15 November 2023

ECONOMIC UPDATE

The saving mountain

BOQ GROUP

Key Points

- **There has been a lot of talk about households having to reduce their excess savings to meet their spending needs;**
- **While deposit holdings have risen to be well above their pre-pandemic trend, equity holdings have declined;**
- **The big increase in household wealth has been driven by higher house prices;**
- **If house prices stay elevated then the saving rate may remain low, with any improvement in real disposable incomes then more likely to be spent.**

How big is a saving mountain

The Australian economy this year has done a little better than had been expected. This has reflected a range of factors including fiscal policy support (particularly from the states) and surprisingly high population growth.

Another factor suggested by some has been the 'mountain' of household savings built up over the pandemic, a reflection of household's inability to spend through lockdowns and border closures at a time of modest income growth. This resulted in households building up what some economists have termed 'excess saving' (i.e., saving more than their long-run desired saving rate). Something similar happened in many other developed economies although the jump in the household saving ratio was particularly marked in Australia, the US and the UK.

As economies returned to 'normal', household saving ratios declined back to their pre-pandemic level in many developed economies. The exception has been in Australia and the US where the household saving ratio is now below its pre-pandemic mark. This move back below the pre-pandemic trend has led to analysts suggesting that households are now digging into their 'excess' saving. In the US, that is being used to fund stronger than expected consumption growth. In Australia it is being relied upon to offset the decline in real disposable incomes (disposable income after allowing for the impact of inflation). The concern is that once the excess saving has been spent it will impact consumer spending.

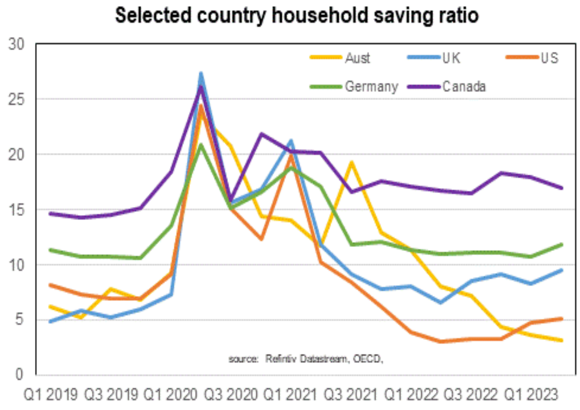
Some of the discussion on this topic implies that households are running down their absolute level of saving. That is not true. Households are saving substantially less of their income than they were in 2020-21, but (in aggregate) they are still saving.

There is no observable 'excess saving'. It is a concept based on a calculation of how much more saving households actually did compared with their preferred saving rate. Practically deciding what the preferred saving rate of a household is, is difficult as it depends upon a variety of factors, including confidence in their income growth, the age of the population (older people save more than the young), the investment returns on offer and the state of the economy. These factors vary over time and so therefore will the desired level of saving.

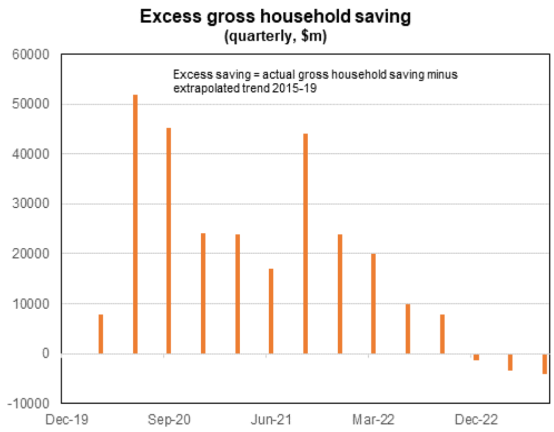
Most of the calculations assume that the desired saving ratio was the average rate recorded in the years prior to the pandemic. Anything above that ratio was determined to be 'excess' saving, anything below is households saving less than at their desired pace. But there is no certainty that the saving ratio prior to the pandemic is still households desired rate of saving.

If you accept that framework the calculations suggest that a large amount of 'excess' saving was built up between 2020-22. That seems reasonable as that was the period with the lockdowns and border closures. The saving ratio dropped below its pre-pandemic trend in the last quarter of 2022 and continued into the first half of this year.

Household saving rates have dropped sharpest in Australia and the US.



