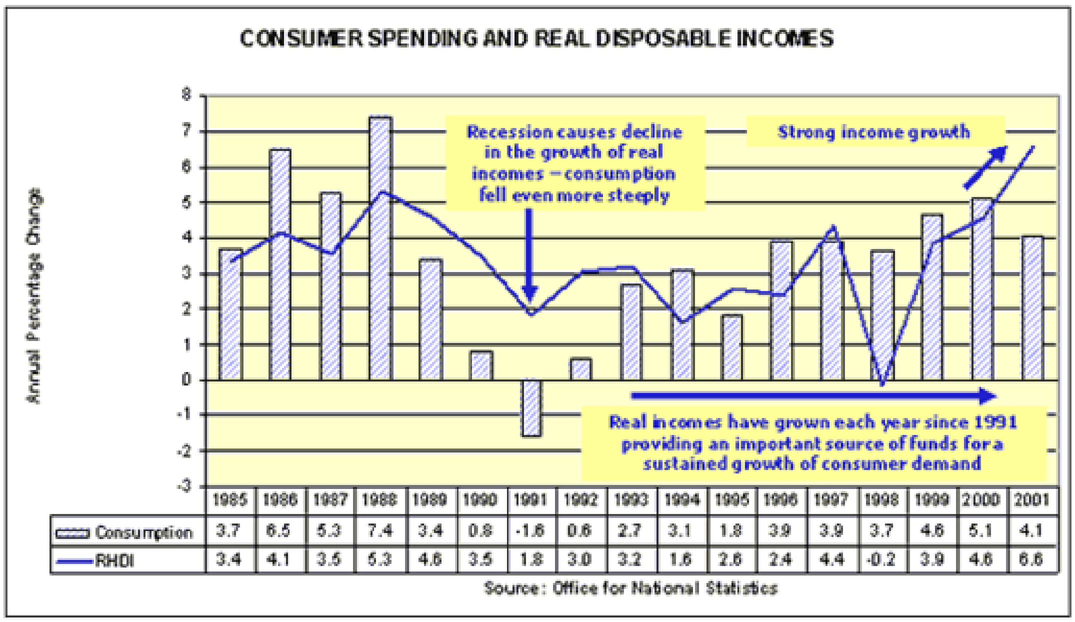
<u>Analyse the causes and consequences of the rise in the share of household consumption from 0.61% of GDP in 1996 to 0.65% in 2000.</u>

The Keynesian theory of Consumption is that in short run, the current levels of real disposable income are the principal determinant of consumption. Real disposable income is one's income deducting both taxes and benefits and taking into account inflation. An increase in people's real disposable incomes increases their purchasing power and gives them greater financial resources to spend or save.

Due the marginal propensity to consume in the UK being fairly high, a small rise in incomes results in a significant rise to consumption. For example, taking the mpc as 0.75, a £1,000 raise at work would mean that the employee spends £750 of this on goods and services. Furthermore, considering that on the whole, people on lower incomes tend to have a higher marginal propensity to consume (i.e. a lower marginal propensity to save) the recent rise of the national minimum wage would have had a knock on effect on consumer demand.

The graph below demonstrates how the growth of real incomes in recent years has funded the sustained growth in consumer demand, and that in the early '90s recession a steep fall in real incomes had a catastrophic impact on consumption, falling by almost -2% in 1991.

