Goldman Sachs | Economics Research

18 September 2024 | 4:30PM BST

European Economics Analyst

# Euro Area—Consumption to Recover More Gradually (Stott/Vashkinskaya)

- One of the most striking features of this cycle in the Euro area has been the absence of an improvement in household consumption despite the rebound in real income. Or conversely, the household saving rate increased a further 2pp over the last three quarters, well above our and ECB staff expectations. We therefore revisit the outlook for household income, savings, and consumption.
- We expect real disposable income growth to decelerate to trend by early 2025, as the catch-up of household real income completes. Non-wage income—which includes sources of income such as profits, net transfers, interest receipts, and dividends—made a significant contribution to income growth in Q1, but we are pencilling in more conservative assumptions going forward. Our base case is still that the process of rebalancing labour and capital income concludes without derailing the return of inflation to target or of employment growth to trend.
- The increase in the household saving rate in the first half of this year is hard to explain in our standing framework, as the fundamental drivers we consider—economic uncertainty, deposit rates, and the gap of wealth-to-income to trend—all either stabilised or improved. We see several potential explanations for the recent increase in the household saving rate, including sticky consumption behaviour, changes in the composition of income, a higher sensitivity to deposit rates, and post-pandemic habit-resets. Taken together, we now expect the saving rate to more gradually decline to a higher terminal level.
- Our revised forecasts for income growth and the saving rate imply a small sequential pick-up in consumption in the second half of the year, before returning to trend in early 2025. Our forecast is above the ECB staff projections over the next few quarters, as we expect slightly higher income growth and an earlier decline in the saving rate. Our forecast for GDP growth is below trend in the second half of 2024, given significant weakness in other components.


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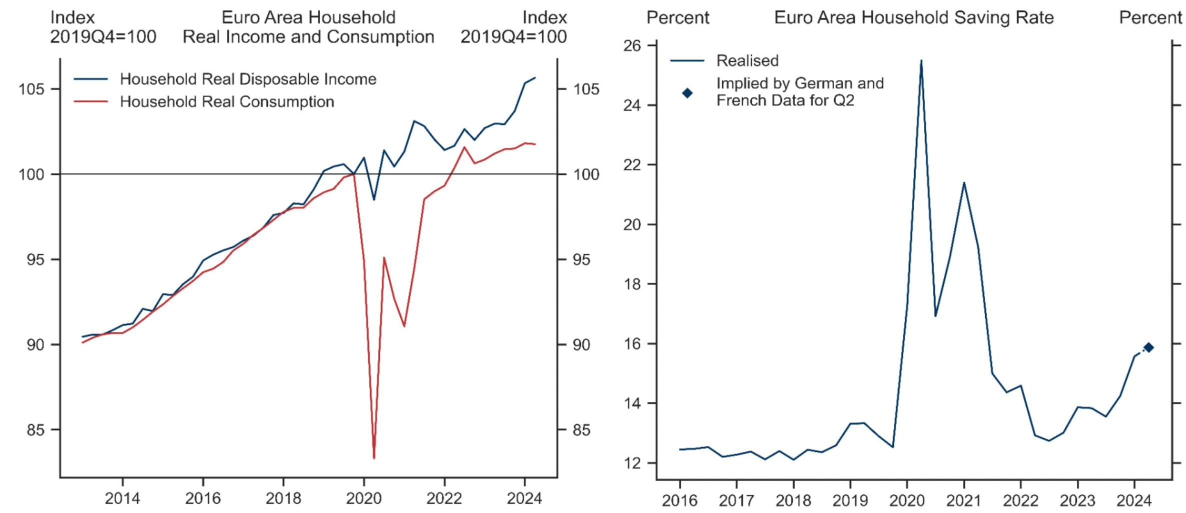
## Euro Area—Consumption to Recover More Gradually

One of the most striking features of this cycle in the Euro area has been the absence of an improvement in household consumption despite the rebound in real income (Exhibit 1, left). Or conversely, the household saving rate increased a further 2pp over the last three quarters (Exhibit 1, right).

**Exhibit 1: Household Income Gains Have Outpaced Consumption, Resulting in a Higher Saving Rate**




On the left, disposable income in Q2 is derived from our forecast.

