tullett prebon **strategy notes** | issue 43 | Wednesday, 20 February 2013

measuring the real cost of living

launching the tullett prebon uk essentials index

- **The Tullett Prebon UK Essentials Index, launched today, shows that the cost of non-discretionary purchases has continued to out-grow broader inflation indices.**
- **The cost of essentials rose by 3.7% in 2012, much faster than CPI inflation (2.8%), let alone nominal growth in incomes (1.6%). This said, the 2012 reading was a great improvement compared with 2011 (7.8%).**

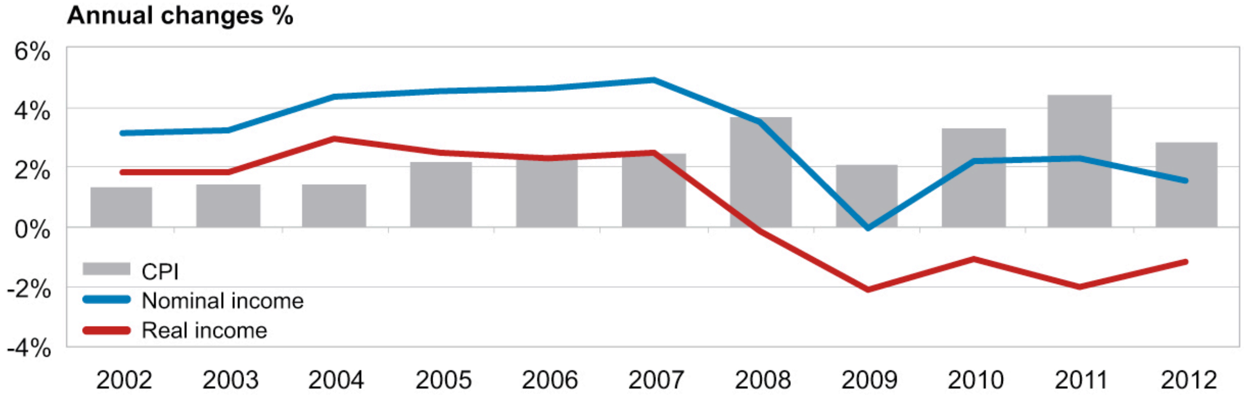
Amongst the various factors which, time and again, have stymied official expectations for growth in the British economy, none has been more critical than the failure of consumers to respond as the forecasters have hoped. If the initial forecast from the Office for Budget Responsibility (OBR) had been right, the economy would now be almost 6 percent larger than it was when that projection was made in 2010. Instead, the economy has barely grown at all (though this has not prevented the authorities from sticking to the “jam tomorrow” mantra that growth always lies two years in the future).

No single shortcoming in the official forecasts has been more important than repeated over-optimism about private consumption. Part of the reason for this failure surely lies in an underestimation of the role played by debt – consumption growth before 2008 was powerfully fuelled by borrowing, whilst the sheer scale of household indebtedness may well have been sufficient to preclude consumption-driven growth since then.

This said, part of the explanation has to lie in the behaviour of real incomes, which are measured by comparing trends in nominal incomes with the behaviour of prices. As fig. 1 shows, average wage growth slumped after 2007, but inflation, as measured by the official Consumer Prices Index (CPI), has remained comparatively high, eroding real incomes very markedly.

Headline Indicators	
Annual	**Monthly**
Tullett Prebon UK Essentials Index values:	**Tullett Prebon UK Essentials Index rates of change:**
2012: 162.21	**January 2013: 2.9%**
2011: 156.43	December 2012: 2.3%
Tullett Prebon UK Essentials Index rates of change:	January 2012: 6.0%
2012: 3.7%	
2011: 7.8%	

