OXFORD ECONOMICS

Evaluating the Consumer Financial Vulnerability Index

A report for Genworth Financial
October 2010

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Contents

Executive Summary

As the publication of the fourth annual Consumer Financial Vulnerability index approaches, specialist insurers Genworth Financial have commissioned an assessment of the first three waves of their annual study, to examine and identify the predictive power of the Index. Our analysis reveals that the Index is a key indicator of households' confidence in the economy, which is itself strongly correlated with the business cycle. The Index scores indicate that the global recession triggered by the financial crisis was anticipated by households in 2007 and 2008. Moving into 2009, the scores also suggest that households were able to identify the subsequent different recovery paths across Europe.

Within the broad macro trends, the Index results are able to predict movements in unemployment in particular. This reflects the fact that job security is a key determinant of financial vulnerability, and that consumers are able to accurately identify how stable their household income will be in the near future. Our analysis also highlights the fact that consumers' confidence in their income stream feeds directly into their decision of how much to consume and how much to save. As a result, trends in consumption over the year following the survey are strongly correlated with the Index. Finally the Index is less strongly correlated with GDP. This finding can be explained by the fact that government spending has been used to prop up economies in Europe in recent years, and whilst this has prevented an economic collapse it has not stopped unemployment from rising and consumer confidence falling.

1 Overview

The fieldwork for the Genworth Financial's index of consumer financial vulnerability in 2007 coincided almost exactly with the beginning of the financial crisis[1]. Using survey data to measure the ratio of financially vulnerable households to those that are financially secure (based on their current financial position and how they expect this to change in the future) the Index is a key indicator of consumer confidence in the economy. It is also a signal of the current levels and expected changes in the determinants of financial vulnerability; earnings and the unemployment rate[2].

The first survey was conducted in the second half of 2007, as the beginnings of the credit crunch were being felt by the global economy, and in retrospect the survey's predictive power was already clear at this stage. With the exception of Ireland, households in Southern Europe[3] were already feeling financially vulnerable, resulting in Index scores significantly higher than their northern European counterparts. By the second survey conducted in September 2008, household financial vulnerability had increased across the board. At this point only households in Scandinavia felt relatively financially secure on average, whilst Italy, Ireland, Spain and Portugal (the economies that went on to experience the deepest recessions and sharpest rises in unemployment) were four of the five most vulnerable countries within the sample. The surveys conducted in September 2009 presented a more mixed picture. In Western Europe and Scandinavia households' position and expectations had improved, and as a result the average Index score in these areas was lower than in 2008. In contrast, Ireland and the Southern European economies still showed signs of vulnerability. Consumer confidence in Ireland in particular had worsened dramatically, propelling the country to the top of the Index.

Box 1.1: Region definitions

To draw broad conclusions about the survey's predictive power, we have grouped the European economies sampled into three groups; Scandinavia (Denmark, Norway, Sweden and Finland (from 2008)), Western Europe (Germany, France and the UK) and Ireland and Southern Europe (Portugal, Spain, Italy, Ireland and Greece (from 2009). The Index score for each region is calculated as the mean value across the member countries.

[1] By working with the European Credit Research Institute and the Personal Financial Research Centre at the University of Bristol, Genworth Financial have ensured that the survey and results are academically robust.

[2] Note that the Index measures the degree of household financial vulnerability, so a large positive score indicates a high degree of vulnerability, whilst a negative score indicates that households feel relatively secure.

[3] Peripheral and Southern Europe includes Portugal, Spain, Italy, Ireland and Greece (from 2009).

Calculating the regions' Index scores using a weighted average (where each country's importance was captured by their GDP) did not produce significantly different values.

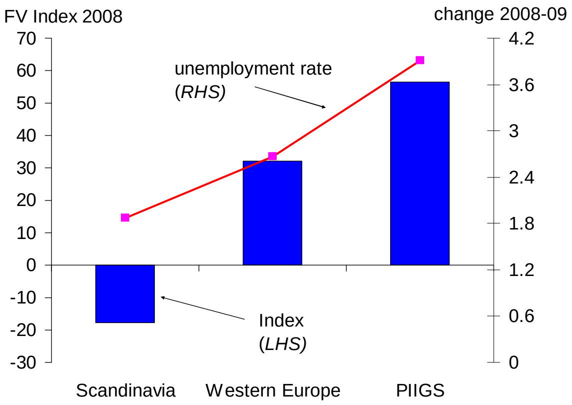
The Index has clearly highlighted the key stresses in the European economy and identifies those countries that were most vulnerable. The beginnings of the global recession and the impact this has had on households were anticipated in 2007 and 2008, whilst the diverging recovery patterns of Scandinavia and Western Europe (which have returned to growth) and Southern Europe and Ireland (which in some cases are still contracting) are clear from the 2009 results.

