Recession Watch: no rescue from excess savings

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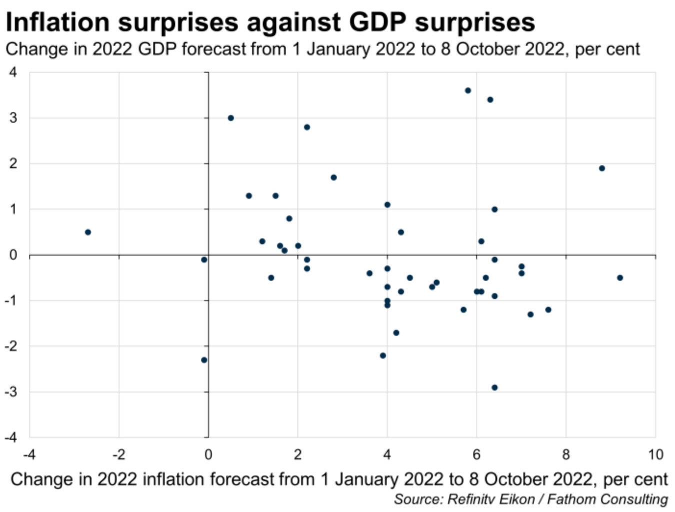
Headlines

- Major economies are facing a policy-driven recession
- Excess savings are unlikely to provide much protection – they are concentrated in the richest quartile, where they have been offset by falling equity prices
- Recession will squeeze out overheating aggregate demand

Forecasts for growth and inflation across the OECD for 2022 have been revised several times already this year, and nearly every time the change was to predict higher inflation and generally lower growth too. That pattern is consistent with a negative supply shock; the obvious culprit is higher energy prices, mostly courtesy of the war in Ukraine. But there are other factors in play too – specifically, the growth in demand for goods that occurred during the pandemic, stretching global supply chains and pushing up prices everywhere; and the run-down of the 'excess savings' that were built up during the pandemic thanks in part to the exceptionally large transfers from governments to consumers and companies. The recovery in 2021 was extremely rapid, fuelled in large part by those transfers. The slowdown in 2022 suggests that that process might have come to an end – surprisingly swiftly, judging by the pattern of growth surprises so far this year.



Part of the reason why the excess savings have not had a larger or longer-lasting impact on aggregate demand is because of how they are distributed across the income brackets. In dollar terms, the largest portion of those excess savings has accrued to

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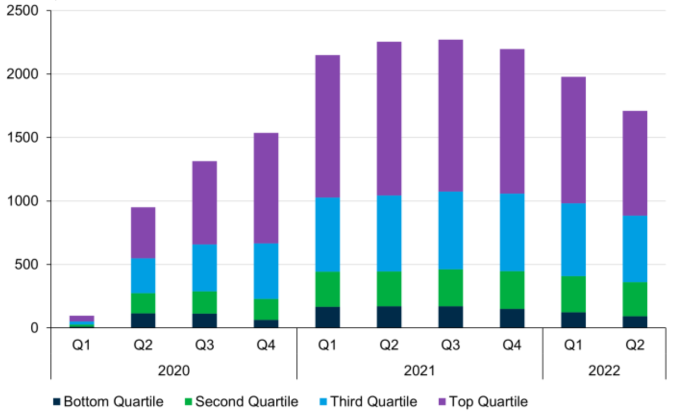
the highest income quartile, as the chart below shows. As a rule, the higher your income, the smaller is the proportion of it that you spend: the rest you save. And something similar is generally observed when it comes to ‘windfall’ shocks to income, like the government transfers. So, on the face of it, the more that excess savings are accrued by the higher income groups out of the windfall transfers that occurred during the pandemic, the lower the marginal propensity to consume you would expect to see.

