HSBC Global Research

27 June 2023

Continental thrift

Can Europe's excess savings still come to the rescue?

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Economics - Eurozone

- Post-pandemic 'excess' savings continue to rise in Europe, in stark contrast to drawdowns seen in the US…
- …due to 'unseen' income gains, low confidence and rising interest rates
- As interest rates continue to rise, savings might stay high, and we think the likelihood of a US-style drawdown is low

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Five reasons for continental thrift

Although European savings rates are well off their lockdown-induced highs, they remain elevated – eurozone and UK households are still saving more every quarter than they did before the COVID-19 pandemic. That is in stark contrast to the US, where households have been drawing down on 'excess' savings for over 18 months.

We see five reasons behind this apparent continental thrift: (1) a large chunk of recent income growth has been in 'unseen' components, such as imputed rents, mechanically raising savings rates; (2) income gains have been skewed towards richer households (unlike in the US), which have a lower marginal propensity to consume; (3) high interest rates are making saving more attractive; (4) high interest rates are also diverting more income towards mortgage payments; and (5) confidence remains soft.

Only in America

The US example shows that it may be possible for households to reduce savings rates (or *flows*) below pre-pandemic levels, so draw down the 'excess' savings *stock*. After all, consumer confidence is now edging up, and households may need to draw down their liquid assets (or borrow more) to 'smooth through' the ongoing squeeze on real income.

But there are plenty of reasons for caution too. We start by posing a simple question – if the savings drawdown has not happened already, will slightly higher confidence trigger it now? Moreover, particularly in the eurozone, although headline savings rates are still high, the 'gap' in household deposits relative to pre-pandemic levels is now closing, with households locking up more liquidity in equities and bonds. And interest rates are set to rise further, increasing incentives to save, while diverting more funds to housing costs rather than spending. We also see many reasons for households to remain cautious, including prospects for a (gradually) softening labour market, and weak productivity.

Flattish savings rates and no drawdown in prospect

Taken together, we see European savings rates falling only slightly from here, and remaining above pre-pandemic levels. In other words, we see no scope for a US-style savings drawdown. But there are big risks in both directions. We calculate that a 1ppt fall in savings rates could add 0.5% to eurozone GDP. So if 'excess' savings do 'come to the rescue', we could see a very solid recovery from the eurozone's (mild) winter recession. But, on the other hand, if savings rates rise further, we might see little recovery at all.

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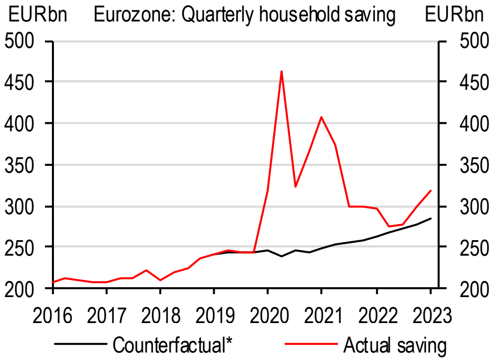
European savings keep rising

The COVID-19 pandemic led to a surge in 'involuntary' household savings, as locked-down households were unable to go out and spend. But the story since then reveals a stark transatlantic divide. While Europeans are saving less than they did during lockdowns, they are still saving more than they did before the pandemic. Meanwhile, American households are drawing down their pandemic-era savings.

European households are still saving more than they did before the pandemic

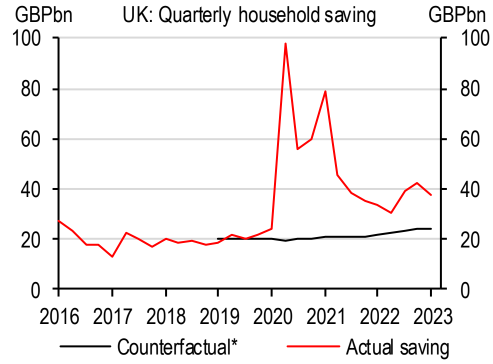
These developments are shown in charts 1-3, which plot quarterly household savings, namely the difference between income and consumption. These are compared to 'counterfactual' paths, which would keep savings *ratios* steady at their 2019 levels.[1] In both the eurozone and the UK, savings running 'in excess', and actually took another leg up last year.