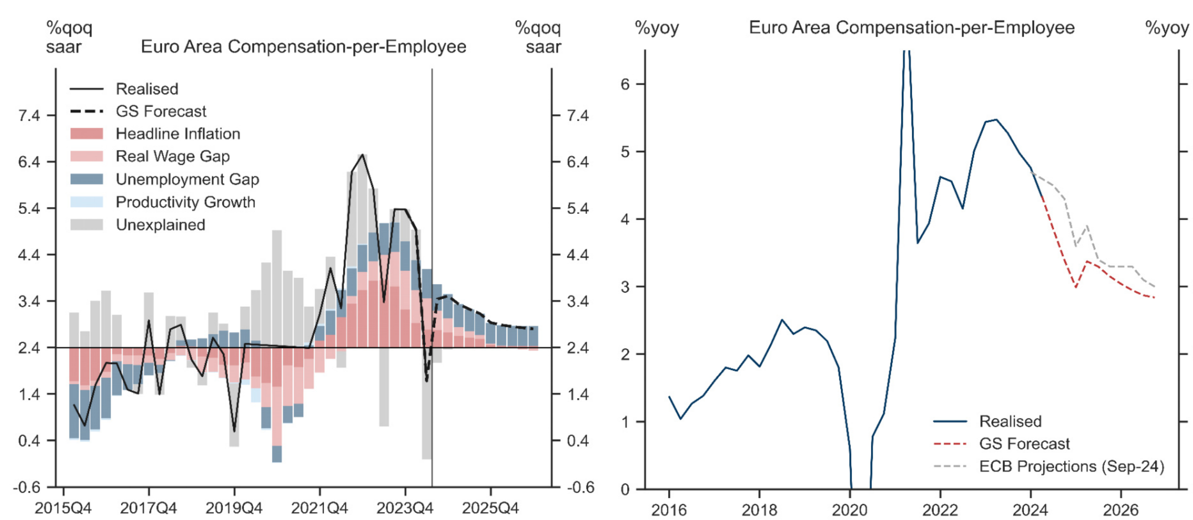
Source: Goldman Sachs Global Investment Research, Haver Analytics

This week's *Analyst* therefore revisits the outlook for household income, savings, and consumption.

## Real Income Growth Past the Peak

Wage income accounts for 80% of gross disposable income and has been the main driver behind the recovery in household real income. Compensation-per-employee growth averaged 4.5% (annualised) in the first half of this year, and we look for a gradual deceleration to 3% by the end of 2025, as the catch-up of household real income completes (Exhibit 2, left). We see risks skewed towards a faster cooling in wage growth than projected by the ECB staff in September (Exhibit 2, right).

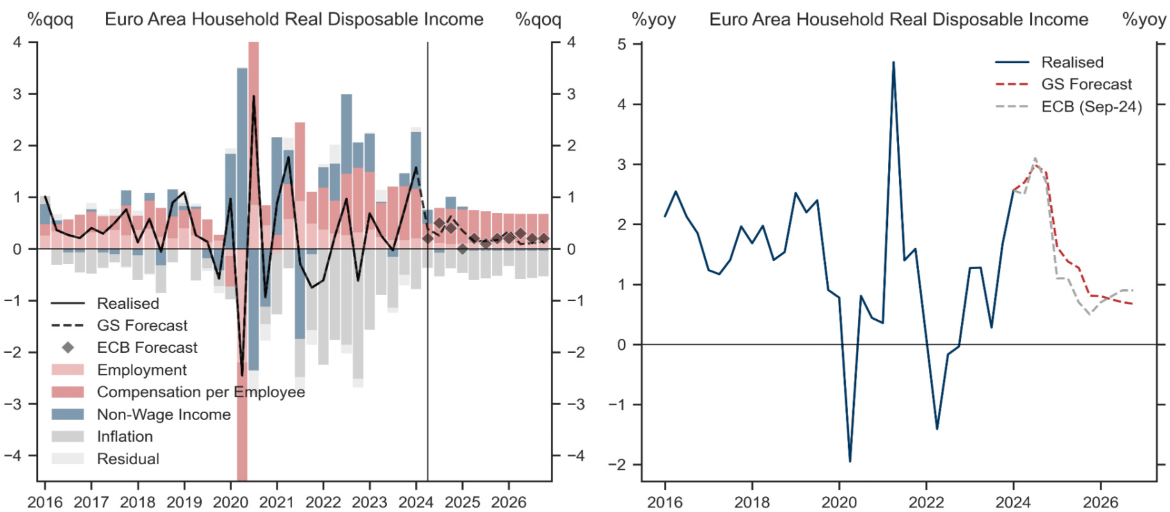
**Exhibit 2: We Look for a Rapid Deceleration in Wage Growth as Real Catch-up Completes**




Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

We forecast sequential real income growth to moderate to trend by early 2025 (Exhibit 3, left). Non-wage income—which includes sources of income such as profits, net transfers, interest receipts, and dividends—made a significant contribution to income growth in Q1, but we are pencilling in more conservative assumptions going forward. Employment also grew rapidly in recent quarters—following strong participation and immigration gains—but is now back at trend according to our forecast. Real income grows at trend in 2025 in our forecast, but stands above the ECB staff projections, partly because of lower inflation assumptions (Exhibit 3, right).

**Exhibit 3: We Forecast Real Disposable Income to Return to Trend by 2025H1**



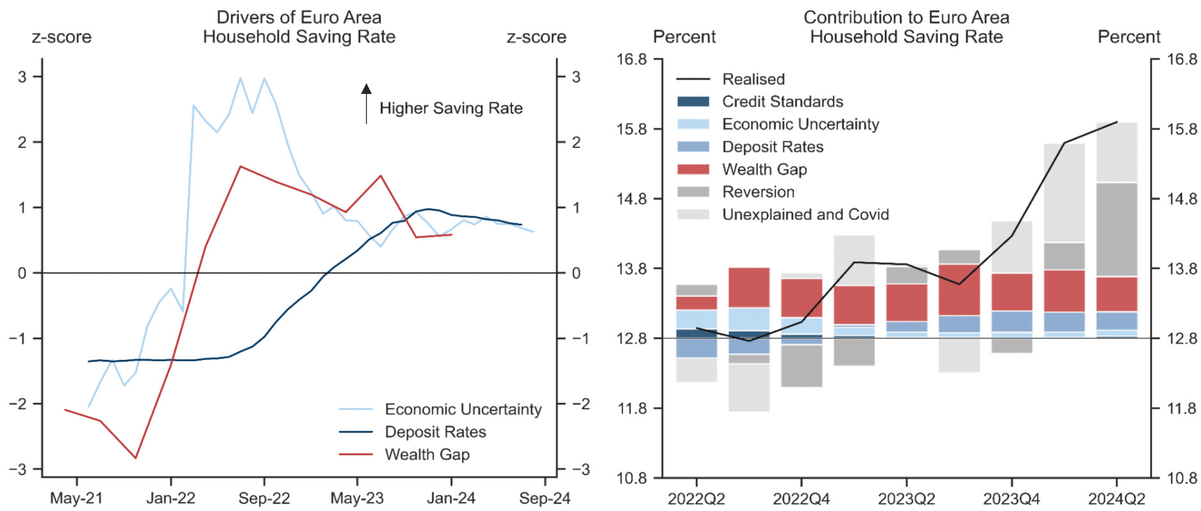

Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

Our forecast for household real income reflects the end of a catch-up process which rebalanced the region's total income losses between capital and labour income. Our base case is still that this process concludes without derailing the return of inflation to target or of employment growth to trend.

## Slower and Shallower Saving Rate Decline

The increase in the household saving rate in the first half of this year is hard to explain in our standing framework. The fundamentals drivers we consider—economic uncertainty, deposit rates, and the gap of wealth-to-income to trend—all either stabilised or improved (Exhibit 4, left). Our model has continued pointing towards a decrease in the saving rate and is set to be surprised to the upside again in Q2 based on German and French data released so far (Exhibit 4, right).

