16 March 2021

RESEARCH NOTE

All Hail the Spender of Last Resort

Vaccines are being rolled out, economies are reopening, and the recovery is coming. However, it won't be the same everywhere. Household consumption, by far the biggest part of U.S. and European spending, has a very solid outlook in the U.S., but less so in Europe. Fiscal and monetary policies left American households with more income and wealth, while European households have instead borne some losses—particularly the poorer ones. In the short term, a consumption boom is likely in the U.S., while a more normal recovery is in the cards for Europe. Inflation dynamics should diverge between the U.S. and the EU, and with it, higher U.S. interest rates should lead the dollar to appreciate against the euro.

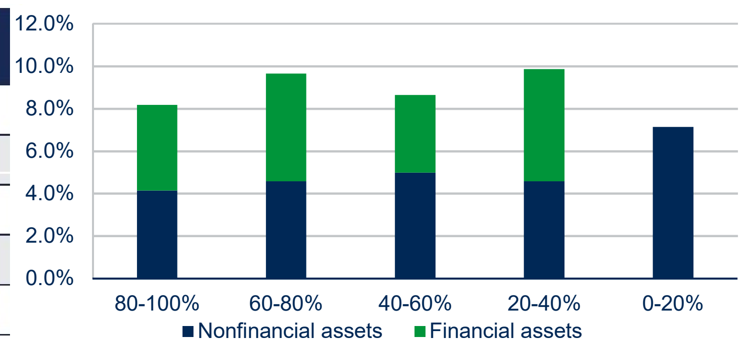
Rich and poor American families have become wealthier

In the U.S., despite the COVID shock, incomes soared. Fiscal support packages have driven income up 12% above pre-crisis levels at a time when 9.5 million Americans are still out of a job. What's more, U.S. policies have been very progressive**; income support from the CARES Act and Emergency COVID Relief Act left those in the lowest-income bracket with 84% more income than prior to the crisis**, according to our calculations. Meanwhile, the highest earners did not see their incomes fully replaced (see table 1). Our estimated magnitude of income replacement is consistent with earlier research by the National Bureau of Economic Research, which used micro data to study the impact of unemployment insurance (UI) benefits from the CARES Act[1]. The most recent bill passed, the American Rescue Plan Act of 2021, will likely do even more to support low- and middle-income households.

Table 1: CHANGE IN INCOME BY QUINTILE*
(CARES ACT & EMERGENCY COVID RELIEF ACT)

Income Quintile	Average Income	Change in Income
Bottom 20%	$12,000	83.8%
20%-40%	$32,800	21.8%
40%-60%	$56,800	3.7%
60%-80%	$93,400	-0.5%
80%-100%	$218,700	-4.2%

Chart 1: HOUSEHOLD ASSETS BY INCOME QUINTILE, % CHANGE 3Q20 VS. 2019



*Assumes that unemployment benefits are received for maximum number of weeks allowed in each bill at the maximum benefit allowed by the 'average' U.S. state. Calculations also assume that stimulus checks are received by the bottom four income quintiles.

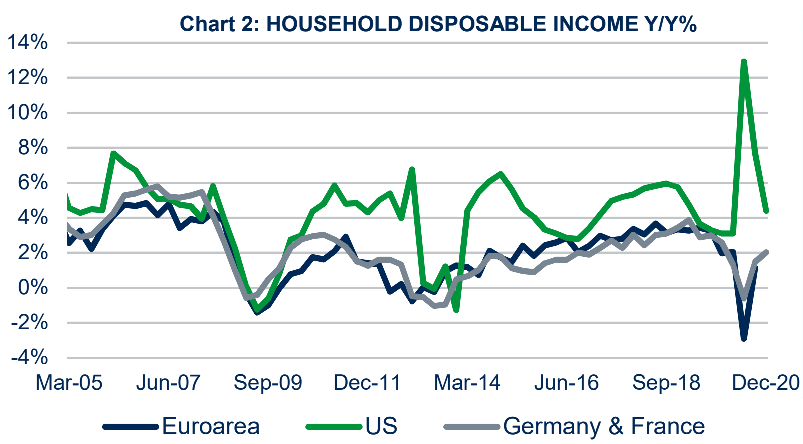
Source: Barings calculations, BLS, TrackTheRecovery.org, Federal Reserve. As of March 9, 2021.