1. Eurozone households are still saving more each quarter than pre-pandemic…



Source: Refinitiv Datastream, Eurostat, HSBC calculations
*Path of EUR saving that would have kept the saving ratio unchanged at its 2019 average, given actual income (see footnote at the bottom of this page).

2. …and so are UK households



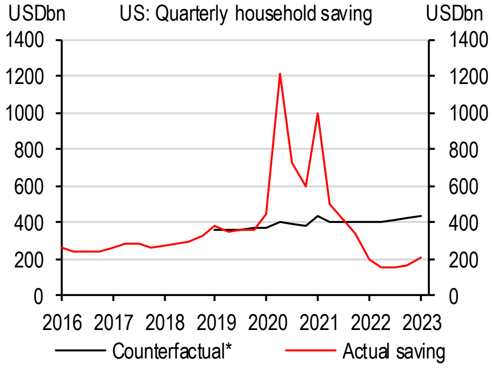
Source: Refinitiv Datastream, ONS, HSBC calculations
*Path of GBP saving that would have kept the saving ratio unchanged at its 2019 average, given actual income (see footnote at the bottom of this page).

1 Specifically, we take household incomes as given, then we ask 'what level of household spending would keep savings ratios at their 2019 levels'? Then the savings path (actual income minus counterfactual consumption) falls out of that. There are various other ways of working out 'counterfactual' savings paths. For example, for the US the San Francisco Fed defines 'counterfactual' savings as a simple continuation of the 2016-19 trend (see FRBSF Economic Letter published 8 May 2023). But we think our approach makes international comparison a little easier, and, in any case for the US, it delivers a similar end result.

US 'excess' savings are being drawn down, in stark contrast to Europe

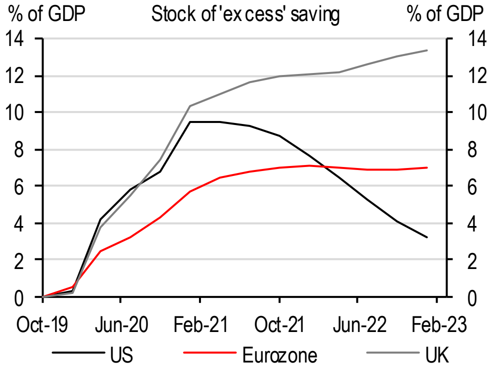
In contrast, US households have, since the second half of 2021, been saving *less* each quarter than prior to the pandemic. This means that, while European 'excess' savings levels are still rising gradually, US levels continue to fall sharply. Indeed, in the US, the excess saving stock stood at USD827bn, or 3.2% of GDP, in Q1. In the eurozone, our estimate of the EUR953bn 'excess' saving stock in Q1[2] equates to 7.0% of GDP, while in the UK, the GBP339bn savings pile is worth a hefty 13.4% of GDP.

3. US households are saving much less than before the pandemic…



Source: Macrobond, BEA, HSBC calculations
*Path of USD saving that would have kept the saving ratio unchanged at its 2019 average, given actual income (see footnote on page 2).

4. …so, unlike Europeans, are running down 'excess' savings



Source: Macrobond, Eurostat, ONS, BEA, HSBC calculations

Why so high?

Five reasons for continental thrift

Why are European households, in aggregate at least, still saving so much? We think there are five explanations:

1. A large portion of recent income growth is 'unseen' as it reflects growth in components such as imputed rents or pension valuations
2. Savings increases have been concentrated among wealthier households, which may have a lower marginal propensity to consume
3. Higher interest rates are incentivising households to save more
4. Higher rates are also diverting household income away from consumption, towards servicing pricier mortgages, particularly in countries with more short-term mortgage fixed deals such as the UK
5. Confidence remains low, so households may be keen to keen to raise larger savings buffers than before the pandemic

Understanding the relative importance of these factors, and their likely persistence, can help us determine whether or not Europe's 'excess' savings stock can 'come to the rescue' and help power a recovery in household spending.

