



Box C:

QB 3 – July 2019

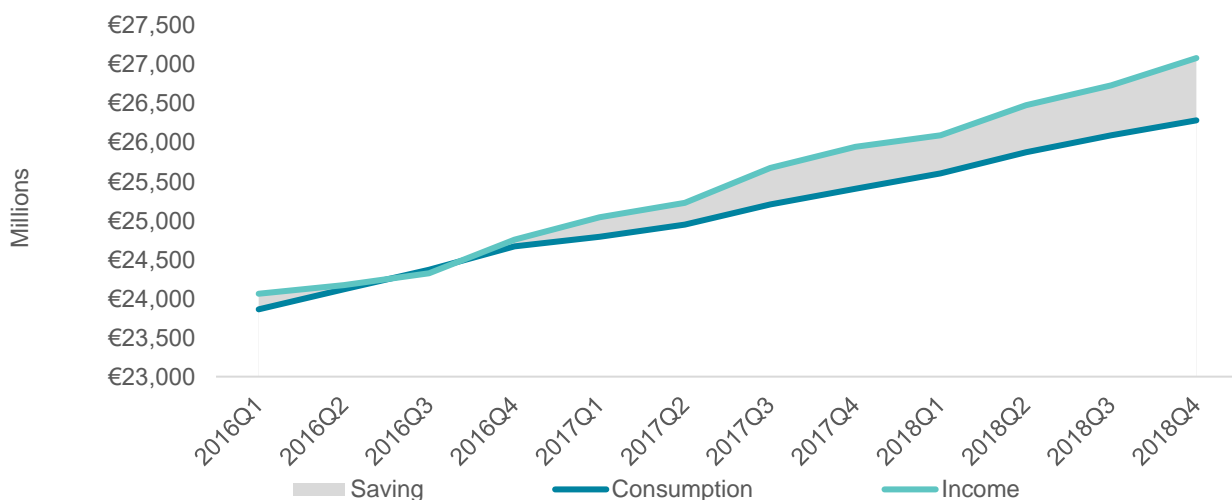
This Box content is extracted from the **Quarterly Bulletin – Q3 2019**

Consumption and Income Growth in the Current Expansion

By David Staunton, David Horan, and Reamonn Lydon

After falling during the recession, income and consumption have now grown for six consecutive years. The gap between income and consumer spending has widened, with consumers spending a smaller proportion of their disposable income since 2016. The latest Personal Credit and Deposits data¹ show that household deposits rose by €1.8 billion over Q1 2019, the largest increase since Q4 2008. The purpose of this box is to investigate the gap between consumption and income that has emerged since Q1 2016, and to dig deeper on households' income and saving during this period. This is done by decomposing the growth in household disposable income, before investigating plausible reasons for increased saving.

Figure 1: Consumption and Income



Source: CSO; 4QMA.

¹ [Trends in Personal Credit and Deposits – Q1 2019, Central Bank of Ireland](#)



Income

Since household disposable income returned to sustained growth in 2014, most of the contribution has been from labour income in line with the improving labour market (Figure 2). Figure 3 uses data from the Earnings and Labour costs survey to decompose the labour income growth seen in the institutional sector accounts. As recently as mid-2015, hourly earnings contributed negatively to labour income to the household sector, with virtually all the gains coming from rising employment levels. Since 2017, the relative contribution from employment, while still the largest driver, has been declining, with hourly earnings growth becoming increasingly important as wages rise. A continuation of this trend is consistent with the labour market and income forecast in this Quarterly Bulletin. Of primary interest in this box is that recent income growth has not coincided with a similar increase in consumption.

