

Consumption (C)

Consumption (C) is total household spending on goods and services. It is the largest component of aggregate demand, typically around 60% of AD in the UK.

For Example UK households are expected to spend approximately £2.1 trillion on goods and services in 2026.

Disposable Income and Consumption

Disposable income is the income households have available after paying direct taxes (e.g. income tax, National Insurance) and after receiving benefits. It is the **main** determinant of consumption because it affects how much households can afford to spend.

Marginal Propensities

Marginal Propensity to Consume (MPC)

MPC is the proportion of an **increase** in disposable income that households choose to **spend**. It can be written as $MPC = \Delta C / \Delta YD$.

A higher MPC usually means a stronger multiplier effect because more of any extra income is spent. A lower MPC tends to weaken the multiplier because more income is saved instead of being spent.

Marginal Propensity to Save (MPS)

MPS is the proportion of an increase in disposable income that households choose to **save**.

Consumption and Saving

Households can either spend their disposable income (consumption) or save it. When savings increase, consumption usually falls, and when savings decrease, consumption usually rises.

The household savings ratio measures savings as a proportion of income. It is often low during booms when confidence is high, and higher during recessions when households become more cautious.

In the UK during COVID lockdowns in 2020, the household savings ratio reached around 25% because uncertainty rose and opportunities to spend were reduced.

Interest Rates

Interest rates are set by the Bank of England and influence both borrowing and saving decisions. They affect consumption through the cost of credit, mortgage repayments, and the reward for saving.

If interest rates rise, borrowing becomes more expensive (cost of borrowing increases) and saving becomes more attractive (return on savings increase). Higher mortgage repayments can reduce disposable income, so consumption tends to fall.

If interest rates fall, borrowing becomes cheaper (cost of borrowing falls) and saving becomes less attractive (return on savings decreases), so consumption tends to rise.

For example base interest rates jumped from a record low of 0.1% (lowest IR in history) in 2020 to a peak of 5.25% in August 2023 (to try help combat inflation)

Consumer Confidence

Consumer confidence reflects how optimistic households feel about job security, future income and the overall economy. It matters because it affects precautionary saving and willingness to make major purchases.

When confidence is high, households save less for “just in case” reasons and are more likely to spend, especially on big-ticket items. When confidence is low, households often increase saving due to fear of unemployment or falling income, so consumption falls.

During COVID-19 lockdowns, many households built up unusually high savings (from 6 % pre-pandemic to a record 27.4% in 2020) due to uncertainty and restrictions on spending.

Wealth Effects

Wealth effects happen when changes in asset prices affect household spending. If house prices or share prices rise, households can feel richer and more financially secure, so consumption tends to rise.

This is called the positive wealth effect and can be reinforced if households borrow against higher asset values. If asset prices fall, households may feel poorer and cut back on non-essential spending, creating a negative wealth effect.

During the 2008 crisis, a 15% crash in UK house prices wiped out billions in equity, triggering a "negative wealth effect" where consumers cut spending by roughly 5p to 8p for every £1 of lost property value.

Inflation Expectations

If households expect prices to rise in the near future, they may bring spending forward to avoid paying more later. This can cause a short-run increase in consumption.

One example is Germany's announcement of a future VAT rise in late 2005 (effective 2007), which encouraged higher spending in 2006 before prices rose.