'Unseen' income

Last year, an unusually large proportion of European nominal income growth was driven by 'non-labour' income, as opposed to gains in wage and employment growth. This matters because some components of non-labour income tend to be saved rather than spent. For

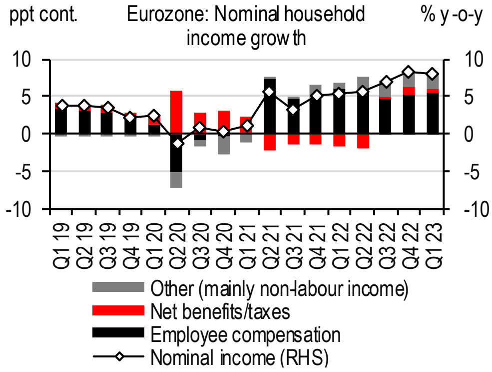
2 For the eurozone and the UK, we estimate Q1 based on full consumption data, but partial income data (eg, compensation of employees), as full Q1 household income data have yet to be published.

example, it may reflect investment income, which may be re-invested (typically by wealthier households). Or it may include forms of 'unseen' income, such as imputed rent (the opportunity cost of homeowners occupying, rather than renting out, their homes) or rises in prospective pension pots.

UK households did not actually 'see' around half of last year's income growth, so implicitly saved it

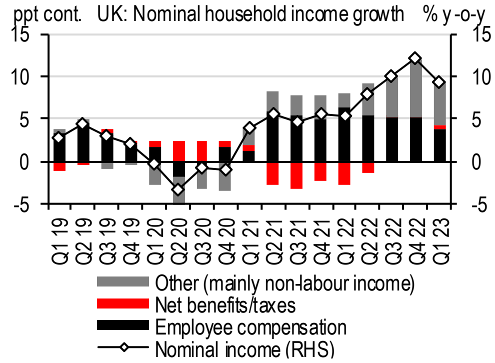
Indeed, in the eurozone, roughly one-quarter of the 8% nominal income growth seen in the year to 2023 Q1 was driven by non-labour income (non-labour income typically makes up less than 8% of total income). But this is primarily a UK story, where over half of the 9.4% y-o-y income growth in Q1 was driven by non-labour income.[3] Half of that growth was driven by imputed rents – largely measured using actual rents – which households do not actually 'see'. The other half reflects a combination of net property income (investment income that households may see but may re-invest), and a rise in pension fund valuations (which will not be realised until households retire). In fact, a large portion of the latter was driven by the jump in gilt yields after October's 'mini-Budget' – not something we associate with a household spending boom.[4]

5. Non-labour income drove one-quarter of eurozone income growth last year…



Source: Refinitiv Datastream, HSBC calculations. NB: 2023 Q1 observations are HSBC forecasts based on partial income data

6. …and over half of UK income growth



Source: Refinitiv Datastream, HSBC calculations. NB: 2023 Q1 observations are HSBC forecasts based on partial income data

Income gains skewed to the rich

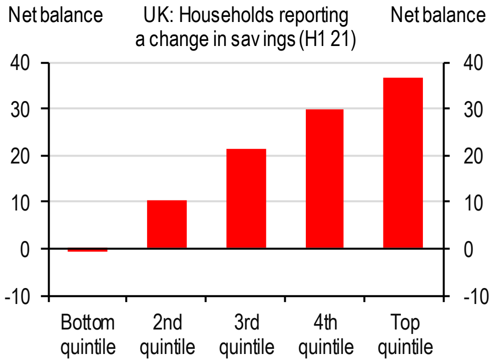
Not only have pandemic/post-pandemic income and savings gains been skewed in their components, they have (relatedly) also been skewed in their distribution across households. Specifically, richer households, whose incomes held up through the pandemic, and who tend to spend more on lockdown-affected services, saw outsized gains in savings (chart 7).