Figure 2: Growth in HDI

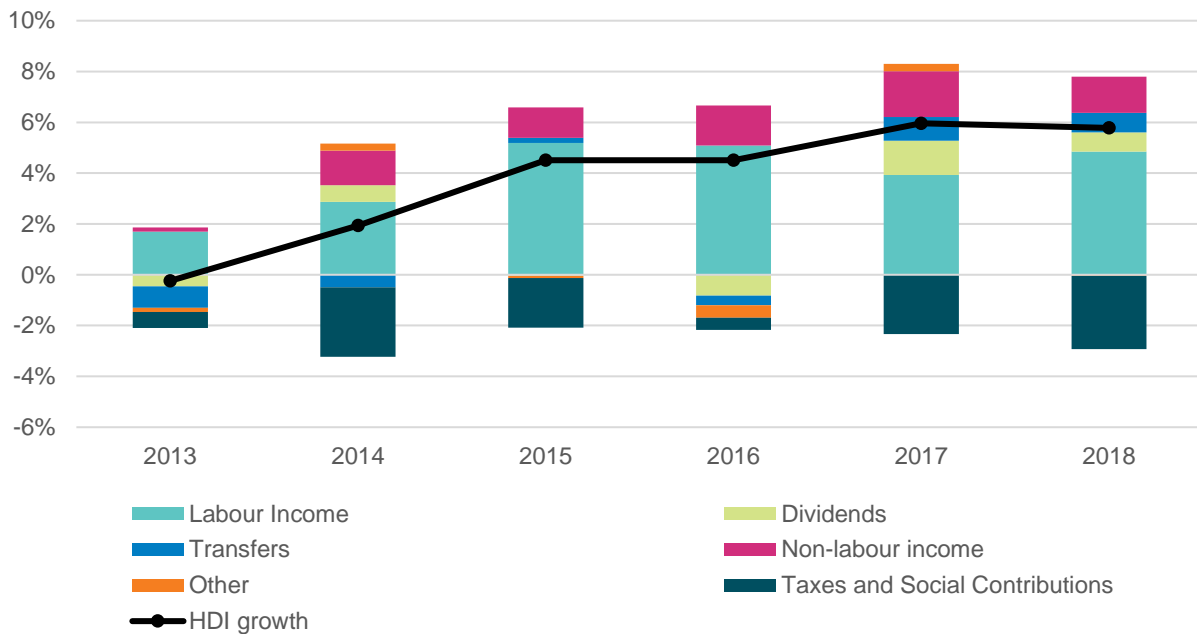
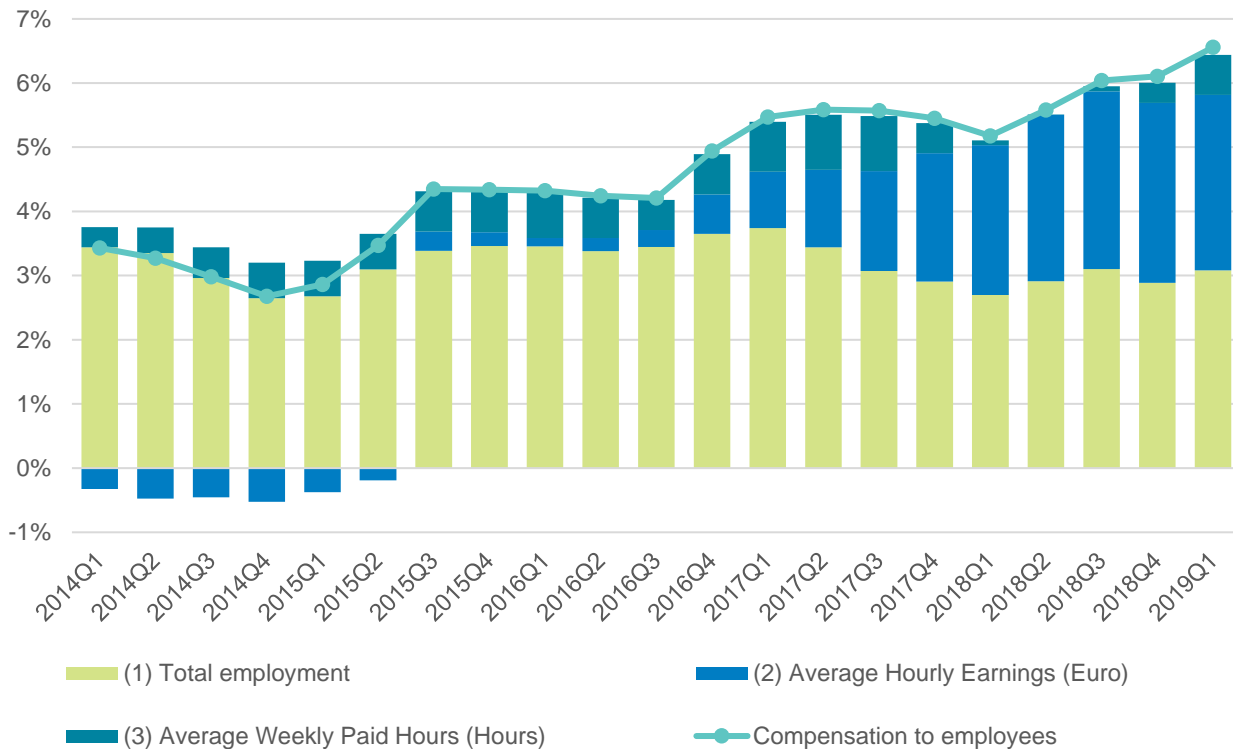




