

Box 5

RECENT DEVELOPMENTS IN PRIVATE CONSUMPTION AND THE IMPACT OF PRICE INCREASES

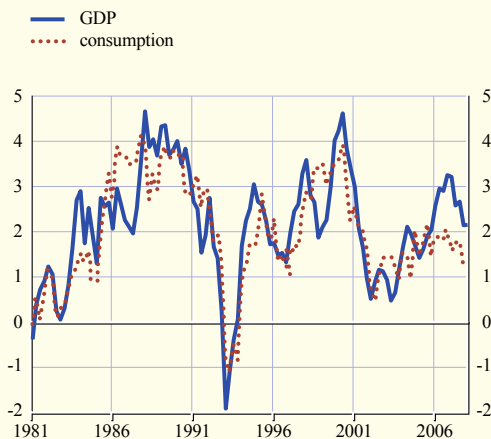
Overall economic activity has outpaced household spending since the recovery began in 2003, and compared with previous economic upturns consumption growth has been relatively moderate (see Chart A). Private consumption contracted by 0.1% (quarter on quarter) in the final quarter of 2007 and increased by just 0.2% in the first quarter of 2008. Available indicators of spending such as retail trade, consumer confidence and new car registrations currently suggest subdued growth in the second quarter. This box looks at the factors underlying recent developments in private consumption.

Although household spending decisions are motivated by a range of factors, a key determinant is household income. In principle, households base their consumption on present and expected future real disposable income derived from labour compensation and returns on financial and non-financial wealth. However, some households may place more weight on current (rather than expected) income developments. Over recent years, households' disposable income has been supported by strong employment growth. However, at the same time, it has been dampened by a series of price shocks. Increases in indirect taxes and administered prices have reduced households' purchasing power. Furthermore, towards the end of 2007, sharp increases in food and energy prices raised the cost of households' typical consumption basket: HICP inflation rose from 1.9% in June 2007 to 2.9% in the last quarter of 2007 and 3.4% in the first quarter of 2008 (see Chart B).

Faced with an increase in prices, households' purchasing power declines. In the long run households would need to adapt spending to account for that change. But the short-term adjustment may depend on the nature of the price shock or expectations about future price developments. While households need to adjust to increases in indirect taxes and administered prices, they may be reluctant to reduce consumption of items such as food and fuel and instead choose to lower savings temporarily rather than scale back consumption – particularly if they

Chart A Consumption and GDP

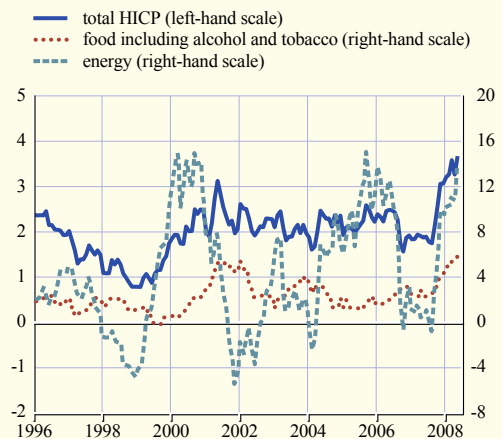
(annual percentage changes)



Sources: Eurostat and ECB.

Chart B HICP inflation: total, food and energy

(annual percentage changes)



Source: Eurostat.

believe the price increases are likely to be temporary. In the past, when prices increases were driven by food and energy consumers typically tended to moderate spending to a smaller extent than when inflation reflected price increases in other goods and services.

However, in late 2007 and early 2008 the opposite happened. Private consumption moderated sharply, while the available evidence suggests that the savings ratio even rose slightly. One reason may be that households believe that the factors driving the recent oil and food price increases are likely to be more permanent. They may therefore be less likely, in this instance, to accommodate the price shock in the short term with a temporary adjustment in savings. As a result, the recent price increases may have affected household spending more than during past episodes of relatively short-lived price increases. An additional factor may be that inflation perceptions are particularly sensitive to price increases for frequently purchased items such as food and fuel and that this has dampened households' confidence regarding the economic outlook and their purchasing power.

While recent price increases appear to have had an important influence on current household spending patterns, other developments may also be playing a role. In particular, households may have been affected by the financial turmoil that began in mid-2007. Households' financial wealth has declined while, according to the ECB's latest bank lending survey, credit conditions on loans to households have further tightened. The turmoil may also have increased uncertainty about the prospects for economic activity. The European Commission's consumer confidence indicator has declined significantly since August 2007, with a particularly sharp deterioration in households' expectations about the general economic situation.¹

Overall, there seems to have been a number of factors contributing to the relative weakness of household spending in the recent past. Looking ahead, growth in household spending is expected to continue at a modest pace during the remainder of 2008, mainly on account of the real income losses resulting from higher prices, a slower pace of employment growth and wealth effects, in particular from lower house price growth. In 2009, as inflation is projected to decline gradually and real income to recover, private consumption growth is expected to rise again.²

1 It is worth noting that, although the balances summarising households' responses to questions on prices are not included directly in the overall European Commission measure of consumer confidence, changes in households' inflation perceptions and expectations may have affected consumer confidence.

2 See the section entitled "Eurosystem staff macroeconomic projections for the euro area" in the June 2008 issue of the Monthly Bulletin.