Fig. 1: Changes in nominal and real incomes, 2002-12*

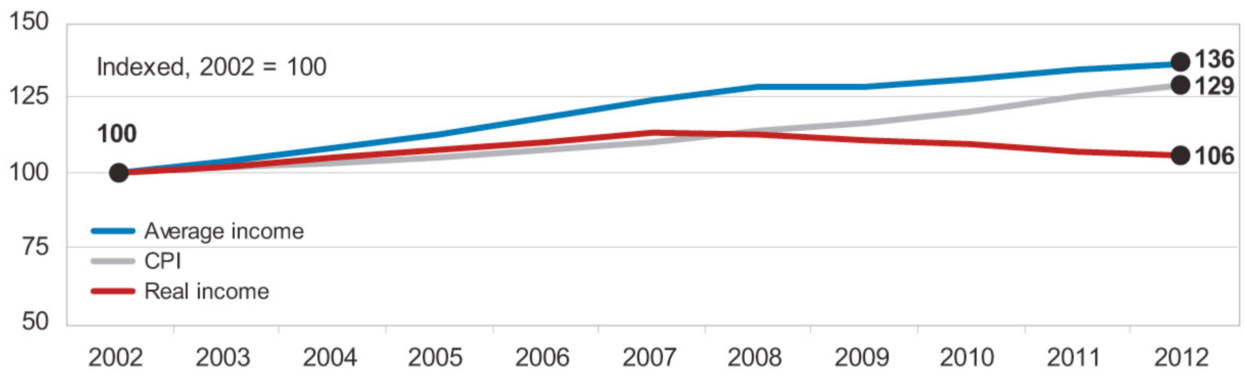


*Source: Office for National Statistics

The cumulative picture, set out in fig. 2, shows how the combination of stagnant earnings and above-target inflation have undercut real incomes. Again, the most pertinent comparison is with 2007, the last year before the economic slump. Between 2007 and 2012, growth of 10% in average nominal wages was far exceeded by cumulative CPI inflation of 17%, leaving real incomes 6.3% lower in 2012 than they were in 2007. In 2007, wage-earners were 13% better off, in real terms, than they had been in 2002. Since 2007, about half of that previous gain has been lost.

This is bad enough in itself, of course, and becomes even worse if high levels of household indebtedness – and increases in direct taxation – are taken into account. But we believe that there is another, highly significant factor to be considered. That factor is the above-CPI rate at which the prices of non-discretionary, essential purchases (including food and energy) have risen. The implications are, of course, that consumers' capacity for discretionary spending has been eroded even more severely than data for real incomes might suggest.

Fig. 2: Cumulative changes in nominal and real incomes, 2002-12*



*Source: Office for National Statistics

Fig. 3: Disparate inflation, 2002-12*

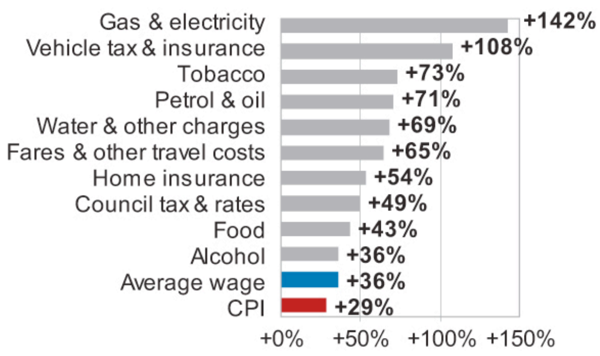
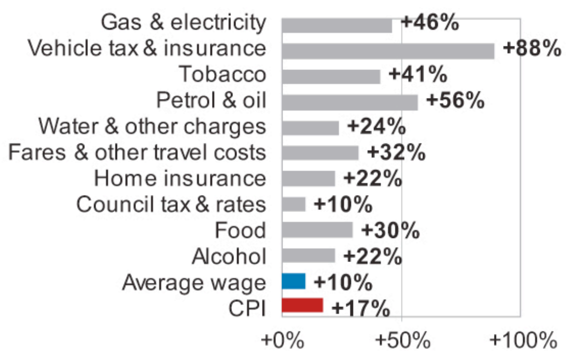


Fig. 4: Disparate inflation, 2007-12*



*Source: Office for National Statistics

Indicators of inflation, set out in figs. 3 and 4, help identify where some of the problems lie. Between 2002 and 2012, cumulative inflation of 29%, as measured by CPI, was far exceeded by increases in the prices of essentials such as gas and electricity (+142%), (+108%), fuel (+71%) and food (+43%). As well as exceeding CPI inflation, the prices of these essentials also rose by more than nominal average wages (+36%).

This trend has been even more pronounced since 2007. Between 2007 and 2012, cumulative growth in nominal wages (of 10%) has been exceeded not only by CPI inflation (+17%) but by far bigger increases in the prices of essentials such as gas and electricity (+46%), vehicle tax and insurance (+88%), fuel (+56%) and food (+30%).

In short, inflation in the costs of essentials, which was already squeezing discretionary spending capabilities before 2007, has since compounded the effect of a widening in the differential between nominal wages and general (CPI) inflation.

This has led us to believe that it is imperative that policymakers and analysts gain an insight into what is happening to the prices of essentials.