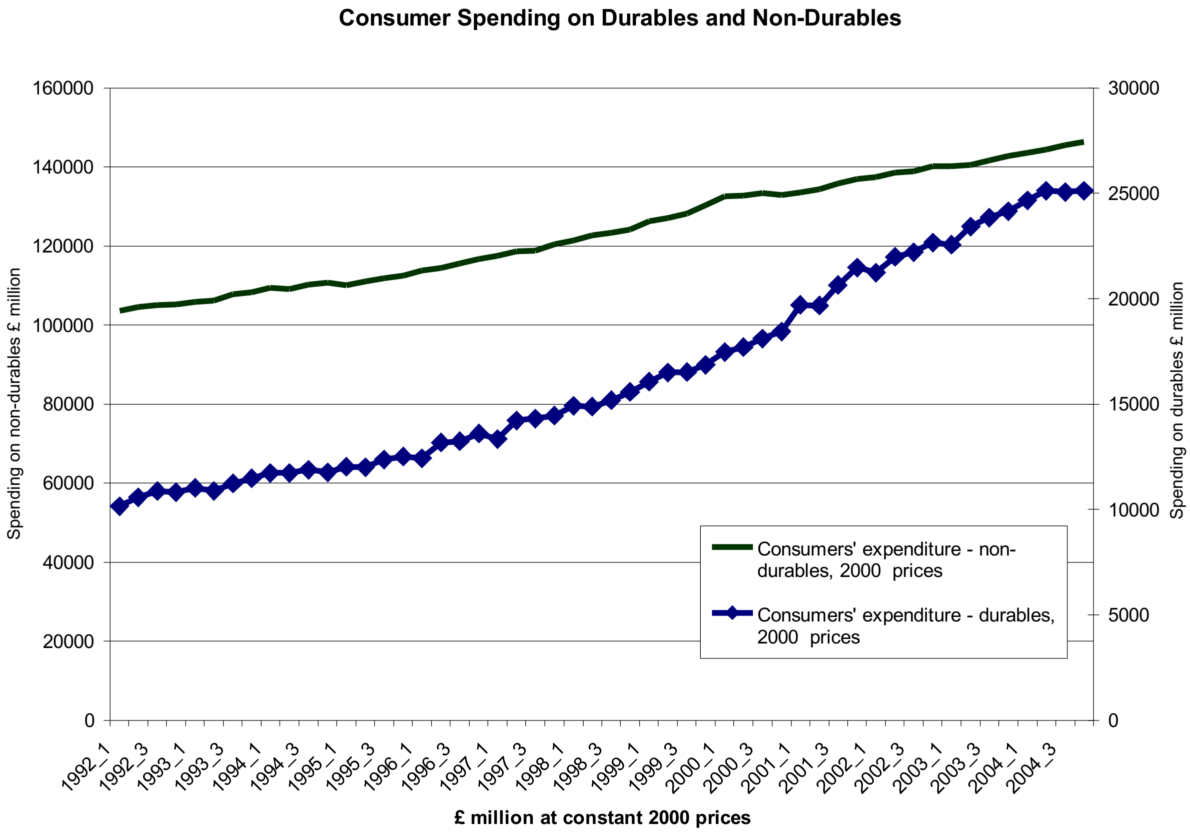


The falling unemployment rate has also resulted in more people's real income increasing as they move away from welfare benefits to wages.

The pattern of spending between non durable goods and services (goods that are destroyed in the act of consumption e.g. mars bar) and durable goods (e.g. washing machine) has also affected consumption. The real level of spending on durables has surged in the last eight years.

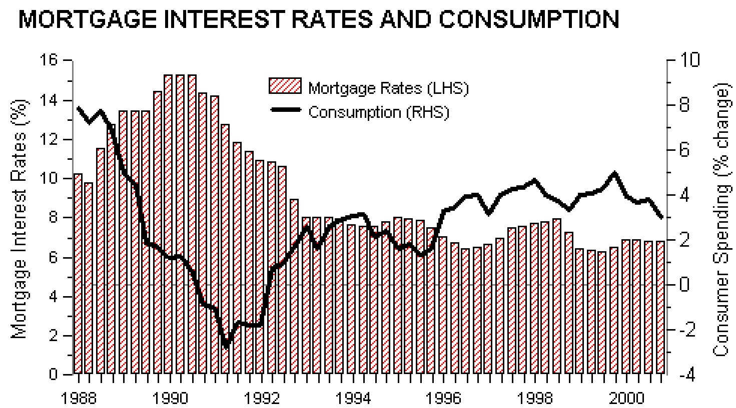
This could be due to many things; firstly most significantly though is the falling price of durable goods due to massive advances in technology and transport infrastructure leading to globalization, e.g. the Dyson factory moving from Wiltshire to Malaysia enabling them to lower production costs and hence the final retail price. Also, the historically low interest rates have not only encouraged people to spend more on 'Big ticket items' but also resulted in huge borrowing levels which in itself illustrates their rise in confidence. Furthermore, due to durable goods, which tend to be luxuries rather than necessities, having a considerably higher income elasticity than non durables, the rise in real incomes shown in Fig .1 has had *more* of an impact on their demand.