**Exhibit 4: The Historical Drivers of the Household Saving Rate Do Not Explain the Uptick in H1**



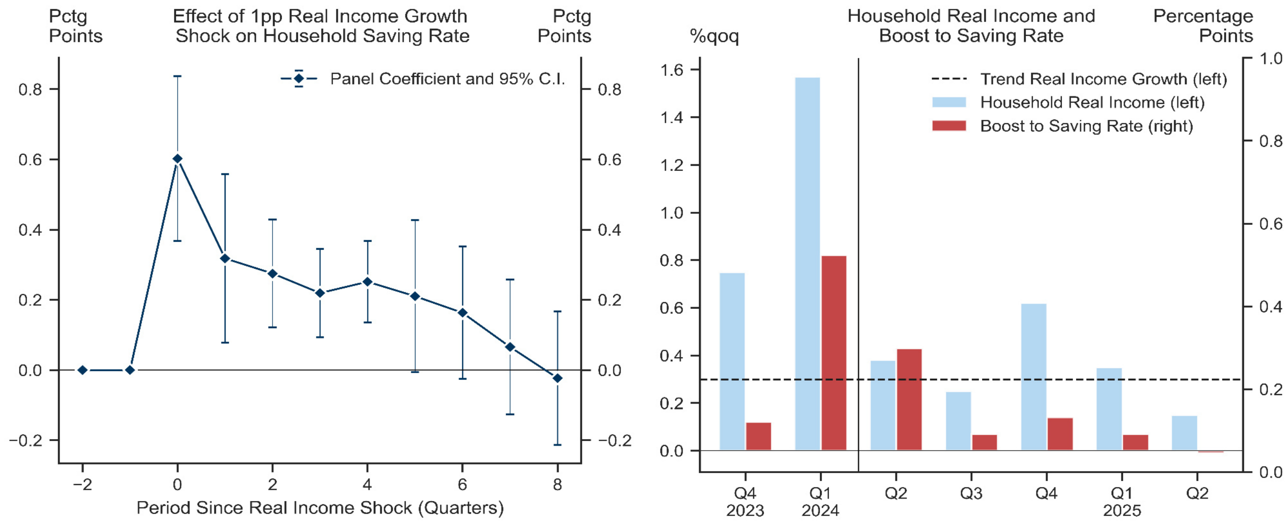

On the left, series are scaled such that an increase implies a higher saving rate.

Source: Goldman Sachs Global Investment Research, Haver Analytics

We see several potential explanations for the recent increase in the household saving rate.

First, the timing of recent increases in the saving rate coinciding with large real income gains points to a potential role for sticky household consumption patterns. Intuitively, households could be slow to ramp up their consumption when faced with a sudden increase in income. We find some evidence of such consumption smoothing behaviour in the cross-section of the five largest Euro area economies, as an exogenous increase in real income contemporaneously boosts the saving rate (Exhibit 5, left). Our estimates imply that the recent recovery in real income could have boosted the saving rate by 0.6pp in the first half of this year (Exhibit 5, right). Our results also imply that this temporary boost would fade as real income returns to trend by early next year.