Richer households have a somewhat lower propensity to consume

More generally, we think it is reasonable to argue that richer households have a lower marginal propensity to consume (MPC). That is consistent with evidence from the Central Bank of Ireland, which shows that Irish households at higher income deciles do indeed have a somewhat lower MPC (chart 8).

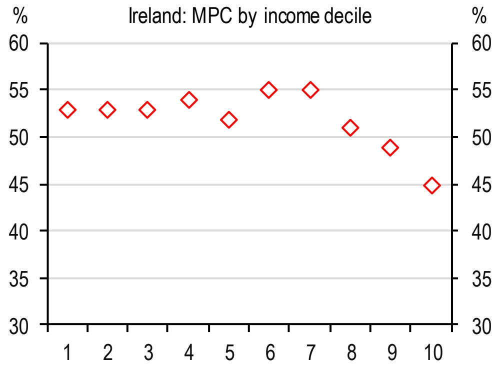
3 Here we refer to household disposable income, adjusted for the change in net equity of pension funds. This adjusted income measure feeds into the household saving ratio.
4 Higher gilt yields reduce defined-benefit pension scheme liabilities. And while the value of many pension schemes' assets has fallen (many hold gilts, the price of which has fallen), the value of their liabilities may have fallen further, reducing pension scheme deficits. This may free up more cash for employers but it does not have an impact on the 'seen' income of pension scheme members. See 'The impact of rising gilt yields on pensions' The Pensions Expert, 13 February 2023.

7. Savings gains have been concentrated among the rich…



Source: NMG Consulting survey, BoE, HSBC.

8. …who have a somewhat lower marginal propensity to consume



Source: Central Bank of Ireland survey: "Imagine you unexpectedly receive money from a lottery, equal to the amount of income your household receives in a month. What percent would you spend over the next 12 months on goods and services, as opposed to any amount you would save for later or use to repay loans?"

Savings accounts offer returns not seen since before the Global Financial Crisis (GFC)

Rising rates: an incentive to save more

Besides the impact of higher interest rates on non-labour income, they should incentivise households to save more. Indeed, households can now achieve better rates of return even on short-maturity bank deposits – at roughly 3% for the eurozone and 4% for the UK (chart 9) – than in recent years. Best-buy tables even show 4%-plus rates for instant access savings accounts in the UK (moneysavingexpert.com) and 3%-plus rates in Germany (konto-testsieger.de). Of course, given high inflation, real interest rates are still very low or negative – it is possible that some households concentrate more on nominal returns, while others are thinking in terms of minimising real-term losses.

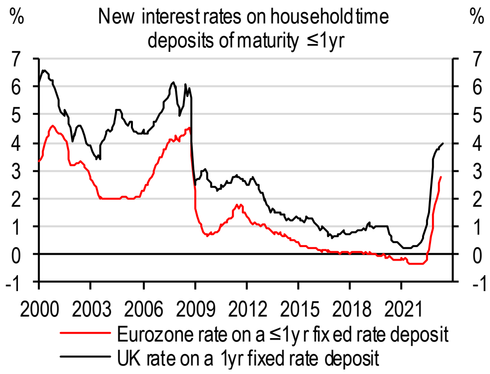
Rising rates: a squeeze on post-housing pay

Mortgage rates are also rising fast (chart 10), which should divert more income away from consumption, towards servicing mortgage debt. This puts direct upward pressure on the saving ratio because headline income measures do not account for housing costs.

More income is being diverted from consumption to mortgages

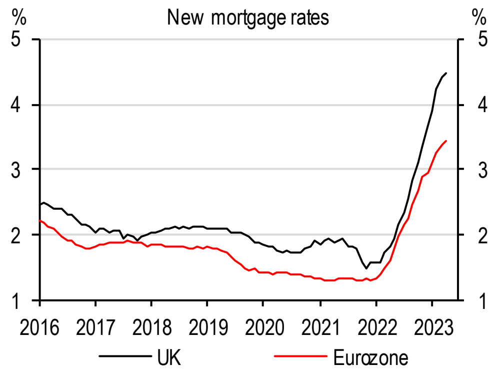
The impact could be large. While BoE data showed UK-quoted mortgage rates climbing to 4.5% in April, a number of lenders have more recently quoted rates at around 6% (The Guardian, 19 June). A borrower with a (fairly typical) GBP175k, 25-year loan switching from a 1.5% to a 6% rate would face a jump in annual mortgage costs in excess of GBP6k. That compares to an average annual household income for remortgagors of GBP87k (UK Finance data, Q1 2023).