Stock of excess savings by income quartile

USD, billions

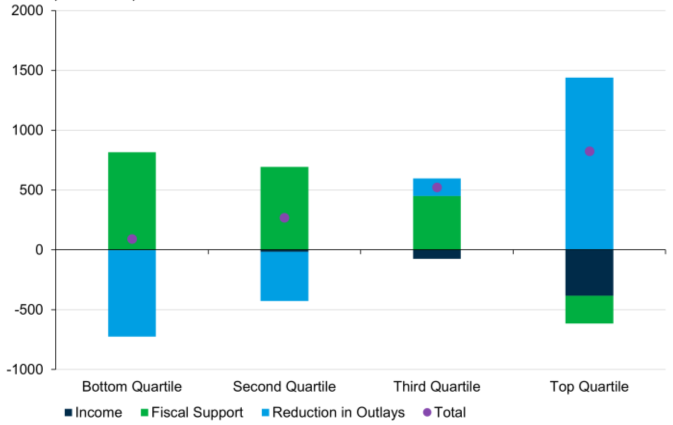


Source: Aladangady et al. (2022) / Fathom Consulting

However, the story is actually more nuanced than that. The excess savings accrued by the richest quartile were not in fact built up thanks to the transfers, which were small relative to their income. Instead they were accrued thanks to reductions in outgoings among that income group during the pandemic. In other words, they spent less than usual, probably because many opportunities to spend (such as on luxury travel and tourism or hospitality) were not available. So the richest quartile have built up savings primarily because they were not able to spend as much as they might have wished during the pandemic, and/or because they chose to accrue higher precautionary savings during that period. Either way, the impact on aggregate demand now that the pandemic appears to be receding might be different than if those savings had come from fiscal transfers.

Contributions to excess savings by income quartile

USD, billions, 2022 Q2



Source: Aladangady et al. (2022) / Fathom Consulting

It is hard to be sure how much of those excess savings will now be spent, or over what period. The normal assumption in most macroeconomic models is that in the long run, consumer spending increases in proportion with income – so a 10% increase in income will lead to a 10% increase in consumption. Note that this long-run relationship can hold no matter what the marginal propensity to consume. For example, a person in the highest quintile of income might spend in each month 57% of their income, saving the remainder. In the long run, in that example, if income (say $1000 in a given week) were to increase by 10% or $100 then consumption (say $570 in a given week) would be expected to increase by 10% as well, or $57.

What happens if the highest income group accrues an extra $1 trillion in savings? In the long run they will increase their spending by the same proportion as that excess saving is a proportion of their income, right? At its peak, the $1 trillion accrued by the highest income quartile of the US population accounted for roughly 12% of their annual household income. So consumer spending should go up by 12% as well, in that income group, right? Well, no – not necessarily.

The difficulty is that the excess saving is a one-off, a windfall, not a permanent increase in income. So the rational thing to do is to consider how much 'lifetime' income has increased, by spreading that windfall across all one's future income. Then the percentage impact on consumption in each year would be tiny.

It turns out in most studies that consumers do not behave 'rationally' in that way. They tend to be much more myopic – focusing on the short term, with a bigger impact on consumption from windfall shocks to income than lifetime smoothing would imply.

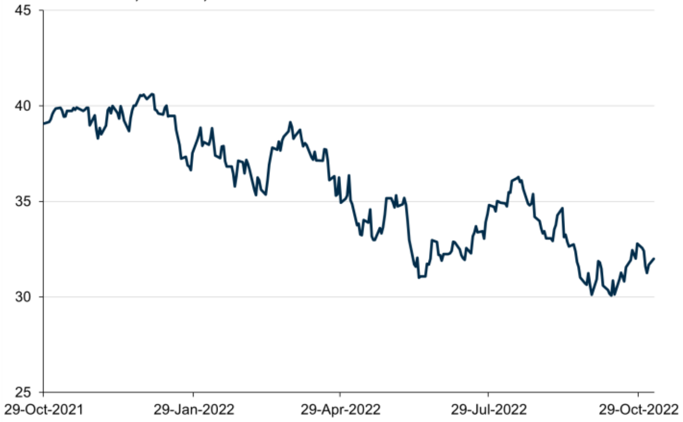
So at one end of the spectrum you have a 1:1 percentage impact on annual consumption in the first year after the shock to savings (implying the top quartile spend an additional $570 billion or so in the first year); at the other end a tiny marginal increment proportional to the effect on lifetime income. Fathom's baseline assumption is in the middle: half the 'excess' saving will be treated as income in the first year across all income groups: more of that will be spent at the lower end of the income spectrum, less at the higher end.