Households built up a large amount of excess saving during the pandemic.



Saving and wealth

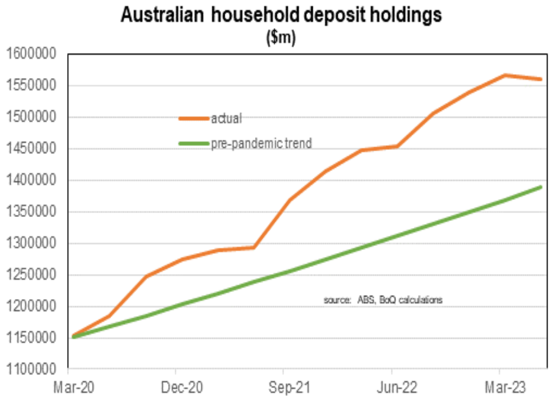
A different way to look at the question of excess saving is not to focus on the flow (the additional saving) but look at the change in the stock (how the level of saving has changed). The stock of saving can be increased by a net increase of new saving plus any increase in the value of existing saving. For example, a stock of saving can increase either because a purchase of more equities or the value of their existing equity portfolio has changed. Saving is implemented through the ownership of a variety of financial assets, for most households this is typically deposits and equities. In Australia there is also superannuation. Another form of saving is the purchase of land (the ABS treats the housing structure as shelter consumption).

Changes in the stock of deposits tells a similar story as movements in the household saving ratio. There has been a big rise in the value of deposits owned by households since 2020 relative to their pre-pandemic trend, although there has been some reduction in deposit holdings more recently.

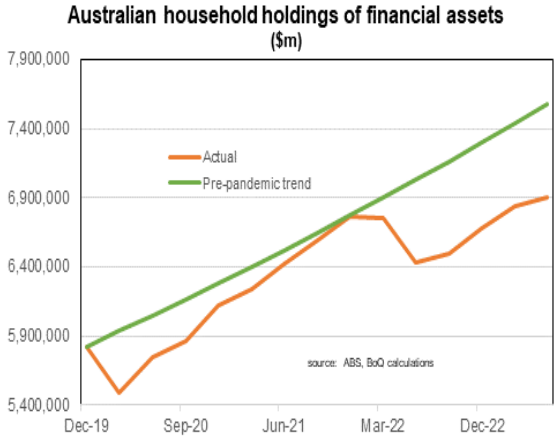
The rise in deposit holdings has been affected by both decisions of how much more aggregate saving needs to be done plus asset allocation decisions. Rising interest rates has incentivised households to pay-off debt (including putting money into offset accounts) as well as shifting more of their saving into deposits (notably term deposits). By contrast, the increase in interest rates has negatively affected equity (and bond) prices, as well as superannuation balances (which were also impacted by the early release allowed by the Government in the early part of COVID).

The net result has been that household holdings of financial assets have declined relative to their pre-COVID trend, with the increase in deposit (and cash) holdings only partly offsetting the decline in equity and superannuation balances. Households were shifting their saving allocation towards safer, more liquid assets that supplied higher returns at a time of heightened economic and financial market uncertainty.

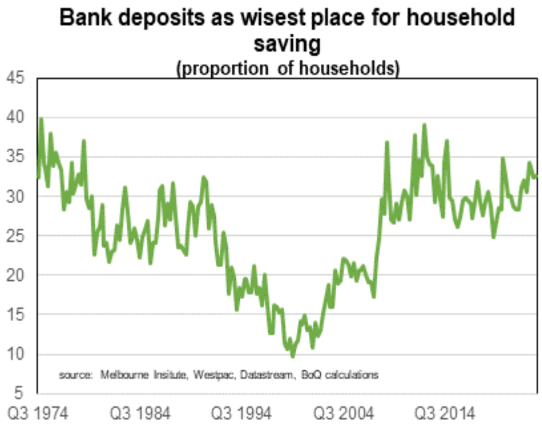
Household deposit holdings are more than their pre-pandemic trend.



