Standard Life Investments

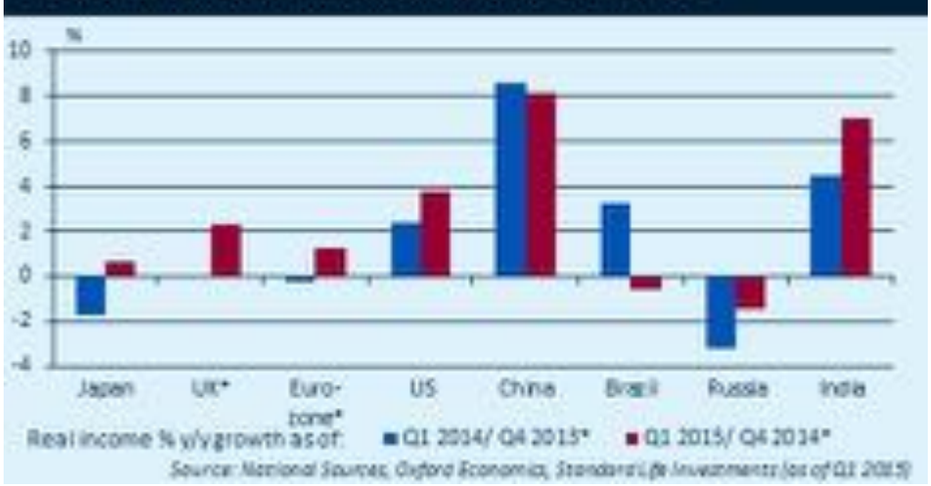
Weekly Economic Briefing
Global Overview

Real Income Support
19 May 2015

There has been a widespread increase in real household income growth across the developed economies since the beginning of 2014 (see Chart 1). Real income growth has risen from 2.4% to 3.8% in the US, from -1.6% to 0.7% in Japan (abstracting from the sales tax increase), from -0.2% to 1.3% in the Eurozone and 0% to 2.3% in the UK. There have been two main drivers of this improvement. Consumer price inflation has fallen significantly, mostly due to plunging oil prices, and nominal income growth is being pushed up by recovering labour markets. The second of these drivers is the most important for the longer-run growth outlook. The positive effect of lower oil prices will wash out of the numbers over the coming year, but further increases in employment and wages will provide a healthy platform for a sustained recovery in consumption. That is especially the case in Europe and Japan where real incomes had been under sustained pressure for many years, leaving the household sector in a precarious financial position. With interest serving costs also declining, particularly in the Eurozone, there is finally a catalyst to release pent-up demand across the economy.

The income picture in the large emerging markets is more mixed. In both Russia and Brazil, real incomes have declined over the past year. In Brazil's case, the deterioration of the economy against a backdrop of still-high inflation has been dragging purchasing power down. In Russia's, an increase in nominal income growth has not been enough to offset surging inflation. Both economies are likely to remain mired in recession until real incomes start to recover. China faces a different problem. The economy is of course not in recession, but it has slowed, lowering both nominal and real income growth despite a commodity-induced drop in inflation. Although there is some scope for a modest cyclical improvement in growth this year, Chinese growth is on a long-term downward trend and income growth will have to moderate accordingly. The challenge is to engineer this transition without a significant increase in unemployment. Real Income prospects are brightest in India because the household sector is benefiting from a broad-based decline in inflation as well as the cyclical improvement in the economy.

Chart 1: Real incomes pick up in developed markets



Contributors

Authors:
Jeremy Lawson
James McCann
Govinda Finn
Alex Wolf

Editors:
Jeremy Lawson

Chart Editor:
Craig Hoyda

Contact:
Jeremy Lawson,
Chief Economist
jeremy_lawson@standardlife.com

Higher income and higher saving

Household income is one of the most important variables that economists monitor because it is the key driver of private consumption spending. Income trends have been very favourable of late. Nominal disposable income growth picked up to 4% through 2014 after taking a big hit during 2013 when Congress allowed the Bush and social security tax cuts to expire during the so-called 'fiscal cliff'. When the recent fall in inflation is taken into account, household income trends look even better. Real disposable income increased 3.8% over the past year, which is only a little below the peaks of the past decade (see Chart 2). This is the reason why most forecasters expect private consumption growth to recover after a weak start to the year. However, some of that faith has been shaken by the failure of consumer spending indicators to pick up over the past two months; vehicle sales dropped back in April, core retail sales were weaker than anticipated and consumer sentiment has fallen from its highs. **If the poor winter weather was mostly at fault for the failure of consumption to keep pace with incomes in Q1, why hasn't spending recovered strongly in the spring?** There are two main possibilities. One is that consumers are waiting to see if the drop in oil prices is sustained; anecdotal evidence suggests that many expect oil prices to rise back to their post-crisis average and are looking through the positive real income shock accordingly. The other, which has more negative consequences for the outlook, is that consumers are rebuilding their savings after running them down in the aftermath of the fiscal cliff. At the time, many economists were surprised at the strength of consumption and perhaps now we are seeing the payback.