Zooming in on the highest income quartile specifically, Fathom's baseline would be consistent with around $300 billion of the $1 trillion in excess savings for that group being spent within the first year after the shock to savings – about half of that income group's usual marginal propensity to consume out of income.

But the story does not end there. Because, over the same period, there has been another shock affecting that group: the shock to financial wealth. The chart below shows that some $7.1 trillion (around 18%) has been wiped off the value of the S&P 500 since the start of 2022, thanks to the war in Ukraine, the slowdown in growth and the increase in interest rates that have occurred over the same period.

S&P 500 market value

Market value, trillion, USD



Source: Refinitiv Datastream / Fathom Consulting

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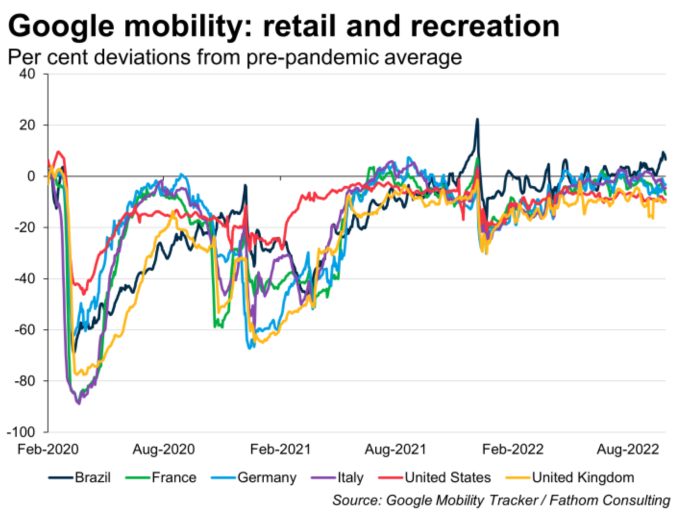
Fathom's proprietary macroeconomic model, GESAM, suggests that a 17% reduction in financial wealth would result in a 1.3% reduction in consumer spending, all else the same, with the bulk of that change occurring within the first four years. But, since the bulk of financial wealth is owned by the highest income quartile, the impact on their spending must be larger than for other income groups – perhaps two or three times as large (our model is silent on this question).

Therefore it is reasonable to assume that a hit to financial wealth like we have seen will tend to reduce consumer spending by the highest income quartile by around 2% to 3% in the first year after the shock. It turns out that 2% to 3% of consumption of the highest income quartile is around $200 to $300 billion a year.

In other words, the net impact of excess savings and a reduction in financial wealth for the highest income quartile in the US is probably close to zero. We should not look for much support for growth from that part of the population. To the extent that excess savings will support consumer spending in the US, that support is likely to come from the third and second income quartiles, where the dollar quantities are large enough to matter and the hit to financial wealth is probably smaller.

High-frequency indicators such as Google mobility trackers support this assessment, in the US and elsewhere. Mobility around retail and recreation venues is still some 10% below its pre-pandemic level in both the US and the UK, while it is close to its pre-pandemic level in Germany, France and Italy and a little above that level in Brazil. These are among the activities that the higher income groups held back on during the pandemic, and they are now flatlining below the pre-pandemic level, with no sign of imminent recovery: if anything, rather the reverse.



All of this suggests to us that without substantial support from macroeconomic policy, a recession in the US is now looking increasingly likely. And that support is unlikely to be forthcoming, with the Fed signalling further rate hikes to come.

Interesting reading

Excess Savings during the COVID-19 Pandemic: Aditya Aladangady, David Cho, Laura Feiveson, and Eugenio Pinto suggest that excess savings are a dwindling buffer for US consumption https://www.federalreserve.gov/econres/notes/feds-notes/excess-savings-during-the-covid-19-pandemic-20221021.html

Remember, remember: just because Liz Truss's efforts to reset the UK's economic strategy were misconceived does not mean that macro policy has not been a disaster for the last decade, writes Fathom's Erik Britton https://www.fathom-consulting.com/research-notes/remember-remember/

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Watch the Sky News broadcast of Fathom's Emergency Monetary Policy Forum, where four former members of the Bank of England's Monetary Policy Committee criticised the Bank's failure to react hard and fast to mounting inflation
https://www.youtube.com/watch?v=6P4HzROd9iQ

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