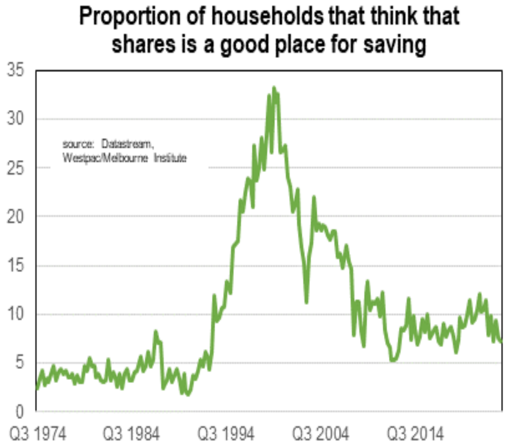
But total holdings of financial assets are less.



Higher interest rates have led to households wanting to shift saving towards deposits.



The popularity of investing in shares has fallen.



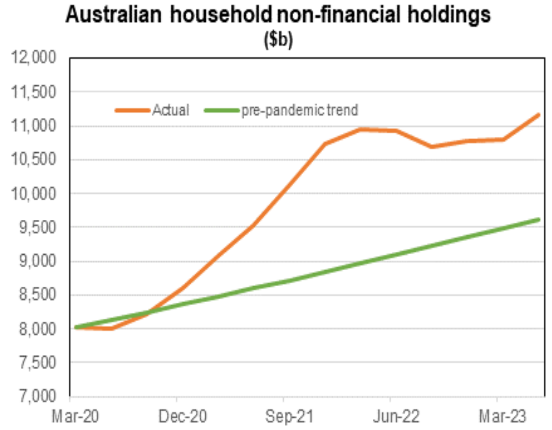
Saving and house prices

Household saving also includes non-financial assets (notably housing). The big rise that has taken place in house prices in most parts of Australia has meant that the wealth (and therefore the stock of saving) of many households has risen strongly since the start of the pandemic, both in absolute terms and relative to their pre-pandemic trend. Indeed, once non-financial assets are considered aggregate household wealth is well ahead of its pre-pandemic trend. The question then is whether the rise in housing wealth influences households spending and saving behaviour.

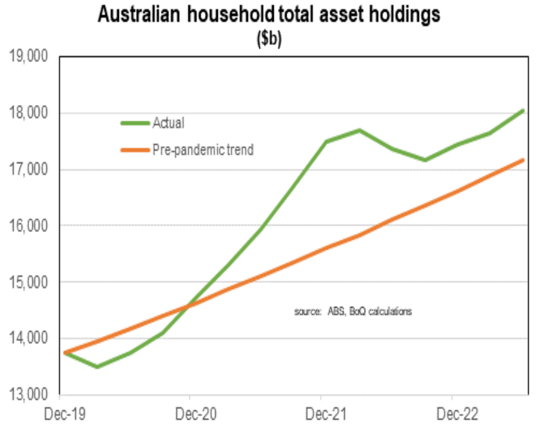
I have always been a little sceptical about the suggestion that rising housing prices leads to increased spending. While movements in house prices are always a topic of conversation, individual homeowners can't be certain of the value of their house unless they sell. The current modest pace of credit growth and low number of listings suggests that relatively few households are accessing the additional value of their homes. But it is fair to say that most homeowners are more likely to feel confident if they believe the value of their home is rising rather than falling. Research has found that households historically have tended to save less when wealth (including house prices) are on the rise.

A basic model that includes the fundamental factors that would be expected to drive household saving behaviour suggests that the household saving ratio should currently be low. And if over the next year there is some improvement in real disposable income growth, interest rates stay where they are, and house prices don't decline (essentially the consensus forecast), the model suggests that the household saving ratio will remain around its current low level (and potentially even decline further) over the next year.

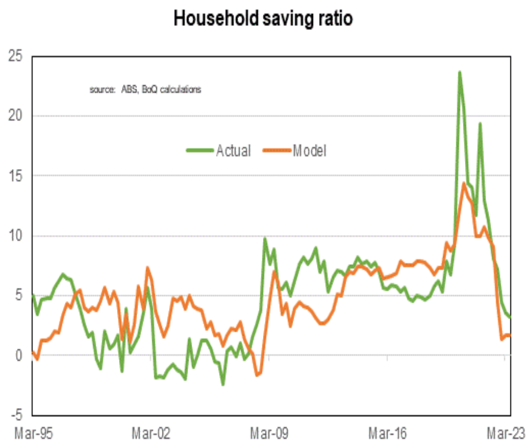
Holdings of non-financial assets have risen strongly reflecting the large rise in house prices.



