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European Economic Perspectives

UK Retail Margins Under Pressure

If the major high-street retailers are to be believed, the pre-Christmas period was a terrible time for UK retail sales. In addition to numerous profit warnings, British Retail Consortium (BRC) data showed like-for-like sales down an annual 0.4% in December. This prompted the BRC to call it "the worst Christmas for retailers in the last decade." However, while this may be true for some retailers, it is probably not true for the sector as a whole, and it is certainly not true for the consumer.

The headline BRC data mask a number of important details. First, the 0.4% year-over-year decline in like-for-like sales concealed a 2.5% rise in total sales. At a time when established high-street names are losing market share to new entrants, the latter may be a better guide to underlying trends. Second, the BRC publish data only for the value of retail sales. If we adjust total sales growth for the BRC's estimate that prices were down 1.4% in December, we get volume growth of 3.9%. This is in line with the average recorded over the last six months and can hardly be described as "weak."

Hence, the BRC data may be telling us more about competitive pressure than underlying volume trends. The scale of the margin squeeze is evident in several indicators. The implied deflator for UK retail sales is running at -1.5% for total sales and -3.3% for household goods. In addition, a simple margin indicator for the UK retail sector shows that a structural deterioration in margins has started to intensify again (**Display 1).**

It may seem strange that margin pressures are rising when household income growth is also rising; third quarter data show nominal primary income[1] up 6.2% year over year, compared with average growth in 2003 of 4.9% and just 2.5% in 2003. However, the answer may lie in the sharp pickup in prices for many household essentials. This is reducing the amount of income available for expenditure on non-essential, or discretionary, items.

Consumer price index (CPI) inflation is currently running at just 1.5% in the UK. However, while the CPI may have many uses, it may not be the best indicator of the cost of living. The traditional cost-of-living measure in the UK is the retail price index (RPI). Besides some technical differences, the main discrepancy between the CPI and RPI is that the RPI includes house prices and mortgage-interest payments. Mainly because of this, RPI inflation in the UK is currently running at 3.4%.

The situation may, however, be worse than this. We can illustrate this by splitting the RPI into two broad components. We have called the first component the non-discretionary RPI. It includes housing, utility bills, public transport, energy and food. It accounts for 55% of the RPI, and inflation in this component is currently running at 6.5% year over year.

The second component includes items which people have much more discretion about purchasing; there is rarely a pressing need to buy a new computer or car, but most people do have to pay their mortgages and fuel bills. We have called this the discretionary RPI, and it accounts for 45% of the index. With the non-discretionary component of spending eating up so much disposable income, it is not surprising that inflation in this component has been squeezed and that prices are now falling **(Display 2).**

Much of the increase in the non-discretionary RPI has been due to housing and fuel **(Display 3).** If, as we expect, housing and oil prices continue to ease, then non-discretionary inflation is likely to fall back. With household income growth rising, this should leave more income available for discretionary spending, and take some pressure off retail margins. In the meantime, we should be careful not to extrapolate from the problems of some retailers to the general health of the economy and to likely changes in interest rates.

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[1] Wages and salaries, property income plus social security benefits

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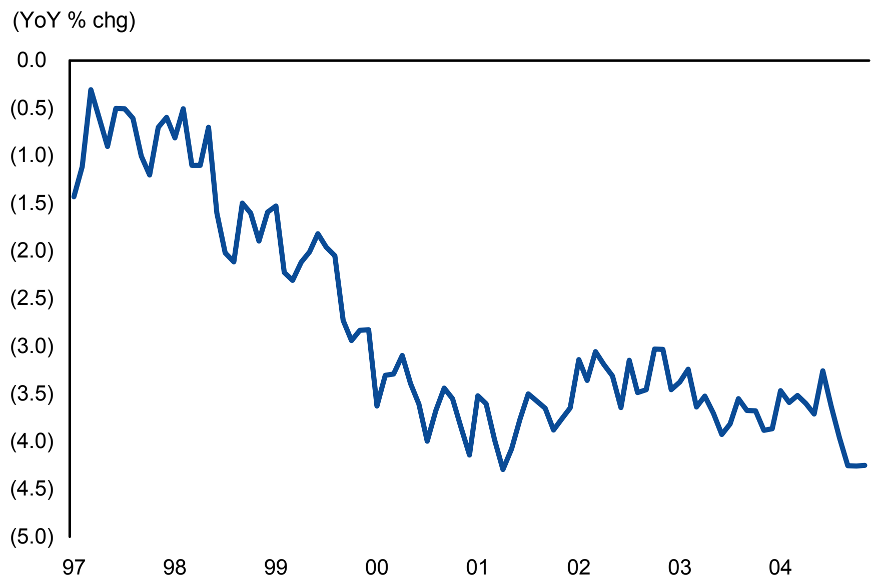
Display 1: Retail Margins Under Pressure