2 Determinants of the Index

As the Index is a measure of the degree of future financial security, it should reflect households' future expectations with respect to income and unemployment (see Charts 1.1 and 1.2). Focusing on the 2008 and 2009 surveys, the Scandinavian countries reported a negative Index score (indicating relative financial stability for the average household) which was followed by relatively small movements in unemployment over the next year[4]. In contrast to this, in Ireland and the Southern European economies high vulnerability scores were followed by relatively large increases (in most cases from an already high base) in unemployment in the following 12 months. These results suggest that there is a strong link between the Index and shifts in the labour market.

Chart 2.1: Genworth Index 2008 and change in unemployment 2008-09

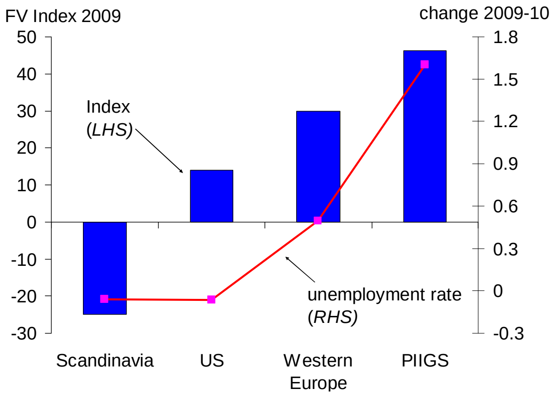
Index and unemployment rate



Source : Oxford Economics/Genworth Financial

Chart 2.2: Genworth Index 2009 and change in unemployment 2009-10

Index and unemployment rate



Source : Oxford Economics/Genworth Financial

In contrast to unemployment, inflation and consumer borrowing rates do not seem to have a direct impact on households' vulnerability. For those workers that managed to retain their jobs, falling inflation and mortgage interest rates have increased the income available for consumption in real terms. Despite this, in 2008 in particular 32% of households felt that their financial position was going to worsen over the next twelve months. This finding indicates that job security is the key determinant of financial vulnerability, with real incomes and the cost of borrowing playing only a minor role.

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[4] It is likely that the very generous welfare states that exist in Scandinavia also contribute to household financial security. This may explain why the Index remained negative throughout the financial crisis and subsequent recession.

3 The Index's predictive power

Households' financial vulnerability feeds directly into the decision over how much of their income to spend, and how much to save. As such, the Genworth Index should be highly correlated with future consumption. As Charts 1.3-1.4 illustrate, the inverted Index score (where a positive number is a sign of relative financial security) is positively correlated with the growth of consumption over the year following the survey. This supports the statement, and highlights that households' current and future expectations of their financial position play a key role in consumer confidence and the decision to spend or save disposable income.

Chart 3.1: Inverse Genworth Index 2008 and consumption growth rate 2008-09

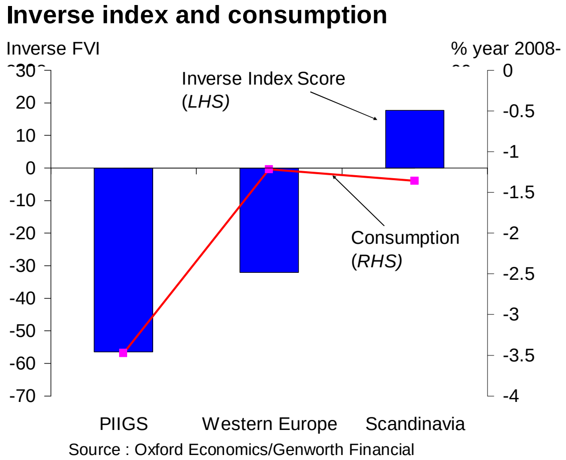
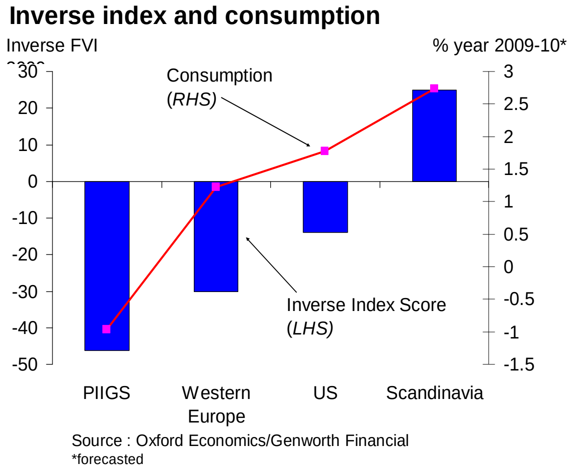


