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The unwinding of savings accumulated during the pandemic

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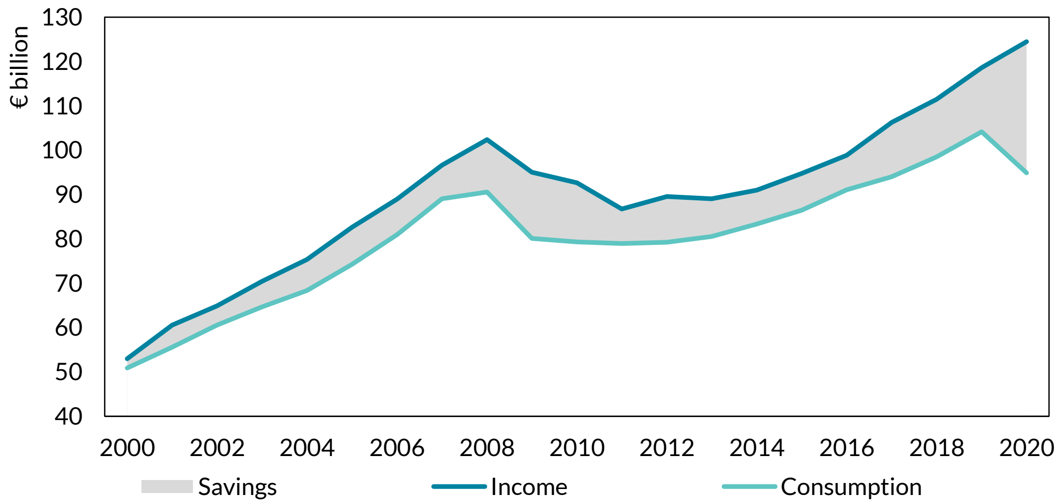
The COVID 19 pandemic, and the measures to contain its spread, led to a 9.1 per cent decline in consumption between the start of 2020 and the first quarter of 2021 (Figure1). Much of this decline was forced, as pandemic-related retail closures restricted opportunities to spend while the spread of COVID-19 reduced the willingness to engage in contact intensive activities. At the same time, significant government interventions in the labour market supported incomes and meant that the gross disposable income of households grew by 5.3 per cent in 2020 (Figure 2).

Significant savings

The savings ratio, which is equal to disposable income minus consumption as a fraction of disposable income, rose to 23.7 per cent on average during 2020, well above its long-term average of just under ten per cent. The baseline forecast contained in this Bulletin assumes that the savings ratio returns to its pre-pandemic level by 2023, following the lifting of uncertainty relating to the pandemic and the full relaxation of restrictions on consumption.

Figure 1: Savings grew from the unspent portion of gross disposable income



Source: CSO and authors' calculations

This assumption is subject to considerable uncertainty. The level of savings accumulated during 2020 has been unprecedented, and the extent and speed at which savings are unwound will have significant implications for the economy in the coming years.

Several factors will determine this. First, the extent to which the accumulated savings were “forced”, i.e. because of reduced opportunities to consume, or “precautionary”, resulting from uncertainty about the economic outlook. The ECB has estimated that approximately 90 per cent of the savings accumulated during the second quarter of 2020 were forced, while Central Bank research has indicated similar numbers for Ireland. However, the savings accumulated during that period have been held on household’s balance sheets for more than a year and, over time, some may continue to be held for precautionary motives. This would then limit the extent to which they are spent.

Second, the marginal propensity to consume (MPC) out of financial wealth is lower than the marginal propensity to consume out of income. Previous Central Bank research found that the median Irish household would spend approximately 50 per cent of a lottery win equal to a month’s salary.[1] However, if over time households have begun to treat the savings accumulated during the pandemic as akin to financial wealth rather than additional “windfall” income, then the increase in spending for each additional euro (i.e., the MPC) could be significantly lower than such a lottery win. Another factor influencing the MPC is the age and income profile of those who have accumulated the savings. Lydon and McIndoe Calder (2020) show that the accumulated savings have, on average, accrued to older and higher income households. These cohorts have, on average, a lower MPC out of both income and wealth – but conversely spend more of their income on those sectors that have been closed during the pandemic.

Scenarios

To address this uncertainty, we conduct two counterfactual scenarios to the baseline for the evolution of the savings rate, while keeping our assumptions on disposable income unchanged. The first, positive scenario assumes that households quickly unwind a significant portion of the savings accumulated during the initial quarters of the pandemic, treating a large part of those savings as lagged income (as in Lydon and McIndoe-Calder). Under this scenario, the savings ratio falls below its pre-pandemic level in 2022 and 2023, and does not revert to its long-run average before the end of the projection horizon.

When seen under a quarterly profile, the savings rate in the baseline scenario similarly goes below long-term average levels by the end of 2023, although it does so much more slowly than in the positive scenario, and in 2023 as a whole on an annual basis it remains above its long-term average but slightly below 2019 levels. As the economy returned to growth following the global financial crisis, savings

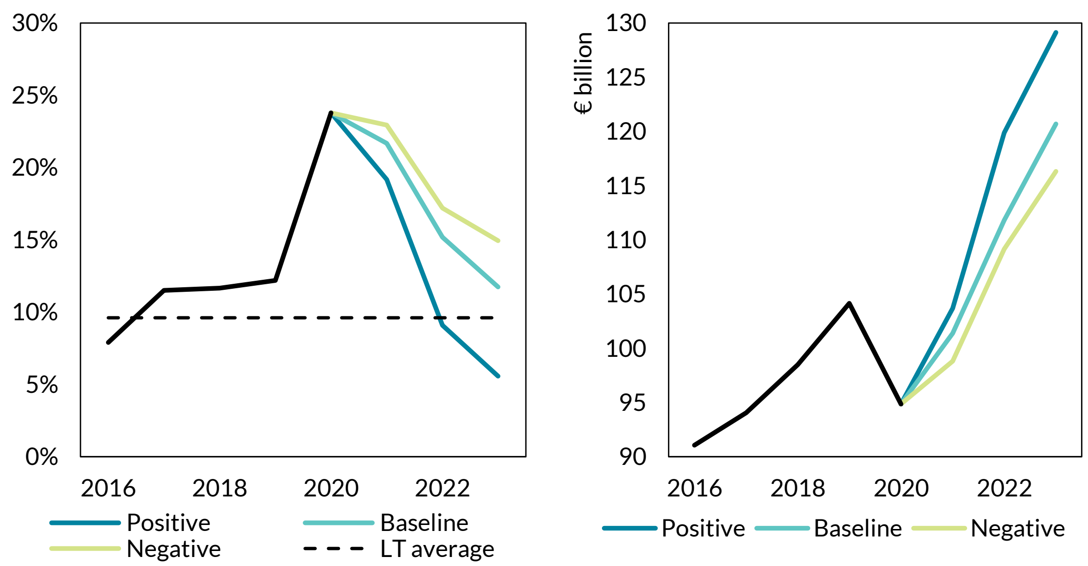
[1] Lydon, R. and McIndoe Calder, T. “Saving during the pandemic: Waiting out the storm?” Central Bank Economic Letters 2021.4

rates remained lower than average for a few years, while they had been high during the crisis. In the positive scenario, the cumulative level of nominal consumption across the forecast horizon would be about 5.6 per cent higher than in the baseline, with consumption by 2023 being 36.1 per cent above 2020 levels compared with 27.2 per cent in the baseline scenario.

In a second, more adverse scenario we assume that precautionary motives prevail and households maintain a higher savings ratio compared to baseline throughout the forecast horizon. Specifically, the savings ratio remains elevated reaching 14.9 per cent by the end of the forecast horizon. Under this scenario, cumulative nominal consumption between 2021 and 2023 would be 2.9 per cent lower than in the baseline scenario, and consumption by 2023 would be 22.6 per cent above the 2020 level. Figure 2 illustrates the projected paths of the savings rate and the resulting paths of real consumption expenditure across the baseline, positive and negative scenarios described above.

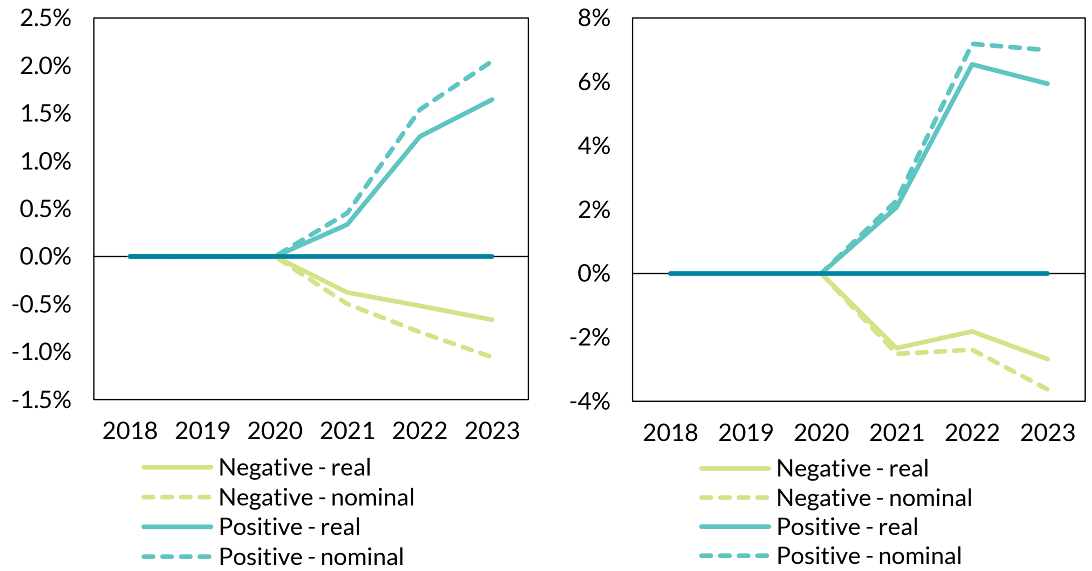
Figure 2: Higher levels of consumption accompany the reduction in the savings rate

a. Savings rate **b. Consumption (nominal)**



Source: CSO and authors' calculations

Figure 3: Deviation of GDP and consumption from baseline projections (real and nominal) under the two alternative scenarios for the savings rate



Source: CSO and authors' calculations

It should be noted that these estimates do not assume any second order impacts of a substantial unwinding of savings on employment, trade or inflation. Depending on the capacity of the economy to absorb the extra levels of consumption generated by the unwinding of savings in a short time frame, more expenditure could generate additional employment and thus extra income, which is kept fixed in this analysis through the three scenarios. However, if the economy is facing capacity constraints, extra spending would either come from increasing imports of goods and services and/or put upward pressure on prices.

To address the impact that these scenarios would have on the GDP forecast, we use estimates from the Bank's Core Structural Model (COSMO) of the Irish Economy to derive the impact on real and nominal GDP. Figure 3 shows that the positive savings rate scenario would result in approximately 1.3-1.6 percentage point higher GDP growth in 2022 and 2023 than in the baseline projection. Reflecting the pass-through to prices of such a consumption boost, nominal GDP would rise by closer to 2 per cent more than under the baseline scenario.

Conclusion

As the domestic economic recovery from the COVID-19 pandemic is set to be consumption-led, the dynamics of consumer spending in the next few years will be crucial for the economy. The pace and extent of the unwinding of the exceptional levels of "forced" savings accumulated during the pandemic will be an important determinant of economic outcomes in the next few years. This Box highlights how the evolution of the savings ratio can greatly influence the path of consumption, by illustrating three possible scenarios. A quicker than expected unwinding of savings, while bringing consumption closer to its pre-pandemic trend, could generate pressures on the economy in the form of a higher import content of consumption and rising prices, both of which have a negative impact on real output. Further work is required to evaluate the extent of these pressures.