Household consumption will be pivotal in the resumption of growth, but consumer concerns about rising household debt may but the brakes on spending

The Office for Budget Responsibility has recently suggested that household debt will rise sharply in the next four years, as households compensate for higher costs with greater borrowing. Gavin Kelly and Matthew Whittaker of the Resolution Foundation examine the impacts that higher levels of debt might have on consumer spending and thus the prospects for a growth-led recovery.

What are we to make of different views on the extent to which growing household debt will offset the squeeze in living standards in the coming years?

The independent Office for Budget Responsibility caused a bit of a stir at the time of the Budget when it suggested that household debt is set to rise over the rest of the Parliament – from £1.6 trillion in 2011 to £2.1 trillion in 2015, or from 160 per cent of household disposable income to 175 per cent. Rising debt will sit alongside low savings, so that the ratio of household saving to disposable income falls to around 3½ per cent – half its average over the last 50 years – for the duration of the OBR’s forecast period. The clash between these projections and the government’s favoured narrative concerning the need for the country to rein in its debt-fuelled spending habits – public and private – attracted some attention and prompted an online debate about whether tighter fiscal policy is shifting the balance between public and private debt.

But the underlying economic implications, and their impact on household living standards between now and the next election, remain largely unprobed. Last month the OBR published a little noticed note that set out to clarify why it has changed its projections for household debt since last June. It makes for interesting reading – but doesn’t really answer the most fundamental issues. The most important argument that the OBR makes is that – regardless of high existing levels of debt – household indebtedness will continue to rise over the next four years as families battle to sustain their living standards, running down savings and ratcheting up more borrowing. And it’s worth noting that the OBR is explicit in saying that its projection for household debt is premised on steadily easing credit conditions and a stronger housing market.

The key question is whether the OBR is right about how households will react: is a further rise in personal indebtedness, already at historically unprecedented levels, a realistic account of how households at the sharp end of the living standards squeeze will behave over the medium-term in the post-crunch economy? No-one really knows. They can’t. Never before in modern times have we seen the combination of such a large fall in household incomes, the severity of the shock to the credit system, and plummeting consumer confidence. So it is very hard to know what the OBR bases its behavioural assumptions on when it claims that greater debt will prevent falling disposable incomes feeding through into reduced expenditures.

It’s a view that seems to run counter to a range of recent expert opinions and forecasts. For example, the Council of Mortgage Lenders has referred to the OBR projection on the scale of the increase in household debt this year as ‘wildly optimistic’ and at odds with its own forecasts, while PwC has projected household debt to be falling as a proportion of GDP throughout this Parliament. Roger Bootle of Deloitte has just marked down consumer spending growth in 2011 to -1 per cent, and takes issue with the notion that household savings will fall further in the medium term, saying that tight credit conditions and the current weakness of consumer sentiment will ‘surely mean that households will want to save more, rather than less’. Likewise NIESR, in its most recent quarterly update, predicts that following a short-term reduction this year, the savings ratio will rise steadily until 2015.

Analysts in the US are similarly sceptical about the scope for medium-term falls in their savings ratio: Cardiff Garcia has argued in the FT that, while such a position might boost the economy in the short term, ‘nobody would think it healthy’ for the savings rate to return to the ‘absurd’ levels of the mid-noughties.

So much for the forecasters and pundits: what does the public say? Despite a well-documented shift from borrowing to saving since the start of the credit crunch, UK households remain severely debt-stressed. Bank
of England polling data shows that at the end of 2010, half of all households said they were concerned by their level of debt. Borrowing more remains off-limits for many: one-third reported suffering some form of credit constraint. At the same time, one-in-three households reported savings of under £500 – leaving little scope for protecting living standards by dipping into these funds.

Our own analysis at the Resolution Foundation shows that those on low-to-middle incomes face sharper constraints than better-off households. As the chart below shows, while around one-third (31 per cent) of households in the top half of the income distribution said they were finding it harder to borrow to finance spending in 2010 than in 2009, among those on low-to-middle incomes this rose to over half (53 per cent), up from just 16 per cent in 2007. And these are exactly the people who are going to feel the fall in living standards most acutely and whom, presumably, the OBR expects to borrow more. Looking to the future, one-fifth of all households said they were saving more in anticipation of fiscal tightening. Just 3 per cent were planning on spending more.

Notes: Households are defined on the basis of their place in the working-age equivalised income distribution. ‘Higher income households’ are in deciles 6-10; ‘low-to-middle income households’ are in deciles 2-5.

Source: RF analysis of Bank of England, NMG Survey, various

Taken together these findings provide powerful grounds for asking what would happen if the OBR used different assumptions about how households may run down, as well as build up, debt during the prolonged fall in living standards. Without this, existing projections appear to be a bit of a punt. No doubt setting out different scenarios for debt in this way would expose some uncomfortable findings: growth is bound to be weaker if household expenditure more tightly tracks falling disposable income than the OBR currently expects. Projections for net exports and business investment can’t just be pumped up to take up the slack. But that isn’t a reason to avoid the issue.

Despite all the frothy rhetoric about the ‘re-balancing of the economy’ the growth of household consumption will be absolutely pivotal in the resumption of steady growth. Indeed, the key factor determining the strength of the UK recovery will be the uncertain reactions of millions of households, who are already close to the edge, to further falls in disposable income. The question of whether ever more personal debt can be used to fill the growing living standards gap deserves far more serious scrutiny than it has received to date.

This article first appeared on the Resolution Foundation’s blog on 4 May.