Figure 3: Growth in Labour Income



Source: CSO

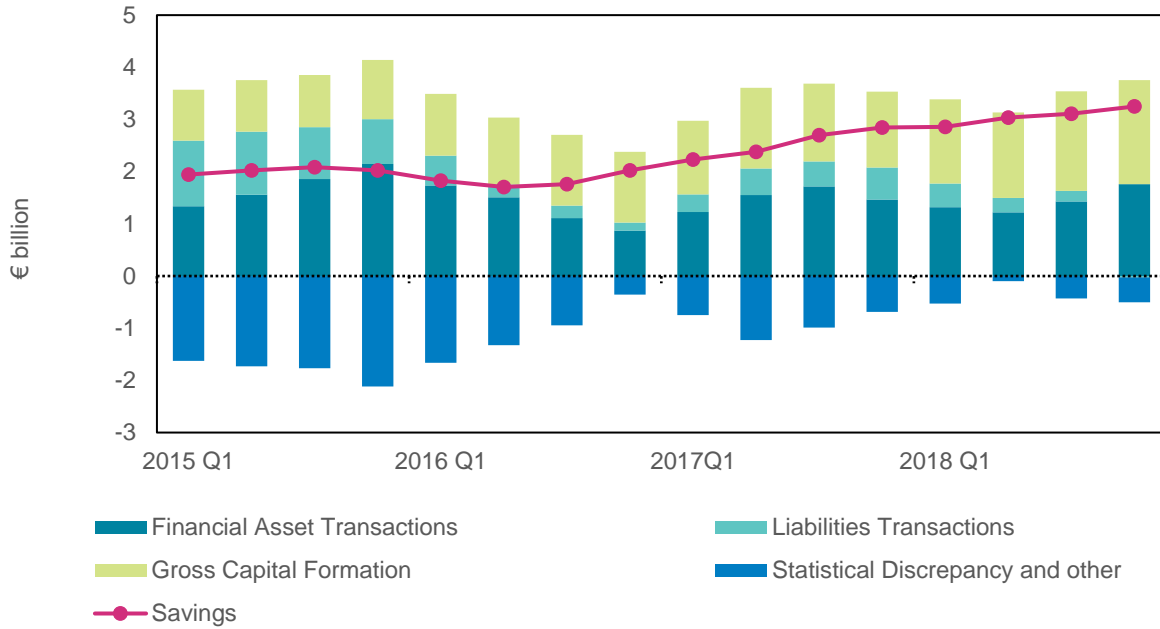
Saving and Deleveraging

The unspent portion of household income can be used in a number of ways; investment in financial assets, deleveraging (paying down debt), and investment in fixed capital, e.g. housing. McCarthy and McQuinn (2015)² highlight the effect that deleveraging can have on Irish consumption and, since the crisis, deleveraging has indeed been an important factor. As Figure 4 shows however, its role has diminished in recent quarters, to the extent that deleveraging flows are virtually absent from Households' Quarterly Financial Accounts in Q4 2018. The growth in savings is thus concentrated in two categories - Financial Assets (bank deposits, savings accounts etc.) and Gross Capital Formation (primarily new house purchases). Figure 5 shows that after years of post-crisis deleveraging, the household sector is now drawing down marginally more debt than it is paying off, although the debt to disposable income ratio is still declining.