Chart 3.2: Inverse Genworth Index 2009 and consumption growth rate 2009-10



Although consumption and GDP are strongly correlated, the relationship between the Index and GDP is less clear cut. Over the year following the 2008 survey the Scandinavian economies performed worst, with an average fall in GDP of 5.1%, compared to 4.6% in Ireland and Southern Europe and 4.2% for Western Europe. The correlation following the 2009 Index is stronger, with Scandinavia performing better than Western Europe (2.7% growth versus 2.6%), but this is a very small difference given the gap between the average Index scores. These results indicate the importance of other types of expenditure in GDP, in particular government spending. Whilst budget deficits supported the major European economies in 2008-09, they did not boost consumer confidence, resulting in divergent paths for the Index and GDP.

The trends that have been highlighted at the regional level are also clear at the country level. The UK economy has been at the heart of the financial crisis, with the banking sector in particular suffering almost catastrophic loses during the credit crunch. As a result the economy was pushed into recession in the first half of 2008, and did not emerge until the final quarter of 2009. The beginning of the recession appears to have taken households by surprise. The 2007 survey indicated that households felt relatively financially secure on average and expected this position to continue during the following year. By 2008, however, the private sector had fully grasped the magnitude of the crisis. The vulnerability

Index rose by 42 points, one of the highest increases on record, and was followed by a dramatic slowdown in growth and rise in unemployment in 2008/09 (see Charts 1.5 and 1.6). Finally the recovery in the economy in 2009/10 was anticipated by households, with the Index falling by 13 points in the 2009 survey, although the level remained elevated compared to 2007. The elevated level may be explained by the persistently high level of unemployment, which has fallen very slowly despite the return to economic growth.

Chart 3.3: Inverse Genworth Index and GDP growth, 2007-2010

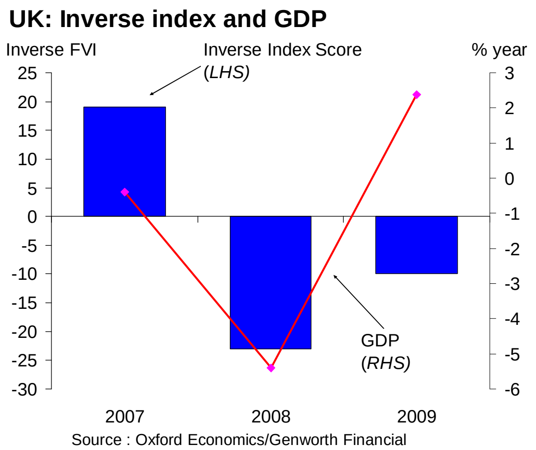
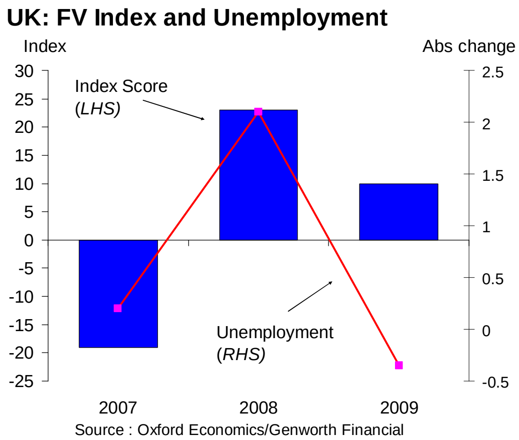


Chart 3.4: Genworth Index and the change in unemployment 2007-2010



In many ways the Irish economy typifies the experience of the vulnerable Southern European economies over the last three years. Growth in the economy in the years before the credit crunch was buoyant, averaging 5%pa in the years 2002-2007. As a result, households felt financially secure, reflected by the negative Index score (-16) in 2007. Since then the economy has contracted substantially and unemployment has risen dramatically. As a result households' financial security has worsened, as have expectations for the future. The financial vulnerability Index rose by a spectacular 67 points in 2008 to 51 followed by a further rise of 12 points to 63 in 2009. Following these rises consumption fell, unemployment increased significantly (chart 1.8), and GDP growth collapsed (chart 1.7). Perhaps the most interesting point to note is the rise in the Index in 2009, which is in contrast to all other countries included in the 2008 and 2009 sample. This suggests that households appear to have anticipated the ongoing recession and magnitude of the government debt crisis currently facing the country and the impact this has had on GDP and employment.