The graph below relates the steady rise in the demand for non durables in comparison to the surge in the demand for durable goods.



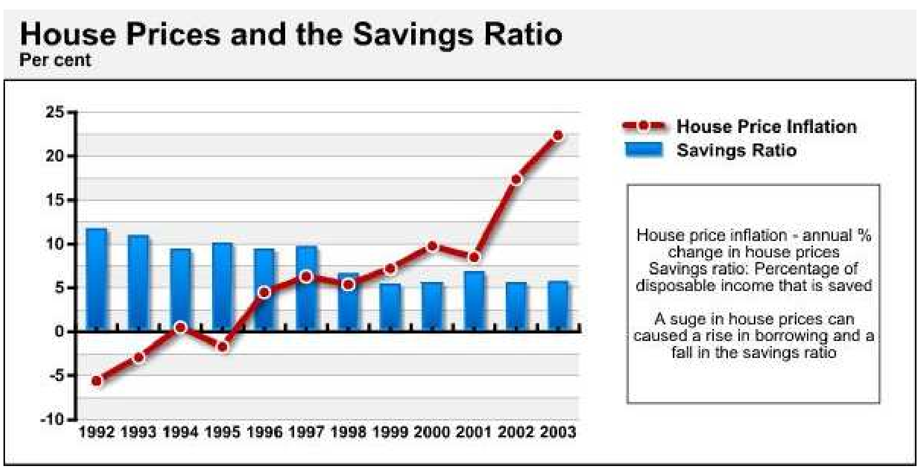
Due to the recent housing boom, homeowners have benefited from the wealth effect. Due to the value of a property increasing in value, in some cases doubling over a five year period, the owners' confidence grows because of their significant increase in wealth (i.e. the value of their assets). People naturally are encouraged to spend more and increase the comfort of their lifestyle hence they take money out of their mortgage known as 'equity release' or 'withdrawal'. Clearly one doesn't take money out of one's house to store it away so therefore this automatically falls into the category of consumer spending. In 2003, mortgage equity withdrawal surged to over £57 billion!

Moreover, a fall in mortgage interest rates over the last 14 years has caused a decrease in the monthly interest repayments on mortgage loans. Again, this increases the effective disposable income available for homeowners to spend on other items, hence the recent acceleration in consumer demand. This graph shows the relationship between mortgage rates and consumption over the last decade.



However, some homeowners are actually at an advantage if interest rates rise because if they have already paid off their mortgage (although an unlikely scenario in this country) and are 'net savers' with banks and building societies, the higher rates boost their monthly income.

The following graph illustrates how this house price inflation has caused a consistent fall in the savings ratio, i.e. a rise in consumption because saving represents the decision to postpone spending.



This fall in the savings ratio is also said to demonstrate the choice to 'spend today rather than tomorrow' which is can often be accompanied by huge consumer debts.

However, consequentially the strength of consumer spending has been a major reason as to why the UK has avoided recession in recent years. Yet there is the worry that household spending has just been too high and one of the principal causes of this is that it has been financed by a 'surge in borrowing' leading to record levels of 'household debt'. Furthermore, the high consumption has a significant negative impact on the UK's trade deficit because of the proportion of spending that has been 'withdrawn' from our 'circular flow of income' by the relative increase in demand for imported goods and services. The demand for imports in the UK is renowned for being very income elastic, because of our want for variety and choice of goods. In addition, the demand for foreign goods is further encouraged by the favourable exchange rate of the sterling.

The questions we have to ask ourselves are; 'What are the risks for the British economy of such a high level of consumption? Is the economy investing enough? Can government finances maintain stability?

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 economies have 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 funded 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

Source: G.Riley's Archives