Inflation And Stagnant Wages Squeeze Western Europes Middle Class

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Author: Countries and Consumers - Date published: 11 Jun 2008

Sharp increases in food and energy prices in 2008 are squeezing Western European middle class households, whose share of total disposable income has dropped from previous years. The slowing down of the housing market in the UK, Spain and other countries is also adding to middle class household troubles. The purchasing power of lower middle class households is undermined and confidence is low. Unease among consumers finds expression in political protest and a growing number of strikes, which will harm business environments. Key pointsThe share of middle class households' total disposable income has fallen in the decade before 2007, as average disposable incomes have not increased much beyond inflation;In some Western European countries, such as the UK and Spain, middle class households benefited from a housing boom that supplemented their incomes and hid the erosion of their share of national income. Yet with the 2007 credit crunch and housing prices falling, bank mortgages are no longer easily available to middle class households;Inflation grew at an alarming pace towards the end of 2007 and reached an annual rate of 3.4% in the first quarter of 2008 in the eurozone. Some items such as food and energy have gone up more sharply during this quarter. These price rises have not been accompanied by similar wage increases. Middle class families increasingly feel their purchasing power eroded. They are more pessimistic about the future and more cautious in their expenditure;The lagging of wages behind inflation has led to strikes and industrial action across the continent, among both white and blue collar professions. Labour unrest is hurting the business environment, for example in the disruption of public transport and airports;While some white collar employees, especially in the public sector, are able to strengthen their income through industrial action, most middle class employees are not unionised and are more likely to vent their frustration through political means. Public opinion has turned against governments, most notably in Britain and France. Political turmoil could hurt the business environment as structural reforms are cancelled or postponed.Middle class hit by inflation, wage stagnation and the credit crunch

The sudden rise of inflation in 2008 and the global credit crunch have come together to give the Western European middle class a rude awakening: Between 2002 and 2007, average household disposable income in the biggest European economies grew faster than inflation, yet slower than national growth. In the UK, total GDP grew by a real 11.9% between 2002 and 2007, but average per capita disposable income grew by only 4.9%. In Germany, real GDP growth of 4.0% was paralleled with a real per capita growth of only 1.8% in average disposable income;Over the same period, the share of middle class total disposable income fell, as wages generally did not keep up with economic growth. The share of the 40% middle income households (deciles 4 to 7) of total national disposable income has shrunk in most countries in Western Europe, falling in Italy from 33.8% of total disposable income in 1997 to 31.7% in 2007;

Â Share of middle 40% of households (deciles 4-7) of national disposable income in major Western European economies: 1997 and 2007 Source: Euromonitor International from national statisticsIn some countries, middle class incomes received a boost through rising house prices before 2007. In the UK, Spain, Belgium and Sweden, the value of houses more than doubled between 1996 and 2006. Middle class households supplemented their incomes by selling their houses or by taking mortgages, due to the easy availability of bank credit until 2007. The wealth effect of higher prices made consumers feel more confident during this period;The housing boom until 2007 made the stagnation of wages less noticeable. Yet the global credit crunch since 2007 has made it much more difficult for middle class households to receive bank loans and mortgages. As the housing market in former hotspots cools down, households are again reliant on their wages to cover their expenditure and debts. This comes at a time when middle class households feel the pinch of higher food and fuel costs;The low rate of disposable income growth makes middle class households vulnerable to inflation. In most of Western Europe, inflation kept within the 2.0% target between 2003 and 2007. However, in the last quarter of 2007 and the first four months of 2008 inflation rose rapidly. The European Central Bank's consumer price index (CPI) rose by 3.3% in April 2008, after a rise of 3.4% in the first quarter of that year;European Inflation is fuelled by global factors, most importantly the inter-related rise of food and energy prices. As the price of fuel goes up, the production, processing and distribution of food becomes more expensive. The drive to replace gasoline with biofuels has also affected the price of agricultural commodities, and by extension the price of staple foods such as rice and bread. Processed food prices in the eurozone have risen by an annual rate of 6.4% in the first quarter of 2008. Energy prices increased by 10.7% in the same period.

Â Annual inflation by quarter in the eurozone: 2006-2008Source: European Central Bank

As the cost of transport, heating and food rises, lower middle class households are left with less to spend on other items. Mood darkens among middle class consumers

As inflation rises, middle class household confidence and purchasing power are undermined: Most affected by inflation are lower middle class households in suburban areas, who spend a larger share of their income on transport due to commutes, and whose expenditure on food takes a higher share of their income than wealthier households. Data from

2005 indicates that lower middle class households in Germany, UK, Italy and France spent on average between 20-25% of their expenditure on food and transport;Even wealthier households are becoming concerned and are less happy to spend on non-essential consumer goods and services. A survey in April 2008 in France showed that consumer confidence regarding the future was falling, while retail sales have fallen to the lowest level in two years. Surveys in the UK in April 2008 have shown that consumers are worried by inflation and are less likely than in October 2007 to make major purchases such as a buying a house or a car. Consumers are also more reluctant to purchase household goods â€“ 12.0% believed that it was a bad time to buy â€“ twice as many as in six months earlier.Labour and political unrest

Rising inflation, after years of low pay increases, has led to industrial and political unrest:A wave of strikes is sweeping through Western Europe. France, Germany, the UK, and smaller economies have seen industrial action in a range of sectors, from teachers to railway workers, demanding wage increases. In some places, like Germany and Greece, strikers succeeded in securing substantial pay rises for employees. Yet such achievements could trigger further inflationary pressures. The strikes are introducing turmoil and instability that is damaging for Western Europe's business environment. Shutting down vital services such as public transport disrupts economic activity of both the public and private sector;Pay rises could lead to increased unemployment. 12 EU countries, including Britain and France, increased the minimum wage in 2007 and 2008. The additional cost of labour makes it difficult for employers to hire new workers and could lead to lay-offs, especially since other business costs are rising because of inflation;Some middle class workers, such as white collar employees in the public sector, could benefit from trade union actions. Yet trade union membership is falling in Europe, among the middle class especially. In the UK in 2006 only 28.4% of employees were members of trade unions, down from 32.6% in 1995. Middle class workers employed on a part-time and temporary basis, or belonging to the private sector, are unlikely to be union members. This puts them in a weak negotiation position vis-Ã -vis employers;Middle class workers who are unable to take organised action are most likely to express their frustration through the ballot box. High inflation, unmatched by wage increases, was quoted as one of the reasons for Labour's humiliating defeat in the UK local elections in May 2008. Labour came third, its worst result in 60 years;Political upheavals could stall economic reforms, especially if they are seen as undermining the lower middle class. In France, Nicolas Sarkozy came to power in 2007 promising to enhance French household purchasing power. His structural reforms aim at making the French labour market more competitive, for example, by loosening up regulation regarding the 35 hour work-week. Such ideas met with staunch opposition and are difficult to pass in the current environment.Future Scenarios

Inflation is set to remain high in the short term: The Bank of England has warned that annual inflation may reach 4.0% in 2008, driven by high energy and food prices. Similarly, the European Central Bank expects annual inflation for the eurozone in 2008 to be â€œsignificantly aboveâ€• the target of 2.0%;Rising prices will continue to squeeze Western European middle classes and hurt consumer confidence. Lower middle class households are likely to feel the pinch more than others through increases of food, energy and fuel bills. Middle class households in the UK, Ireland and Spain are expected to suffer more, because of the falling housing market;Further strikes and political turbulence are to be expected in 2008 and 2009. Private sector employees will find it difficult to achieve wage increases from employers, as business costs soar, but public sector employees could win achievements through industrial action. This, however, may come with the price of driving inflation higher.

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