9. Even short-term savings accounts have become much more attractive



Source: ECB, BoE, Macrobond

10. Higher mortgage rates will divert more income away from consumption



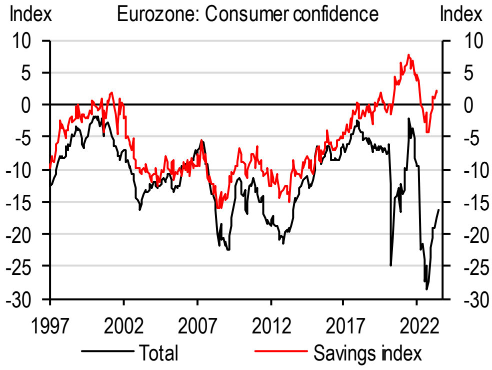
Source: ECB, BoE, Refinitiv Datastream

Confidence has been low

Low confidence may be fuelling precautionary savings

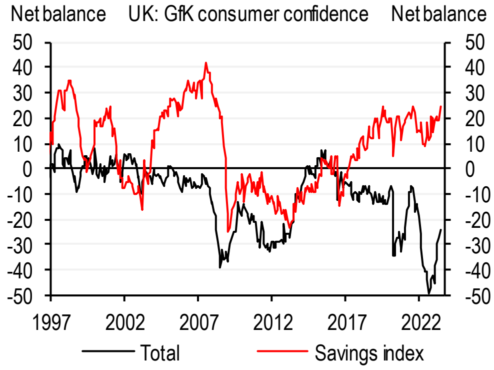
Lastly, despite a recovery in recent months, levels of consumer confidence remain fairly low. In the aftermath of the COVID-19 pandemic, the ongoing war in Ukraine and the resulting inflation squeeze, it is understandable that households may want to build up a larger 'buffer stock' of precautionary savings. Alongside the pull of higher interest rates, we think this is another reason why surveys show savings intentions significantly higher than levels that prevailed over the past 15 years.

11. Confidence has been low, and savings intentions high, in the eurozone…



Source: Refinitiv Datastream. NB: The savings index refers to saving intentions over the next 12 months.

12. …and in the UK



Source: GfK, Macrobond. NB: The savings index refers to agreement with the statement that "now is a good time to save."

Reasons to expect savings to fall

The full note looks at various reasons why one would expect savings to fall further. We look, for example, at what has happened in the US. We concede that the US experience has been different – namely the size pandemic response or impact from the war in Ukraine to name a few – the US experience has shown that savings rates can fall. We also point out how 'unseen' income has also slowed down. In the UK specifically, the change in the pace of rate rises should reduce income growth relating to investment income and pension funds. We take a look at how consumer confidence is on the rise – this coupled with an ongoing cost-of living crisis and stagnating wage growht may mean that consumers will draw down savings – this 'smoothing through' high inflation probably played a significant role in bringing US savings rates down.

Reasons to expect savings rates to remain high

We also take a look at reasons why savings rate may actually stay high. All the above are good reasons for a fall in the savings at least a little from current levels, they certainly do not convince us that we are about to see a US-style drawdown. So – if a drawdown in savings has not already happened, what could change to make it happen? After all, the drawdown in US savings started shortly after the easing of COVID-19 restrictions – any reopening effects in Europe are now long gone. The only likely impending changes are the easing in 'unseen' income growth and the recent uptick in confidence – but those do not feel like enough to trigger a wave of pent-up spending. The full note looks at "locked up" liquidity and the effect of further rate rises.

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