**Exhibit 5: Sticky Household Consumption Behaviour Could be Temporarily Boosting the Saving Rate**



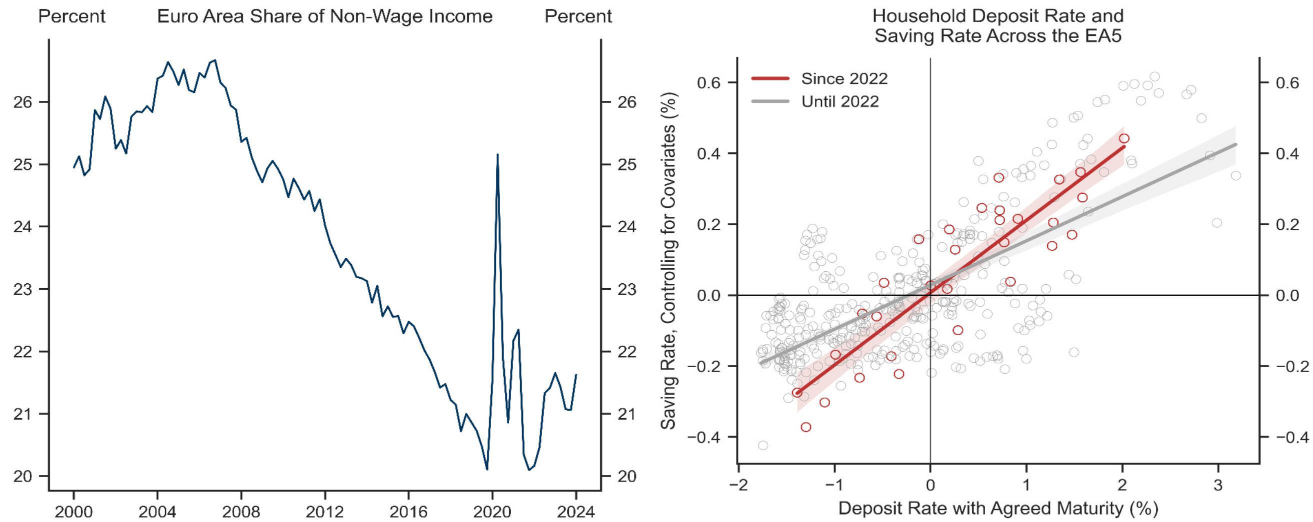

On the left, we show the impulse response of the household saving rate to an increase in income growth, estimated with local projections on an EA10 panel between 2000 and 2024.

Source: Goldman Sachs Global Investment Research

Second, the composition of household income gains in the first quarter of the year looks particularly conducive to a higher saving rate. The share of non-wage income increased 0.5pp and is typically associated with a lower propensity to consume (Exhibit 6, left). The two reasons for this are that non-wage income is typically received in less liquid forms and tends to be skewed towards richer households. Estimates from the academic literature would be consistent with an additional 0.2pp boost to the saving rate from the change in the composition of household income in Q1. A permanent increase in the share of non-wage income would contribute to increasing the terminal saving rate.

Third, the equilibrium level for the saving rate—consistent with fundamental drivers—could be higher this cycle than implied by historical patterns. For instance, looking at the cross-section of the five largest Euro area economies suggests that saving rates were more responsive to increases in deposit rates since 2022 (Exhibit 6, right). The higher sensitivity of household to deposit rates could be related to the salience of policy rate increases over recent years, which brought deposit instruments back into the mainstream. We estimate that this channel could currently be pushing up the equilibrium rate by up to 0.6pp.

**Exhibit 6: The Composition of Income and a Higher Sensitivity to Deposit Rates are Likely Pushing the Equilibrium Saving Rate Higher**

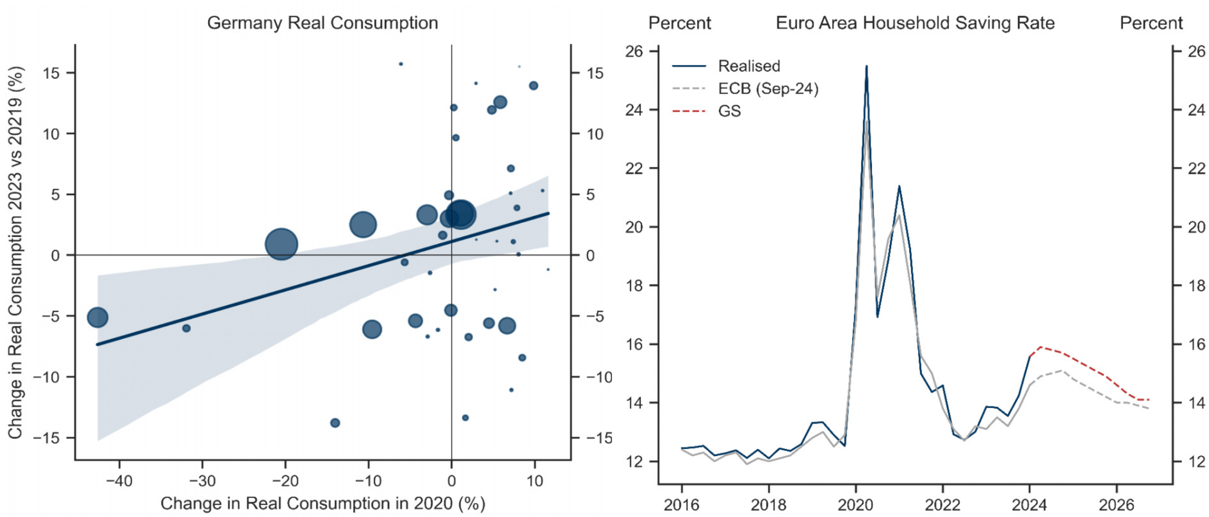



On the right, the slope of the fitted lines is equivalent to the panel OLS coefficient of the saving rate on deposit rates after controlling for covariates.