Chart 3.5: Inverse Genworth Index and GDP growth, 2007-2010

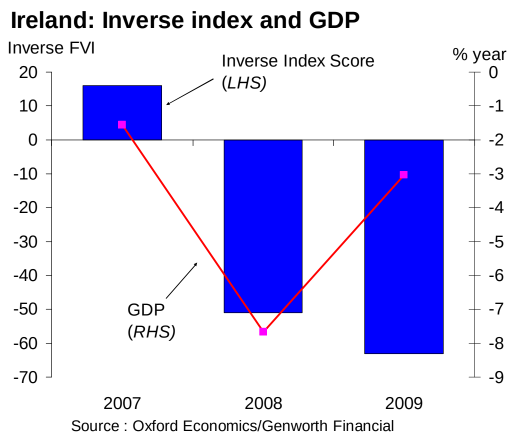
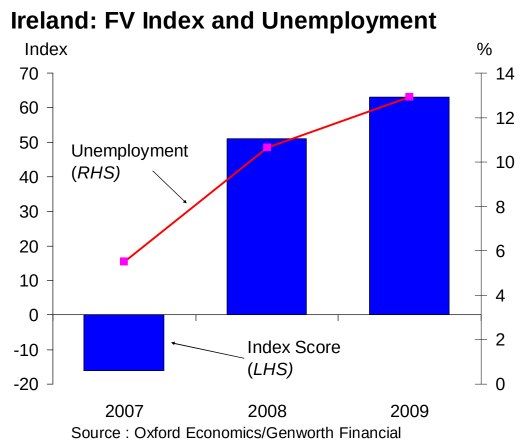


Chart 3.6: Genworth Index and the unemployment level 2007-2010



The experience of the Scandinavian economies over the last three years has been distinctly different to other countries in Europe. The recession in 2008-09 was deep, with GDP falling by 5.1% on average. In contrast to this, unemployment did not rise rapidly during the recession, which may explain the resilience of households' financial position in the face of falling incomes[5]. Denmark typifies the experience of this region. In all years of the survey the Index has been negative, signifying that more households are financially secure than vulnerable. The forthcoming recession (and the relatively small impact it has on employment) is signalled in the 2008 Index, which fell by 11 points to -28, and was followed by a 5.3% contraction in GDP and a 2.2% rise in unemployment. In 2009 the Index showed no change in vulnerability; although GDP recovered strongly in the following twelve months households anticipated the continuing elevated levels of unemployment and resulting ongoing financial vulnerability (see charts 1.8 and 1.9).

Chart 3.7: Inverse Genworth Index and GDP growth, 2007-2010

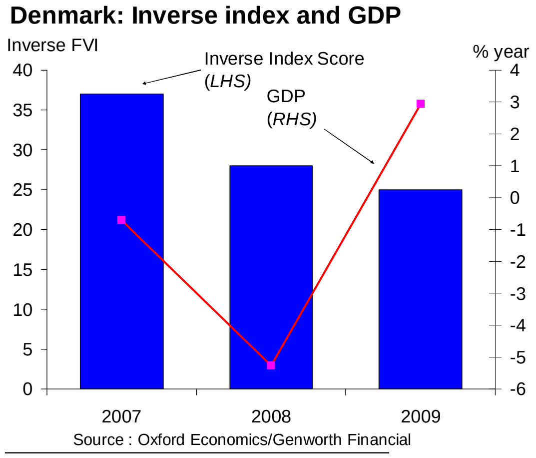
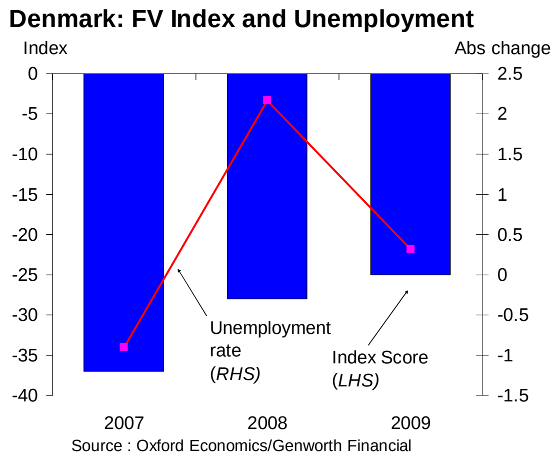


Chart 3.8: Genworth Index and the change in unemployment 2007-2010



[5] As has already been highlighted, the generous welfare state provisions may also have contributed to households' relative financial security.

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