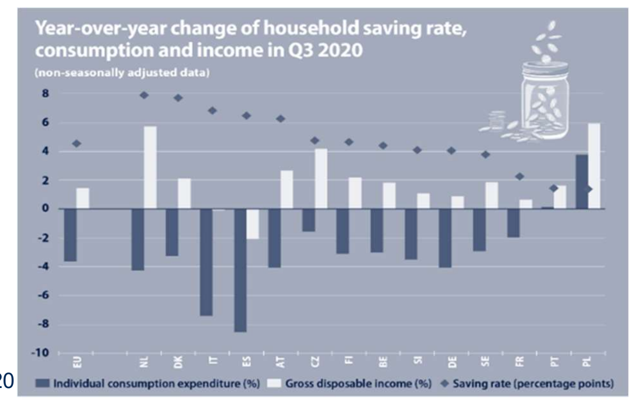
Even though incomes haven't been fully replaced for the richest households, their purchasing power increased due to a rise in wealth. Here, the distributional effects have been very regressive: the vast majority of extra wealth, as measured by increases in financial and non-financial assets between 3Q20 and 4Q19, has gone to the richest households, aided by a sharp rebound in financial markets. However, starting from very little accumulated wealth, **even the lower quintiles appear to have managed to increase wealth and cash savings (see chart 1 above)**.

[1] "US Unemployment Insurance Replacement Rates During the Pandemic," NBER, May 2020.

The picture in Europe is more mixed

While aggregate U.S income soared, euro area income declined starkly [see Chart 2]. Though it has since improved, growth in incomes remains south of that seen in the U.S. Fiscal support in Europe did not make up for 100% of income losses. **The impact varied widely by country, suggesting some countries are poised for a stronger consumption rebound, while others will see a more modest recovery**. Household income dropped 8% in Spain while rising 4% in Poland. Savings also followed very different paths: the Netherlands saw a jump in savings even as incomes rose, similar to the U.S., suggesting a stronger rebound as extra savings are released. Meanwhile, in Poland, a portion of extra income has already been spent, suggesting there should be less pent-up demand fueled by released savings. The three biggest EU economies, Germany, France and Italy, all saw an increase in their savings rates with stable to slightly increasing incomes, suggesting extra savings have been accumulated during the pandemic.





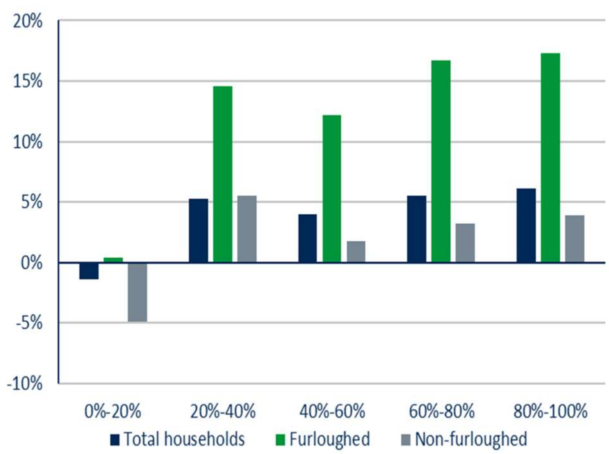
Source: Haver and Eurostat, as of March 10, 2021.

There was substantial disparity in income losses borne by households with jobs which were in furloughed sectors versus the others. The Italian Treasury estimated[2] that during the first lockdown, furloughed workers lost 12% of their income, compared with 4% lost by those who remained actively employed. Looking at wealth dynamics, there is evidence[3] that **EU lower-income households were unable to create a buffer of savings during the lockdown, while richer ones were able to increase their wealth considerably**. So, while richer households on both sides of the Atlantic increased their wealth during the pandemic, poorer households did so only in the U.S. **This should have consequences on the strength of the consumption rebound and of the recovery seen on in both the U.S. and parts of Europe.**

[2] "L'impatto del Covid-19 e degli interventi del Governo sulla situazione socio-economica delle famiglie italiane nei primi tre mesi della pandemia." Nota economica e statistica n.3,