The Tullett Prebon UK Essentials Index

The aim of our index is to measure the rate of inflation in consumer essentials. The index defines these essentials as follows:

- Food, alcohol and tobacco
- Council tax, water charges and home insurance
- The costs of domestic heating and power, principally gas and electricity
- Fuel, road tax and vehicle insurance
- Train, bus and other public transport fares

Fig. 5: Key components of the Tullett Prebon Essentials Index*					
	Share of:		Change:		
	RPI	TPUKEI**	Since 2002	Since 2007	2012
Food	11%	28%	+43.0%	+29.8%	+3.2%
Alcohol	6%	14%	+36.4%	+21.9%	+3.3%
Tobacco	3%	7%	+73.3%	+40.8%	+8.5%
Council tax & rates	4%	10%	+49.2%	+9.9%	+0.4%
Water & other charges	1%	3%	+68.5%	+23.6%	+5.5%
Home insurance	1%	1%	+53.9%	+22.4%	-0.7%
Power & light	5%	11%	+142.2%	+46.3%	+7.6%
Petrol & oil	5%	12%	+71.1%	+56.5%	+1.9%
Vehicle tax & insurance	3%	6%	+108.0%	+88.2%	+2.1%
Fares & other travel costs	2%	6%	+65.0%	+32.4%	+4.8%
Essentials	40%	100%	+62.2%	+33.0%	+3.7%
Memo: wages			+36.2%	+10.0%	+1.6%

*Sources: Office for National Statistics and Tullett Prebon calculations, see text

**Tullett Prebon UK Essentials Index

These items, which we weight in accordance with official RPI data, accounted for 40% of the overall RPI basket last year, a significant increase since 2008 (37%), which in itself shows how the rising cost of essentials has been absorbing a steadily growing proportion of household incomes. The weightings attached to these components, and the rates at which their costs have increased, are summarised in fig. 5.

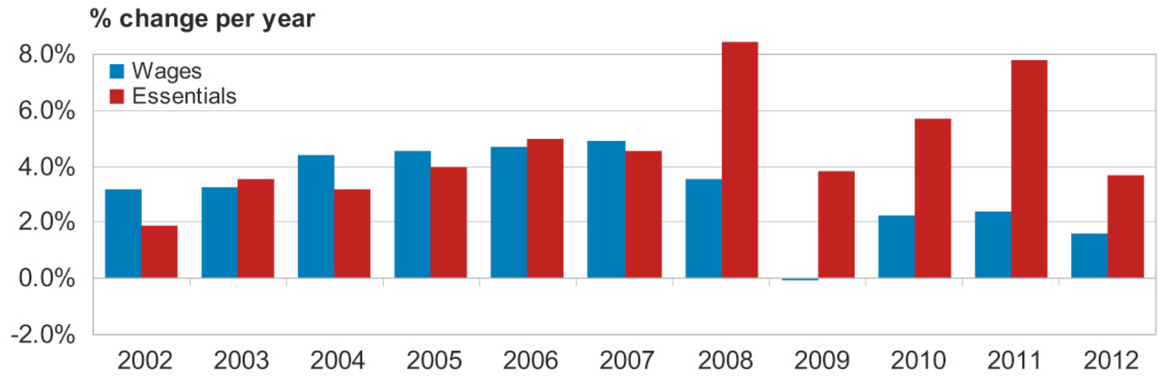
It will be clear from fig. 5 that the cost of essentials, as measured by our index, has been outpacing both wages and CPI inflation for at least a decade. Between 2002 and 2012, the rise in the Essentials Index (+62%) far exceeded increases in nominal wages (+36%).

More to the point, however, this disparity has been widening since the economic crisis. Between 2002 and 2007, nominal incomes increased by 24% and the cost of essentials rose by 22%, meaning that real incomes, measured against essentials, improved by 1.5%.

Since 2007, however, this relationship has worsened dramatically. Between 2007 and 2012, nominal incomes expanded by 10% whilst the cost of essentials soared by more than 33%, meaning that the average working person would have been 17% worse off if he or she had spent the whole of their income on essentials.

Of course, few people do spend their entire income on essentials. However, with real incomes under pressure, and with the prices of essentials now increasing at annual rates of close to 4%, the proportion of household incomes going into essentials is clearly rising, and is set to continue to do so.