Source: Goldman Sachs Global Investment Research, Haver Analytics

Fourth, we see reasons for a reset in consumption habits to leave the saving rate higher than before the Covid pandemic. Our global team has shown that the shortfall in consumption compared to 2019 is most pronounced for categories which underwent large decline during the pandemic (Exhibit 7, left). Intuitively, the reassessment of preferences or spending habits prompted by the Covid pandemic may be weighing on spending and boosting savings. This channel would also contribute to increasing the terminal saving rate.

**Exhibit 7: We Now Look for a Slower and Shallower Saving Rate Decline**




On the left, bubble sizes are proportional to category weights in the consumption basket.

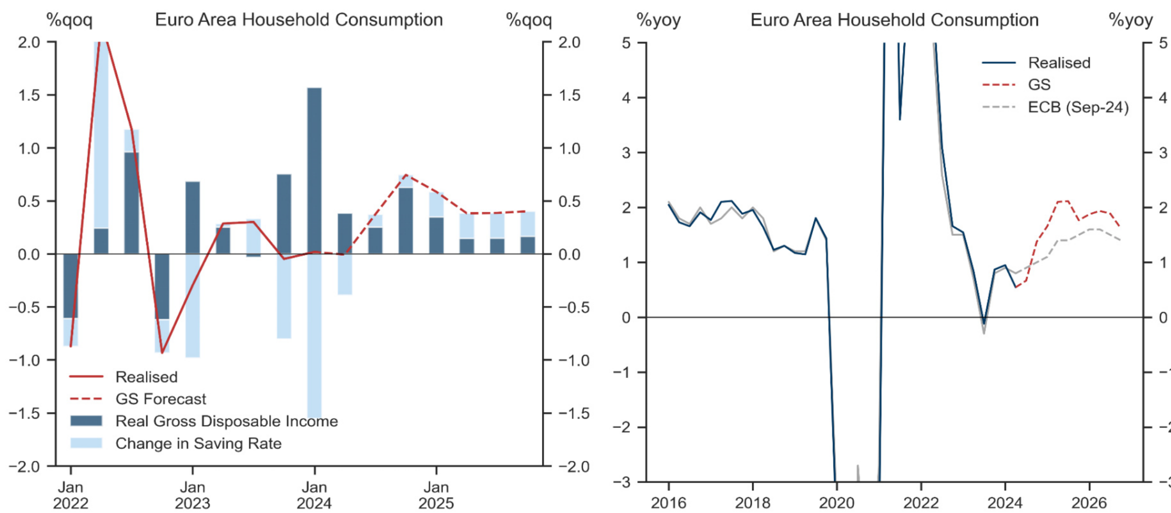
Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

Taken together, we now expect the saving rate to more gradually decline to a higher terminal level. We are pencilling in a 0.3pp normalisation in the second half of this year to reflect further improvement in fundamentals and some adjustment in consumption behaviour. We assume an earlier normalisation than in ECB staff projections but a more gradual decline into 2025 (Exhibit 7, right)

## Consumption to Recover More Gradually

Our revised forecasts for income growth and the saving rate imply a sequential pick-up in consumption in the second half of the year before returning to trend in early 2025 (Exhibit 8, left). Our forecast is above the ECB staff projections over the next few quarters, as we expect slightly higher income growth and an earlier decline in the saving rate (Exhibit 8, right).

**Exhibit 8: We Forecast Household Consumption to Run Moderately Above Trend in 2024H2**




Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

The outlook for household consumption has shifted from a rapid recovery in early 2024—which did not materialise—to a more gradual improvement in late 2024. Our forecast for GDP growth is below trend in the second half of 2024, given significant weakness in other components.

**Alexandre Stott**

**Katya Vashkinskaya**

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