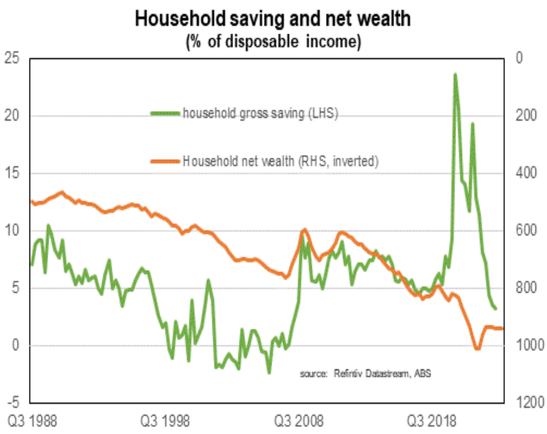
And this is the reason why total asset holdings have risen to be above their pre-pandemic trend.



A fundamental model would suggest that the household saving ratio should currently be low.



A key driver of the lower saving rate has been the substantial increase in household wealth.



Conclusion

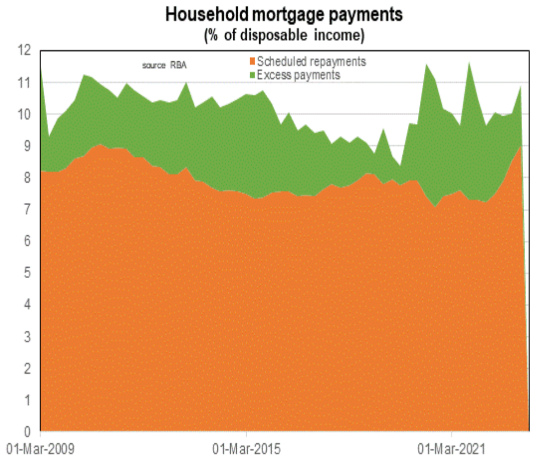
What does all of this mean? First, the size of the 'saving mountain' might be smaller than estimated as the increase in new saving was needed to offset the reduction in equity markets. Second, the rise in house prices may mean that homeowners feel less inclined to boost their saving rate. Any improvement in real disposable income growth for homeowners in coming quarters therefore might be spent.

Finally, recent RBA analysis has suggested that the proportion of disposable incomes being directed towards scheduled mortgage payments has reached its highest level in at least the past twenty years. But there have been many occasions over the past fifteen years when a larger proportion of disposable incomes has been directed towards mortgage payments once unscheduled payments are considered.

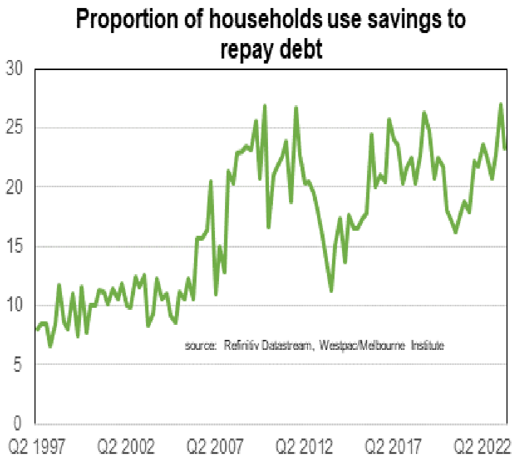
One period when the total mortgage payment ratio (including unscheduled payments) was lower was in the years prior to the pandemic. These were times when there was lower wages growth and a higher unemployment (and underutilisation) rate. The result was that households took the opportunity to reduce the size of unscheduled payments (and the decline in interest rates also reduced their scheduled payments).

RBA data suggests that the crimping of disposable incomes by the high cost of living has led to households again starting to reduce the size of unscheduled payments. But on this occasion, the increase in interest rates means scheduled payments are on the rise. Lower inflation (while hopefully keeping the jobs market relatively strong) would boost real disposable incomes and therefore households' ability and confidence to meet the higher scheduled payments.

Scheduled mortgage payments are at a record high. The ratio of all mortgage payments has been higher.



A high proportion of spare cash flow is going to repay debt.



We really do live in interesting times.

Regards

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