Economics: Time to face the music

We live in interesting economic times. Three months ago, the capitalist system entered what's been coined a "Minsky moment": the point at which credit supply starts to dry up, even to sound borrowers, and the central bank is obliged to intervene. Soon afterwards, the UK witnessed its first bank run since the 70's with the near-collapse of lender Northern Rock. How might these events affect the recorded music industry? Will Page, Executive Director of Research at the MCPS-PRS Alliance, gives an explanation of the concept of 'wallet share' to help us find out.

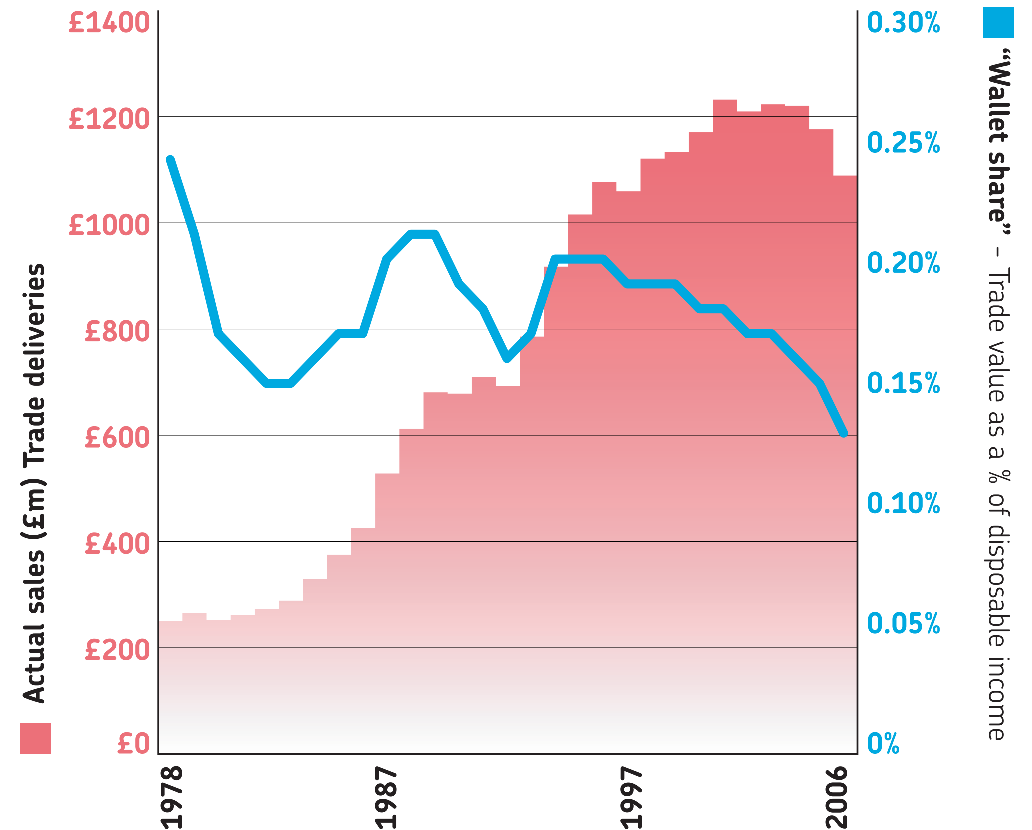
Getting the music industry to take an interest in, understand, and properly apply economics is no easy task. For example, industry commentators often talk about recorded music's "share of wallet" going down, but rarely do they provide evidence to demonstrate: (i) how they calculated its 'share', (ii) by how much has it 'gone down' and (iii) over what 'period of time' did it fall. To correct that, here's a quick crash course to get the debate started.

"Wallet share", in this context, refers to the proportion of disposable income that people devoted to buying music recordings. Disposable income can be interpreted as the maximum amount that a household or a unit can afford to spend on consumption without reducing its net wealth. Put in simple terms, gross disposable income is defined as the money households have available to spend on goods/services, to save or to invest. By focusing on this measure, we can begin to look at trends in "wallet share" over time.

Next we need to work out what the recorded music industry's share of that disposable income actually is. As an initial first step, we can take the trade value of the UK recorded music industry as published in the BPI Statistical Yearbook. Note that this is the trade value, not the retail value, so we are calculating what its worth to the record companies, not what was spent at the till. Also note that this is recorded music, and ignores other revenue streams which may not be all that significant over the period under analysis, but increasingly significant going forward. Nevertheless, it's an important step in the right analytical direction.