² McCarthy, Y. and McQuinn, K. (2015) [Deleveraging in a Highly Indebted Property Market: Who does it and are there Implications for Household Consumption?](#), *The Review of Income and Wealth*, 2015

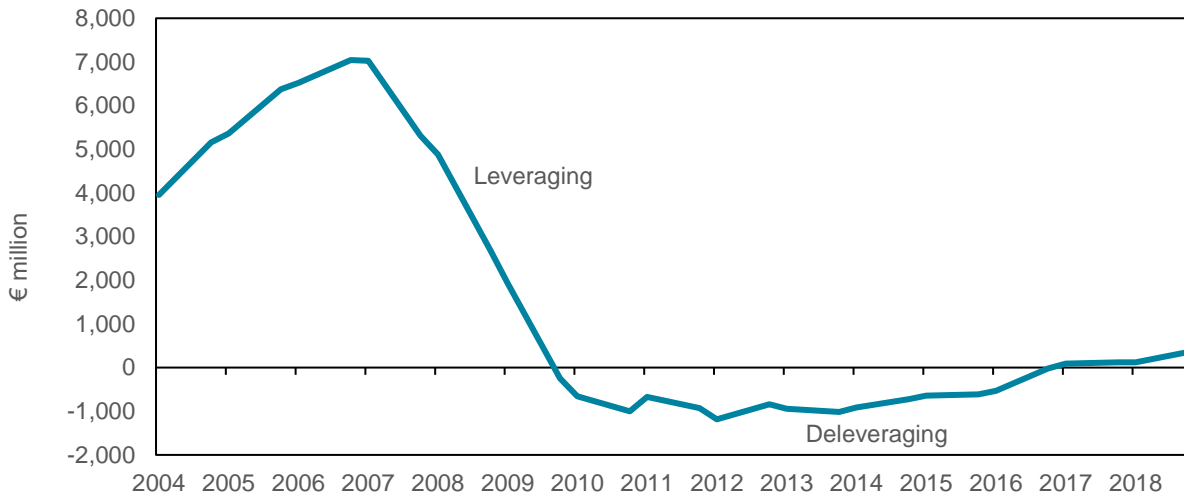


Figure 4: Household Savings by Use Transactions



Source: Quarterly Financial Accounts; 4QMA.

Figure 5: Household Credit



Source: Quarterly Financial Accounts; Lending for house purchase and other personal loans; 4QMA.



Saving for House Purchase

Many Irish households need to build up deposits to purchase a home, and survey data show that 30 per cent of private renters say they are saving to buy a home. Given that 30 per cent of households are renters, that would mean that, at a minimum, 10 per cent of Irish households are saving for a house (approximately 170,000 households). This number would be made greater by those non-renters who are also saving to buy or move house. While it is not possible to estimate how much savings can be attributed to these various cohorts, given the scale of the increase in deposits, amounting to an increase of €1.8 billion in the fourth quarter of 2018, saving for a house purchase is likely to explain only some portion of this increase and be one of a number of factors driving the rise in savings.

Income Uncertainty

In addition to the above factors, uncertainty can be another driver of household saving. The life-cycle model (or permanent income hypothesis) suggests that people “smooth” consumption – using saving and borrowing to maintain a consistent level of consumption throughout their lives.³ This implies that people will save if they expect their future earnings to decline. The contract status of workers could affect expectations of future income – if an elevated proportion of the workforce is on temporary contracts, increased savings may result. In the aftermath of the recession, the labour markets of the most affected countries such as Spain, Portugal, and Greece, became increasingly characterised by short-term and contingent employment. Ireland has a lower level of short-term employment than the EU average, and the proportion of new hires in Ireland signing temporary contracts actually fell to pre-crisis levels in 2016.⁴

If income growth is coming from irregular earnings like overtime and bonuses rather than from salary, households may deem their higher income to be transitory. This less certain portion of income is now marginally higher than its peak in 2008, providing a potential source of uncertainty. However, given the small size of the change (up 2 percentage points over 10 years) and the fact that earnings growth excluding irregular earnings is still very strong, this is unlikely to be an important driver of increased saving.

Consumer Sentiment

The KBC Consumer Sentiment Index (CSI) is based on consumers’ perception of their future financial situation, their economic outlook for the country as a whole and employment expectations⁵. There is a large literature that uses consumer sentiment as a proxy for future expected income

³ Meghir, C. and Pistaferri, L. (2010) [Earnings, Consumption, and Life-cycle Choices](#) NBER Working Paper 15914

⁴ McGuinness, S., Bergin, A., Keane, C., and Delaney, J. (2018) [Measuring Contingent Employment in Ireland](#) ESRI Research Series Number 74, August 2018.

