**: Younger people are often net borrowers of money because they need to fund their degrees, purchase a property and expensive consumer durables. As people grow older, their incomes from work tend to rise and their spending commitments decline leading to an increase in net saving ahead of retirement

The savings ratio

The **household savings ratio** is measured as the level of savings as a percentage of disposable income. The savings ratio was high during the early 1990s partly as a result of the high levels of unemployment and also high interest rates. Savings were also strong because during the consumer boom of the late 1980s, people took on board a record level of debt, and this borrowing had to be repaid – therefore in the first half of the 1990s, millions of consumers were saving to reduce their debts, improve their own financial position and build up future purchasing power.

In recent years there has been a **fall in the savings ratio** in part because consumer borrowing has reached record levels, fuelled in part by the rapid acceleration in house prices. At some point the savings ratio will need to rise again as people rein back on their spending in order to repay debts on credit cards and other forms of secured and unsecured borrowing.



The Importance of the Savings Ratio

Savings provide a **financial safety net for households** and allow them to finance their regular spending even when income flows are volatile. A fall in the savings ratio means that households are choosing spending today rather than tomorrow. This may be accompanied by a build up of consumer debts which will have to be repaid at some point in the future.

Benefits of a high level of consumer demand	**Costs of a high level of consumer demand**
Strong consumption has helped the British economy to avoid a recession at a time when the European and global economy has been weak. The British economy has managed to weather the storms of the negative demand shocks created by the aftermath of the 2001 terrorist attacks and the collapse in international share prices	Much of the high level of consumption has been funding by consumer borrowing. The rising level of household debt poses long term risks for the economy – particularly if the UK goes into a recession or if interest rates have to rise to control inflation
The willingness of consumers to carry on spending has helped to maintain a high level of employment with claimant count unemployment remaining below 900,000 despite a slowdown in GDP growth	Partly because of the strength of the exchange rate, much of the increase in consumer demand had fed through into a high level of imports which has caused a large rise in the trade deficit in goods and services
Higher spending has helped to keep tax revenues strong for the government – providing much needed finance for the Government's spending priorities	Too high a level of consumption indicates an unbalanced economy and creates the risk of demand-pull inflation if the economy operates close to capacity