The chart opposite helps us join the dots. The red bars represent the nominal value of recorded music in the UK and is captured on the left hand axis. The blue line divides that value by the amount of gross disposable income in the economy and is captured on the right hand axis. One might be tempted to use the different axes to suggest there is a relationship, but let's walk before we start to run down 'Correlation Street'.

Trade value vs wallet share



Firstly, and most intuitively, the trade value of recorded music has been falling in nominal terms since 2003, (in real terms it's been falling for a lot longer), and is now heading down towards the £1 billion watermark. Secondly, recorded music's "wallet share" of disposable income has actually been falling since as far back 1996, with just one minor fluctuation. Third, whilst the actual share of wallet is small, at only 0.13%, the drop-off is notable: it's fallen by a third from its peak of 0.20% in 1996. That means record labels are getting a third less of the consumers wallet than they did a decade ago, despite this trend taking root during a period of uninterrupted economic expansion.

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From here you can also use your economics to consider the cause and effect of the various peaks and troughs. For example how much of the peaks between 1988 and 1996 can be explained by the replacement of old vinyl collections with CDs? Then there's the short sharp in the middle of that spell. Can that trough be reconciled with the recession which took place at the time? More interestingly the prolonged-trough kicks in from 1996, yet P2P only really started in the UK with the advent of broadband in 2001, which offers a rebuttal to claims that piracy is the sole culprit of the record industry's current woes.

That's a first step; the second is to think of where the analysis could go next. An example might be to compare with another country. On that note, it's reassuring to see that the UK's 'share of wallet' is broadly similar to the United States according to a much earlier study by SRI Consulting . Indeed, this could provide us with a very useful 'comparative statistic' by which to compare the relative performance of the recorded music industry in different countries.

Another extension is to consider how music is affected by events in the wider economy. For example, are the fluctuations in wallet share which are visible in the late 70's and early 80's a result of macro economics of the recession at the time, or microeconomics to do with the state of the music industry? Are they both connected, even? Could it be that recorded music is a 'good' that thrives in a recession (as people cut back on more luxurious expenditure and stick to CDs) or a 'good' that suffers during times of prosperity (as people opt for more luxurious goods instead).

What we're talking about here is 'consumer theory' economics, which draws upon both preferences (e.g. a football ticket versus a new CD box set) and budget constraints (e.g. maximising your utility given your access to cash). The dynamics of consumer theory can be easily translated to the real world: should the budget constraint tighten, (as mortgage payments go up), then consumers will initially face trade offs between work and leisure, and then exhibit new preferences over what type of leisure goods they want to consume given the 'belt tightening' that will have taken place.

What will be the winners and losers in terms of consumer preferences? One answer might be that items with a 'lock in' effect such as subscriptions to gyms, cable television and music accounts might weather the storm better than those where the consumer has little commitment, such as iTunes, hence a low opportunity cost of forgoing the planned consumption.

We can extend the thinking a bit further up the supply chain and use our economics to think about what might happen to the much-hyped advertising funded models that are currently being touted.

Let's consider the effect of a hike in interest rates, which is one of the many concerns facing the economy at the moment. If interest rates were to go up, that would increase the cost of capital, which more often than not causes cut backs in other parts of the business - and the first to feel the pinch is often the marketing budget. So, whilst the 'free lunch' offered by advertising-funded models might appear attractive to the end consumer, the economics could undermine the model itself, as advertising expenditure dries up, leaving royalties exposed, (as opposed to insulated), to changes in the macro economy. Of course it could all work the other way, as Spiral Frog might argue, but it's alarming that few people have considered the wider economic considerations.

Getting economics to the music industry table would be timely, as the UK macroeconomic outlook is considerably uncertain given the recent turmoil in financial markets, reduced expectations for economic growth and concern over the future path of interest rates. Investment banking giant HSBC views the economy as about to enter a "short and sharp slowdown". Should that happen, then analysis like this might help us consider what would happen to disposable income and, of that income, how much is dedicated to recorded music. This is especially relevant now, unlike 1996, as consumers can always cut back on their entertainment expenditure by 'consuming' music for free.

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