Annual Change in UK Retail Margin Indicator

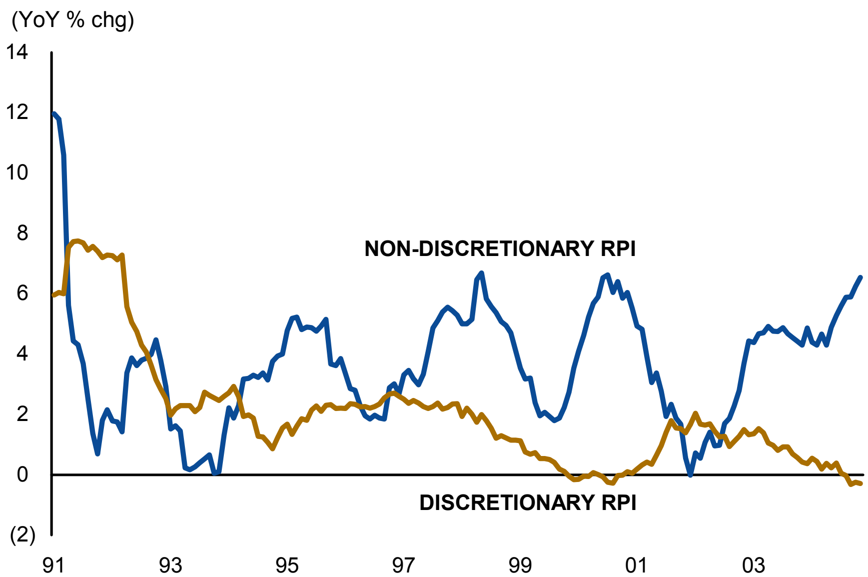


Margin Indicator = CPI inflation for durable goods less PPI inflation for durable goods
Source: Haver Analytics and Alliance Fixed Income, January 14, 2005

Consumer price inflation for consumer goods is currently running at -2.4% while producer price inflation for consumer goods is running at +1.8%. The squeeze on retail margins is structural, but has intensified in recent months.

Display 2: High Inflation in the Non-Discretionary Component of the RPI Has Squeezed the Discretionary Component

Breakdown of RPI Inflation by Discretionary and Non-Discretionary Items



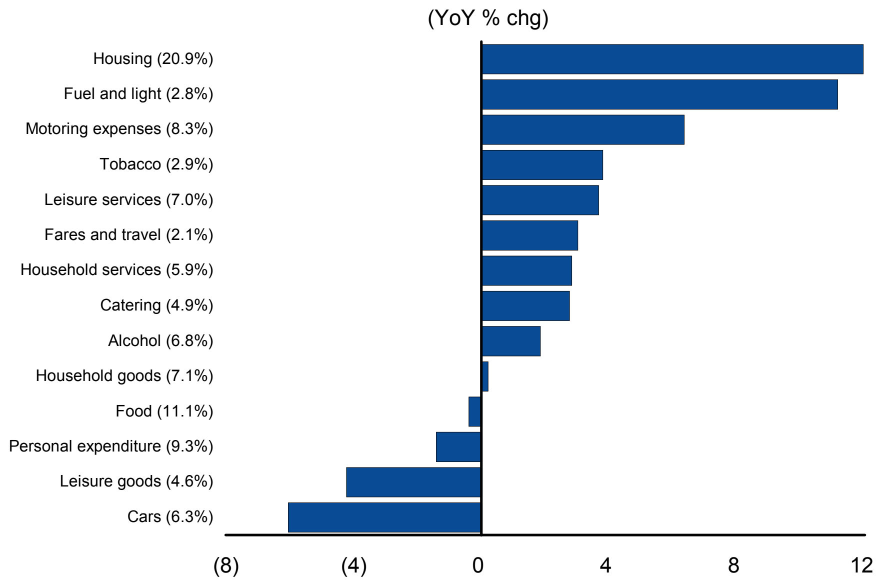
Non-Discretionary RPI = housing, food and beverages, utility bills, motoring expenses and public transport; Discretionary RPI = household goods and services, leisure goods and services, cars and catering

Source: Haver Analytics and Alliance Fixed Income, January 14, 2005

Prices for essential, or non-discretionary, items have risen sharply in the UK. This has reduced the amount of income available for non-essential or discretionary spending and added to pressure on retail margins.

Display 3: Housing and Fuel Have Led the Rise in Non-Discretionary Inflation

Breakdown of UK RPI Inflation by Major Component



Figures in brackets represent RPI weights

Source: Haver Analytics and Alliance Fixed Income, January 14, 2005

Housing and fuel prices have led the rise in non-discretionary inflation. If, as we expect, housing and oil prices continue to moderate, this should lead to a drop in non-discretionary inflation. This, in turn, might take some pressure off retail margins.