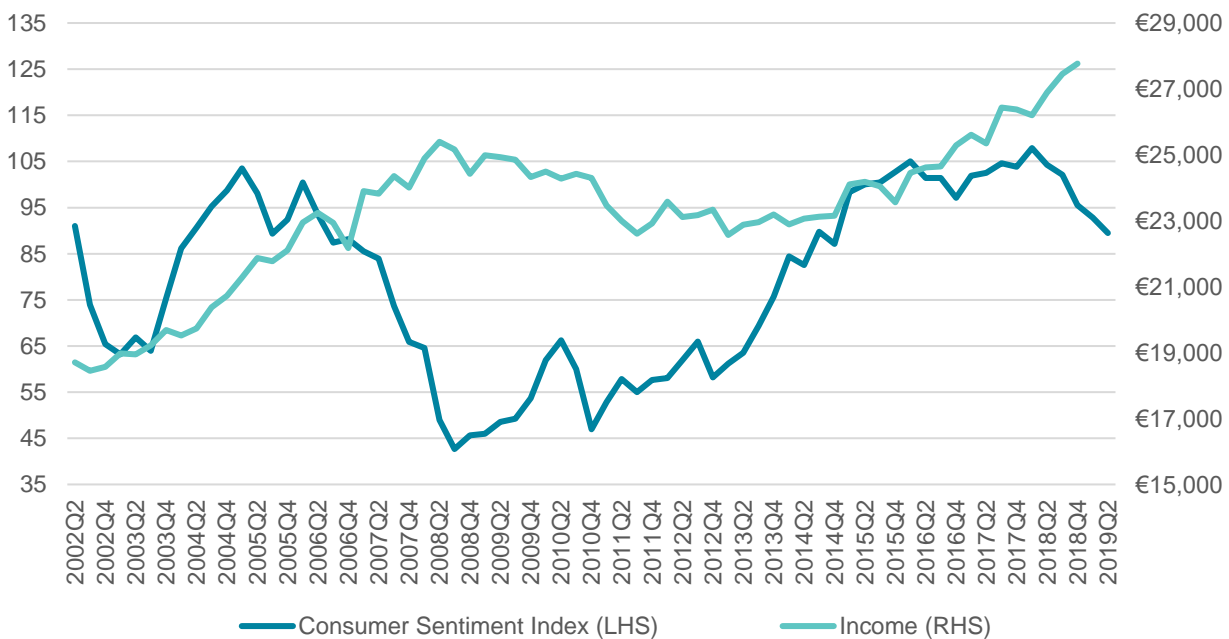
⁵ For full details on how the Consumer Sentiment Index is compiled see notes section on page 3: <https://www.esri.ie/system/files/publications/CSI2019Mar.pdf>



which in turn may serve as a leading indicator for forecasting consumption developments⁶. In the past, the level of consumer sentiment has also tended to reflect current and near-term income developments⁷. However, in recent quarters, the decline in sentiment cannot be attributed to a slowdown in income growth. In fact, Figure 6 shows that despite strong gains in income growth – on average, household disposable income rose by 4% per annum between Q1 2016 and Q4 2018 – consumer sentiment has been underperforming over the same period, with the index declining over the past year.

The fall in consumer sentiment reflects a more pessimistic view on the part of consumers of the general economic outlook, in part, reflecting concern about the potential impact of Brexit on future employment and incomes. This was evident from the sharp fall in the CSI in Q1 2019, as the UK approached the original deadline for leaving the EU without having accepted the proposed withdrawal agreement. Depending on the progress made in the negotiations through the rest of 2019, increasing or decreasing uncertainty in relation to Brexit could have an impact on the evolution of consumption. Of course, other factors will also continue to affect consumer sentiment and consumption over the medium term.

Figure 6: Consumer sentiment index/household income



Source: KBC, CSO.

⁶ Esaw J.Z., Garratt, D., and Heradi M.H (2005) '[Does consumer sentiment accurately forecast UK household consumption? Are there any comparisons to be made with the US?](#)', Journal of Macroeconomics, Vol. 23, No. 3.

⁷ See: McIntyre, K.H (2007) '[Reconciling Consumer Confidence and Permanent Income Consumption](#)', Eastern Economic Journal, Vol. 33, No. 2, available: