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Research Briefing | Eurozone

How consumers will shape the recovery

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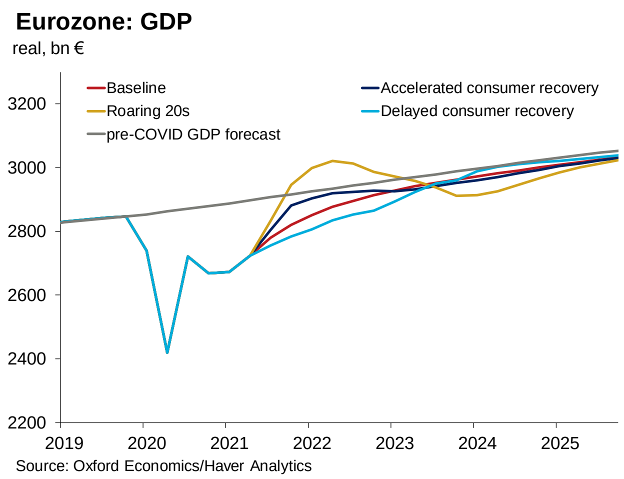
- **The response of Europe's consumers to the end of the lockdowns will shape the recovery, for better or worse. Social distancing, constrained spending options, and precautionary savings pushed the household saving rate in the eurozone to a peak of 25% in Q2 2020 – twice the pre-crisis level. By mid-2021, excess savings may amount to 6% of GDP.**
- **But a normalisation of household saving rates is a prerequisite for a vigorous rebound in consumer spending. In our baseline, saving patterns gradually return to pre-crisis levels by 2024. Should the release of pent-up demand post-lockdown accelerate, it could push GDP up to 4% above our baseline in 2022.**
- **Consumption gains in H2 drive around half of the 4% GDP growth we forecast for 2021 in our baseline, mostly due to reduced saving ratios. But plausible upside scenarios could see a more front-loaded fall in saving rates, adding between 0.8% and 1.7% to 2021 GDP. Longer lockdowns or consumer caution could represent a 0.6% drag.**
- **We see a consumption spree on the back of reduced savings rates as a transitory demand shock. Thus, we expect the rise in inflation toward 2% – or even higher in our strong upside scenario – to be temporary as well. But a spending spree won't offset the long-term headwinds to aggregate demand and the disinflationary pressure stemming from secular stagnation in the eurozone.**
- **Considering the ECB's forward guidance, we think the central bank will look through the price spikes and keep policy rates on hold, although a period of above-target inflation could mark an early end for the PEPP. While stronger macro fundamentals and an early end to PEPP could lift German Bund yields significantly during 2022, structural headwinds will put a lid on any policy shift.**

Figure 1: The eurozone could see a much sharper rebound, if household saving rates normalize quickly



We developed three scenarios for the pace at which households' saving patterns will normalize over the coming years, after savings surged to historic highs in 2021.A faster fallback of the saving ratio to its long-run trend is the most plausible scenario and would accelerate the economic recovery.

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Household savings to shape recovery path

Consumers in the eurozone amassed a mountain of excess savings last year as lockdown measures constrained their spending options, while insecurities raised precautionary savings. Despite a fall in households' disposable income this meant that savings surged, contrasting sharply with historical patterns. In Q2 2020, when the harshest restrictions applied, the saving ratio was close to 25% of disposable income – twice its pre-crisis level. **By the second half of this year, when we assume restrictions are likely to be eased significantly, excess savings will add up to some 6% of GDP** (**Figures 2** and **3**).

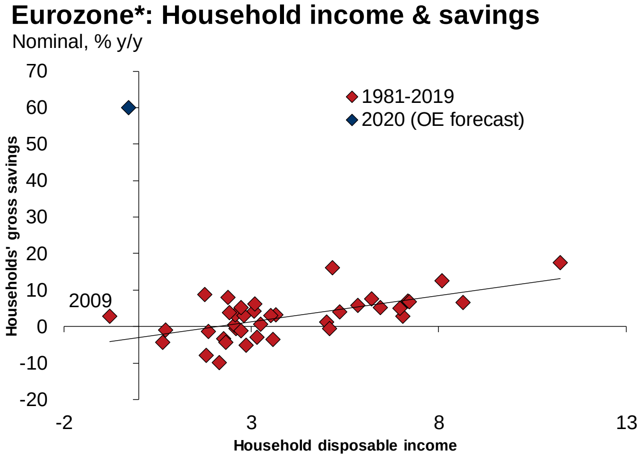
Considering how much the recession has been driven by plunging consumption and a rise in savings, it's inconceivable that we will see a vigorous economic rebound unless consumers open their wallets again (**Figures 4** and **5**).

We expect that household saving patterns will see a big initial step toward normalization in H2 2021 as the economy begins to reopen, followed by a more gradual return to trend. But we think that some precautionary savings, labour market slack, and the skewed distribution of savings to higher income households will keep the savings rate above its pre-crisis levels for a while. **Still, a fall in savings rates rather than the income gains from the expected labour market recovery this year and next will be a bigger driver of the consumer recovery, in our view**.

We are slightly more cautious on the consumer outlook for 2021 than consensus, due to our worries that extended lockdowns and delays to the vaccine rollout will push part of the consumer recovery into next year. **But along with the ECB we are well above consensus for 2022**, based on our view that the savings rate will continue to normalize in 2022 amid rebounding labour markets. But the wide range of forecasts underscores the high uncertainty (**Figure 6**).

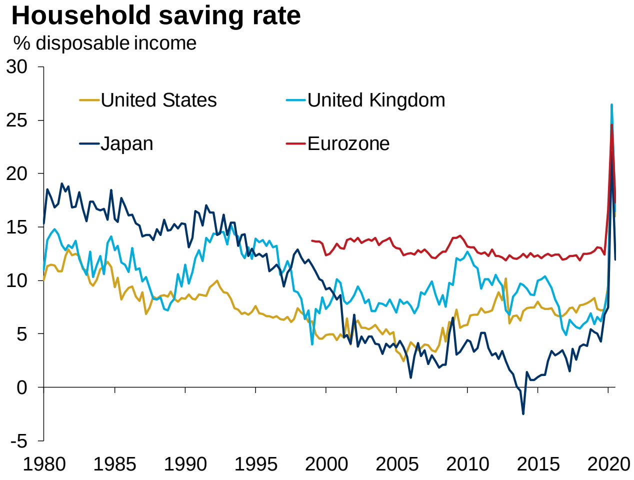
The first dimension of uncertainty pertains to the pandemic. A failure to contain the virus spread and to accelerate the vaccination rollout would keep shops and restaurants shut for longer. This has mostly a reflexive impact on the timing of the recovery. **The second dimension of uncertainty is consumer behaviour.** Lingering infection worries could keep consumers' wallets closed for longer, but equally pent-up demand amid ample savings could lead to a faster normalization of households' savings behaviour. In a strong upside scenario, we may

Figure 2: Saving patterns diverged sharply from historic norms in 2020



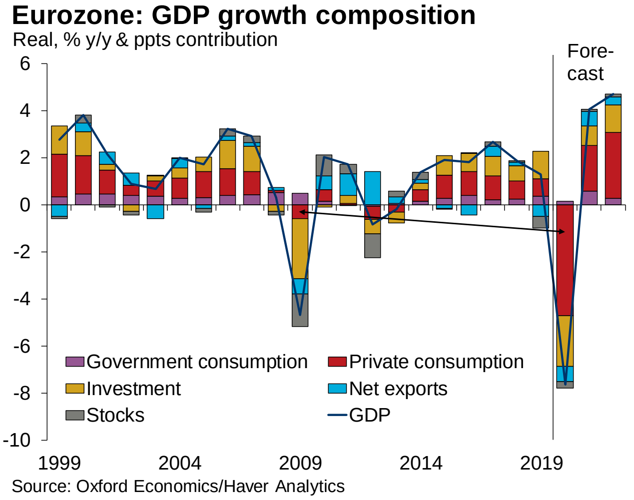
Source: Oxford Economics/Haver Analytics (*avg. Germany, France, Italy, Netherlands for longer data history, West Germany pre-1991)

Figure 3: Forced and precautionary savings pushed savings to historic highs everywhere



Source: Oxford Economics/Haver Analytics

Figure 4: Drop in consumption was principal driver of 2020 recession, sharp contrast to 2009



Source: Oxford Economics/Haver Analytics

even see a period of dissaving, as saving rates undershoot their historical norm. We scale this strong upside scenario so that about half of the excess savings are spent, although we see a low probability of such a swift release as the bulk of excess savings is held primarily by high-income households. On top of this near-term concern, the pandemic could also cause long-term changes to household behaviour.

Given its crucial role, we will examine consumer confidence and behavioural responses in a separate note. Here we focus on three plausible scenarios for household savings after restrictions are lifted, and how these affect the economy. Crucially, we designed the three scenarios (using our Global Economic Model or GEM) as a temporary demand shock, where the household saving ratio returns to its pre-crisis level by 2024 (**Figure 7**).

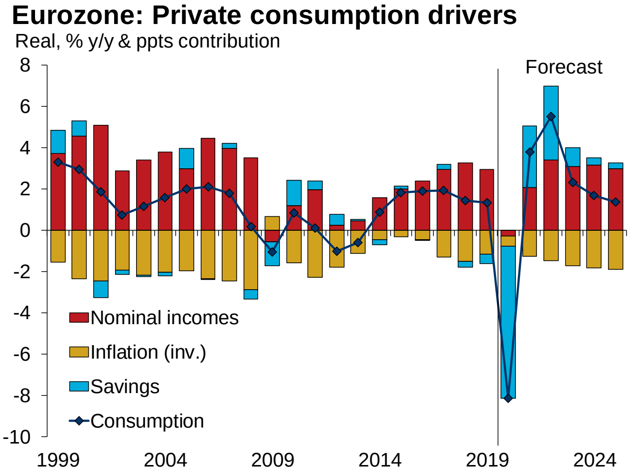
Consumers to make the difference

The two upside scenarios imply a much faster recovery, where higher consumer spending pushes the economy above its pre-crisis GDP level by Q3 or Q4 2021, two quarters earlier than in our baseline. In our downside scenario, that threshold would be reached with a half-year delay. This primarily reflects the direct impact of the different saving rate trajectories on consumption. But there are additional indirect effects, where stronger or weaker aggregate demand affects employment and investment. This is most pronounced in the strong upside scenario in 2022, which could see investment growing at nearly double the rate in our baseline (**Figures 1** and **8**).

Consumers going on a consumption spree could narrow the output gap, which has the potential to significantly lift inflation. But we think the spike would only be transitory, as we modelled the scenarios as temporary demand shocks. These primarily affect the timing and speed of the recovery. An accelerated consumer recovery could see inflation reach 1.7% in 2021, 0.3 ppts above our baseline. But as the dissaving impetus slows, inflation returns toward our baseline trajectory. (**Figures 9** and **10**).

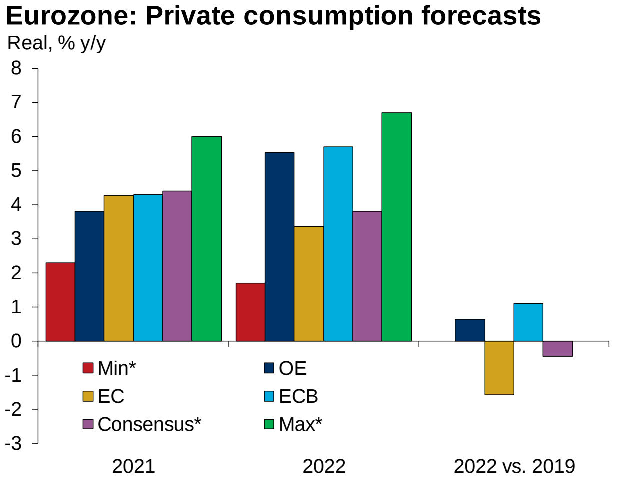
What's more, we think that our model likely overstates the inflationary effects given the unique nature of the pandemic recession. This holds especially for the strong upside scenario, where inflation skyrockets to close to 3% briefly. A faster recovery would likely primarily benefit sectors that had suffered the most under restrictions during the pandemic. So increased consumer demand would hit ample existing supply reducing the inflationary impact.

Figure 5: Fall in household savings rate is prime driver of expected consumer recovery



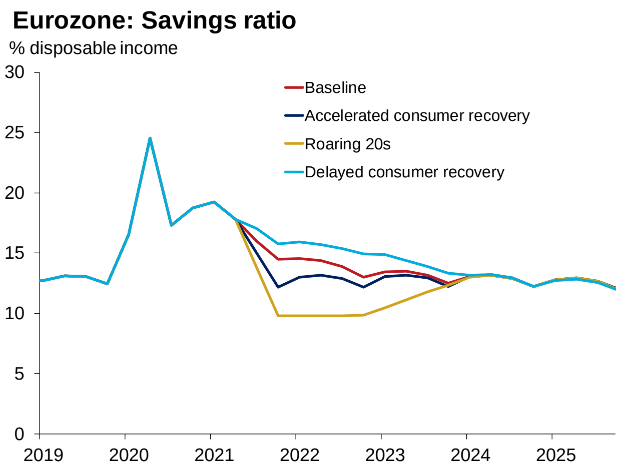
Source: Oxford Economics/Haver Analytics

Figure 6: Along with the ECB, we are more optimistic on 2022 consumption prospects



Source: Oxford Economics/Haver Analytics/*Consensus Economics Jan.

Figure 7: Wide range of plausible trajectories for household savings



Source: Oxford Economics/Haver Analytics

This can be thought of as a faster recall of furloughed workers. We previously discussed other arguments, why underlying prices are unlikely to rise rapidly in the current environment (here and here).

Still, it's feasible that inflation could surge above 2% for several quarters in a strong upside scenario. But in our view a period of sustained above-target inflation looks implausible unless accompanied by a permanent downshift in saving ratios. This seems highly unlikely given structural factors such as demographics. In addition, a perceived increase in the odds of a future pandemic is just as likely to push up savings due to higher income and health risks.

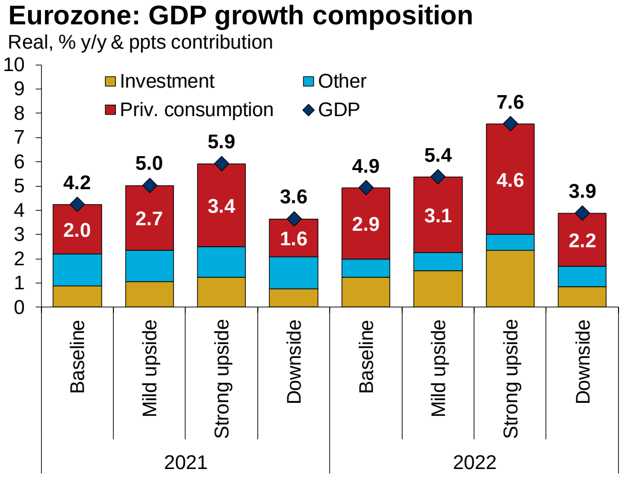
All told, we think that risks to our consumption outlook are skewed to the upside, if and when restrictions are eased. But we doubt that the macroeconomic environment will be conducive to more than one or two years of strong catch-up growth in consumption. The roaring twenties, this is not.

Consumption spree could trigger early end to ECB's PEPP purchases

The transitory boost to growth and inflation in our two upside scenarios could result in some headaches for the ECB. Correctly identifying the cause of the upside surprises in real time, agreeing a suitable policy response, and convincing markets of its appropriateness could be difficult. In our alternative scenarios, inflation rates push close to 2% or rise above that threshold in early-2022, instead of falling back as in both our and the ECB's baseline, as base effects fade. It's possible that markets would see this as a sign of stronger underlying inflation pressures and that more hawkish elements in the ECB could push for earlier tightening of policy.

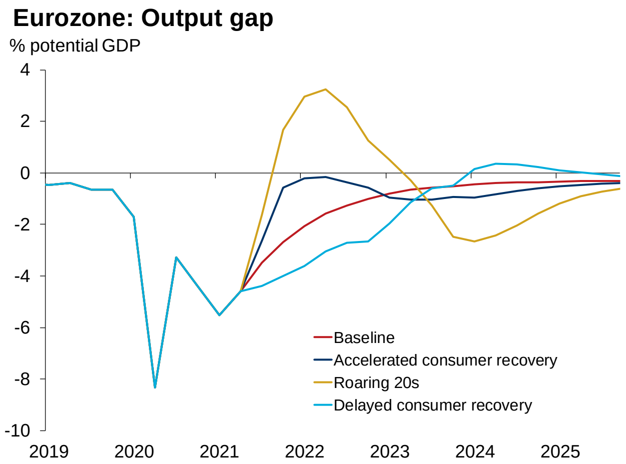
However, **we think that given our scenario results and structural headwinds, it would be a policy mistake to tighten monetary policy too early.** This holds especially for the more plausible, mild upside scenario, while there may be more room to withdraw some policy support in the strong upside scenario. But even there we see underlying inflation dropping back fast after a temporary surge (**Figure 11**). What's more, we think that the eurozone is stuck in secular stagnation, which weighs on underlying growth and inflation, while requiring ECB policy to account for subdued neutral interest rates. And we doubt that a consumption spree will lift the economy out of that malaise on its own.

Figure 8: Strong upside scenario would boost GDP and also lift firms' animal spirits



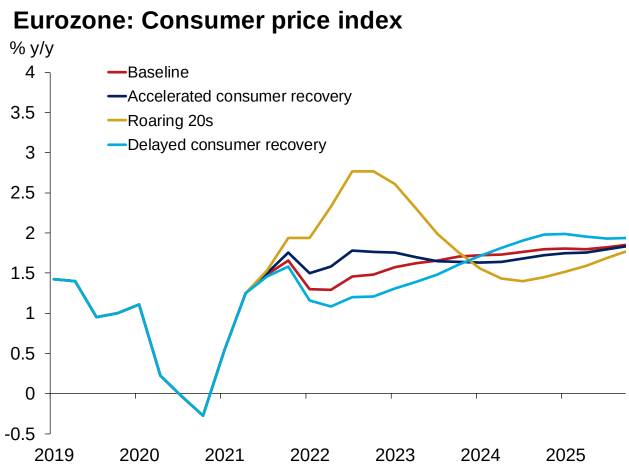
Source: Oxford Economics/Haver Analytics

Figure 9: Economy-wide capacity utilization would rise much faster in the upside scenarios



Source: Oxford Economics/Haver Analytics

Figure 10: Faster consumer recovery would trigger temporary rise in inflation



Source: Oxford Economics/Haver Analytics

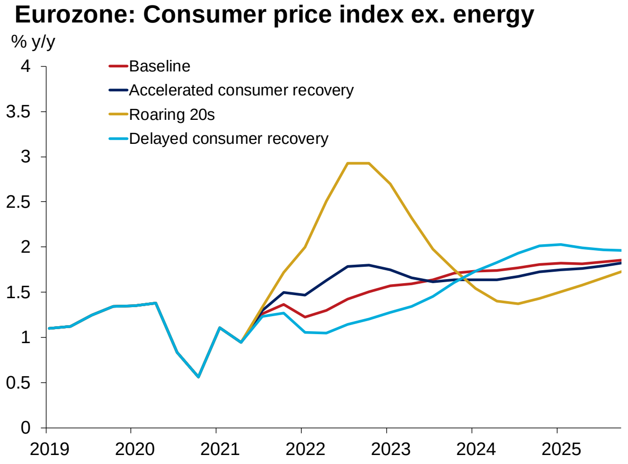
We expect the ECB to largely look through a transitory rise in inflation on the back of a faster release of pent-up consumer demand, given its forward-guidance. Hence, we expect policy rates to remain unchanged in the above scenarios, which – within the model – also sharply reduced the passthrough of the improved macro backdrop to bond yields (**Figure 12**). This would align with the ECB's focus on a "robust convergence" of inflation to 2% in its projections, and it being "consistently reflected in underlying inflation dynamics". For that to hold, the ECB would also have to see the price gains as a transitory shock. We think that's highly likely. And even if it did not, it may respond only with a time lag as it could see a temporary inflation overshoot as conducive to a medium-term recovery.

In an inflation upside scenario, the Pandemic Emergency Purchase Program (PEPP) could be ended earlier, but scope for that may be limited by the need to manage the reaction of bond markets to such an unexpected move. In principle, reduced asset purchases under the PEPP would be the obvious policy response, as flexible management of QE flows was highlighted at the ECB's January meeting. This would raise the scope for bond yields to rise in response to a better macro environment, akin to 2017, when yields rose on the back of higher break-evens despite QE still running high. At that time, German Bund yields reached 0.5% against a much weaker inflation backdrop than in our upside scenarios.

However, we doubt bond markets are positioned for an inflation upside surprise, even if temporary. So it may well be that the ECB will still need to deploy much of the enlarged PEPP envelope to convince markets of the narrative of a temporary inflation overshoot, constraining the upward pressure on bond yields. This would be to engineer a gradual rise that is consistent with sufficiently favourable financing conditions to allow a lasting economic recovery that is not hindered by an early end of fiscal policy support. That would imply that even if yields rise faster, it would mostly be seen as a front-loaded steepening of the yield curve against a backdrop of structural, long-term headwinds.

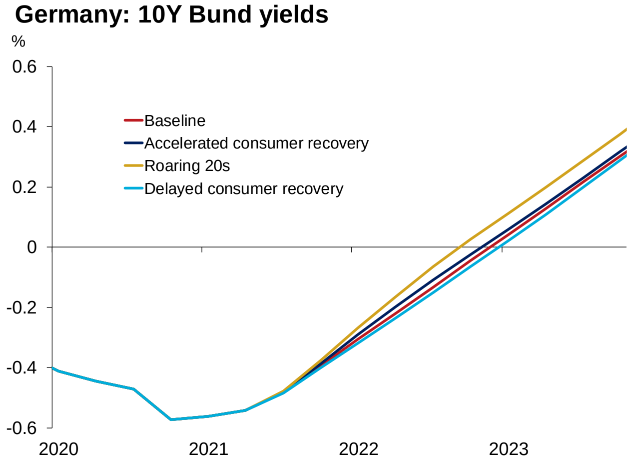
Overall, a faster than expected recovery on the back of a transitory consumption spree is a plausible upside risks to our baseline. A helping hand from consumers would also make the job of fiscal and monetary policy makers easier. But we fear that it could tempt authorities into a premature withdrawal of policy support, which would be a mistake given the region's long-term challenges.

Figure 11: Surge in underlying inflation in strong upside scenario likely overstated



Source: Oxford Economics/Haver Analytics

Figure 12: Low long-term outlook for yields, but inflation rise may cause brief market discloation



Source: Oxford Economics/Haver Analytics