When forecasting consumption growth, we naturally concentrate mostly on aggregate income growth. However, there can also be information content in the composition of that income as the marginal propensity to consume differs according to its source. For example, **most empirical evidence suggests that households receiving government social transfers such as unemployment benefits are more likely to spend that income than households receiving rental or asset income.** And indeed, the current growth rate of total income masks important divergences at the disaggregated level. Income from assets is currently growing more slowly than transfer receipts from government (see Chart 3). Drilling down further into the detail, the weakness in asset income is mostly attributable to the fact that interest income has declined over the past year due to low and declining interest rates on savings accounts and bonds. The growth rate of rental income has also been on a downward trend since the global financial crisis. Meanwhile, government transfer receipts are currently growing at an annual rate of 5.8% despite the outright decline in income from unemployment benefits. With social security and Medicare transfer payments growing at or below their longer-term trends, the recent pick-up in aggregate transfer payments is mostly due to increased growth in Medicaid payments stemming from Obama's policies to expand access to healthcare for the poor. Another feature of the data is that the growth in private wages and salaries is outstripping the growth in government wages and salaries. Although government employment is no longer contracting, it continues to grow much more slowly than private sector employment. In addition, average wages are growing more slowly in the public sector because lawmakers are still trying to rein in the cost of government.

Chart 2: Falling inflation lifts income growth

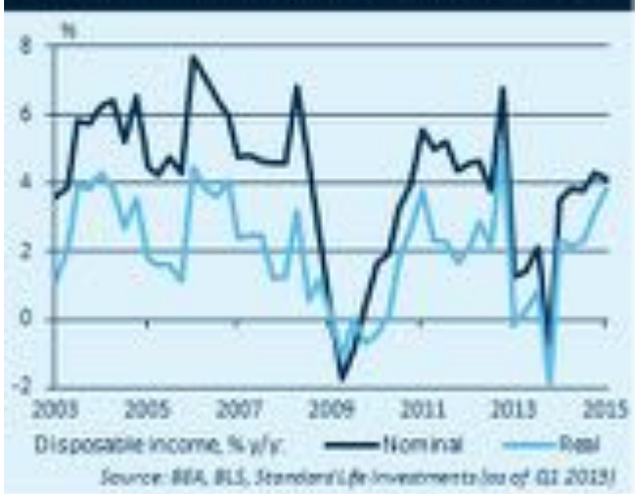


Chart 3: Tepid asset income

A real recovery

To date, the Eurozone recovery has been predominately driven by domestic demand, with the contribution to growth from net trade having been broadly neutral over the past six quarters. The improvement in domestic demand has been widespread. Government consumption has risen in every quarter since the start of 2013, partly reflecting the retreat from aggressive austerity. Meanwhile, investment is up 1.5 percentage points from its early 2013 low, although activity has been patchy. **The largest contributor has been private consumption, which accounts for 56% of Eurozone GDP. Consumption increased 1% year-on-year (y/y) last year, the strongest outturn seen since 2007.** Moreover, while we don't have the expenditure breakdown from GDP in Q1 this year, all indications point to a further acceleration in spending. What is driving this more expansive stance from households and how durable might it prove?

The first thing we can exclude is any material change in savings behaviour. The gross saving rate in the Eurozone has remained broadly stable over recent years (between 12 and 13%) and actually edged a touch higher over the second half of last year. **Instead, the increase in spending has been driven by a rise in income. Gross disposable income in the Eurozone was up 1.4%y/y in nominal terms at the end of last year, a clear improvement from the 0.6%y/y seen in 2013.** This was supported by an increase in wage income, which hit an impressive 2.2%y/y, compared to 0.9% in 2013. This does not reflect a significant pay rise for Eurozone employees, with wage growth actually slowing through 2014. Instead, it shows the effect of rising employment, with more than a million people finding work in Europe last year. Lower interest rates have also helped, with interest payments down 13%y/y, providing significant relief for more heavily indebted households. The improvement in aggregate income becomes even more impressive when we factor in the recent collapse in inflation (see Chart 6). Little wonder then that we saw such a sharp improvement in both consumer confidence and spending last year.

The good news is that the improvement in real incomes is set to persist for much of 2015 given the weakness in inflation. Furthermore, there have been no signs that low inflation is persuading consumers to delay purchases and much of the boost to real income is expected to be spent. However, this spur will not last forever. Inflation is expected to start to accelerate towards the end of this year as the effect of lower oil prices fades and euro depreciation feeds through. This puts the onus on nominal incomes to rise. **On a positive note; there are signs that labour market recovery is strengthening.** A host of survey data point to further gains in employment (see Chart 7) and above trend growth should continue to eat into labour market slack. The contribution to income from employment is therefore expected to increase further. The development of wage growth is more uncertain. A gradually tightening labour market should provide some support for wages, which have slowed over recent quarters. However, this acceleration is likely to be moderate given still sizeable spare capacity in the labour market. **Europe will probably need to rely on getting more people in jobs rather than strong wage growth over the next two years at least.**