Fig. 6: Changes in incomes and essentials, 2002-12*



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Wages	3.2%	3.2%	4.4%	4.6%	4.7%	4.9%	3.5%	0.0%	2.2%	2.4%	1.6%
Essentials	1.9%	3.5%	3.2%	4.0%	5.0%	4.5%	8.4%	3.8%	5.7%	7.8%	3.7%

*Sources: Office for National Statistics and Tullett Prebon calculations, see text

This in turn means that households' scope for making discretionary purchases is clearly under severe and sustained pressure.

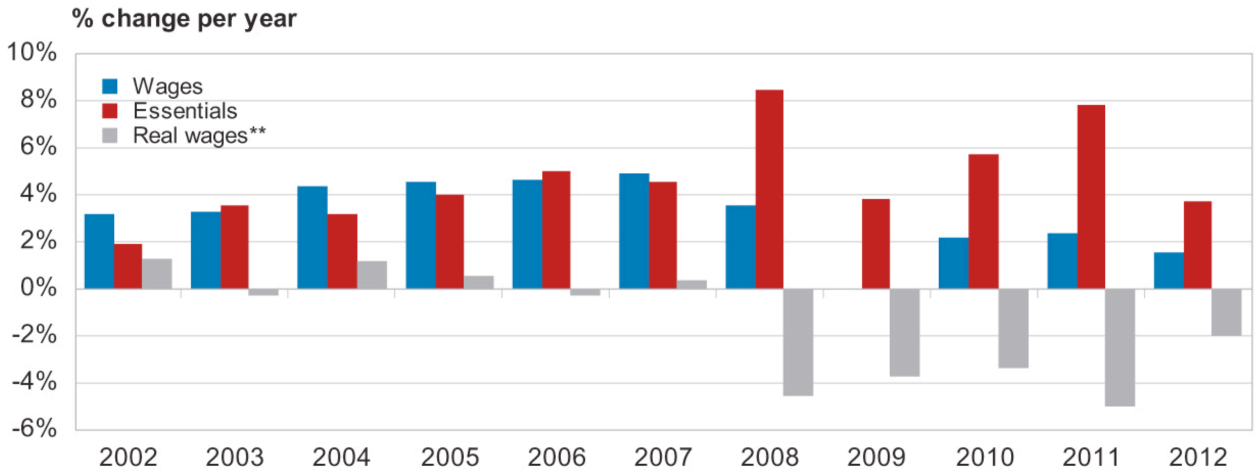
Implications

We draw the following key conclusions from the first issue of the Tullett Prebon UK Essentials Index:

- The cost of essential purchases rose by 3.7% in 2012. Though a sharp improvement over 2011 (7.8%), this remains a faster rate of increase than either CPI inflation (2.8%) or wages (1.6%).
- This continues trends which, though evident since 2002, have become much more pronounced since the financial crisis.
- Conventional inflation measurement fails to reveal the damage that the rising cost of essential purchases is inflicting on consumer budgets.
- Scope for discretionary purchases is being squeezed between stagnant wage growth on the one hand and the escalating cost of essentials on the other.
- Prospects for consumer-driven growth in the economy have been undermined by the adverse impact of the soaring cost of essentials.
- Low income groups (including pensioners) are subject to particular pressure from the escalating cost of essential spending.

Dr Tim Morgan
Global Head of Research

Fig. 7: Changes in real incomes versus essentials, 2002-12*



*Sources: Office for National Statistics and Tullett Prebon calculations, see text

**Nominal incomes measured against essentials

Statistical supplement: Annual

Year	Essentials Index	Rate of change
2000	95.79	+3.4%
2001	98.17	+2.5%
2002	100.00	+1.9%
2003	103.54	+3.5%
2004	106.84	+3.2%
2005	111.09	+4.0%
2006	116.65	+5.0%
2007	121.92	+4.5%
2008	132.21	+8.4%
2009	137.26	+3.8%
2010	145.12	+5.7%
2011	156.43	+7.8%
2012	**162.21**	**+3.7%**

Statistical supplement: Monthly

Month	Rate of change
Jan-12	+6.0%
Feb	+5.7%
Mar	+5.4%
Apr	+4.9%
May	+4.1%
Jun	+3.1%
Jul	+3.4%
Aug	+3.2%
Sep	+2.5%
Oct	+2.5%
Nov	+2.2%
Dec	+2.3%
Jan-13	**+2.9%**

Tullett Prebon Group Ltd | 155 Bishopsgate, London EC2M 3TQ | Tel: +44 (0)20 7200 7000 | Fax: +44 (0)20 7200 7176 | www.tullettprebon.com