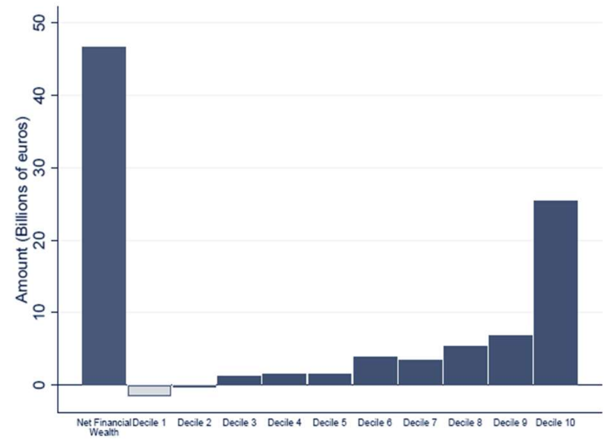
[3] For France: Consumption Dynamics in the COVID Crisis: Real Time Insights from French Transaction & Bank Data, Conseile d'Analyse Economique, 2020, for the UK: "Spending and saving during the COVID-19 crisis: evidence from bank account data", Institute for Fiscal Studies 2020.

Chart 4: CHANGE IN INCOME, ITALY



**Positive number represents a loss. Source: see footnote 2.*

Chart 5: CHANGE IN WEALTH, FRANCE

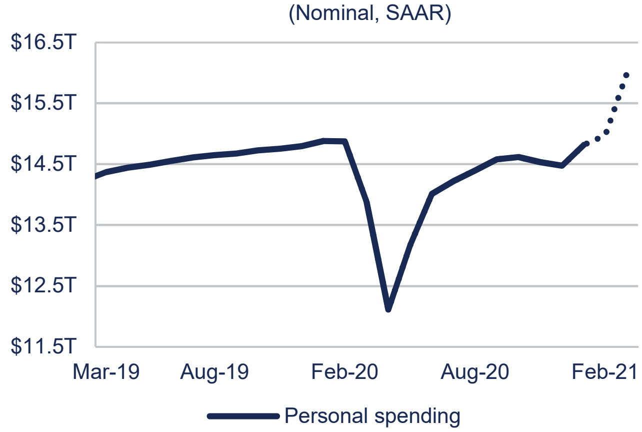


Source: see footnote 3.

Divergence lies ahead

In the U.S., in addition to the excess savings accumulated by households of all incomes, another massive fiscal stimulus bill largely targeted to low- and middle-income households was signed by President Joe Biden. If consumers spend the same percentage of newly received support as they did with the stimulus checks from the CARES Act, this upcoming round of stimulus checks—worth $1,400—**would boost personal spending to 9% above pre-crisis levels.** To put that into context, the average yearly growth of U.S. personal spending was 4% over the last decade. And obviously, $1,400 will imply a much bigger income boost for lower-income households, which have higher propensity to consume, than for richer ones. Coming on top of rising incomes at all income levels, the new stimulus should foster a consumption boom, building a bridge to 2022. If labor markets have fully recovered by then (as Treasury Secretary Janet Yellen is expecting), the savings rate will decline back to pre-covid levels, funding the next leg of the recovery as fiscal supports fades. Otherwise, a slowdown in consumption and the recovery should materialize.

Chart 6: PERSONAL SPENDING
(Nominal, SAAR)



Source: Barings calculations, NBER[4], Bloomberg.

[4] "Income, Liquidity, and the Consumption Response to the 2020 Economic Stimulus Payments," NBER, May 2020.

Such a consumption boom is unlikely to materialize in Europe. For starters, fiscal support is not accelerating as the main support plans are being extended in the current fashion, but not expanded. Second, vaccination programs are progressing slowly (except in the U.K.) and so is the reopening of the most-impacted service sectors. Third, the EU recovery fund will support the most-impacted countries, such as Italy and Spain, but it will focus on investment, and its effects will be felt starting from 2022. Finally, savings have increased only for the richest cohorts, which happen to be those with the lowest propensity to spend. Most estimates find that, out of every extra € or £ of wealth acquired, the highest-income EU households spend between one-half and one-sixth of the lowest-income households[5]. Assuming that wealth dynamics **in Europe** are similar to those documented in France, where almost all new wealth has accrued to the wealthier half of the population, **the pent-up consumption following a release in the extra savings accumulated during the pandemic should be around half of that if the wealth increases had been distributed in a means that raised it equally for households of all incomes.** Conversely, as household wealth of all income levels has increased in the U.S, the proportion of extra savings spent should be that of the average population, and not that of the higher-income cohorts. Hence, a larger proportion of extra savings should be released in the U.S. than in the EU, translating into a stronger consumption rebound in the U.S. All hail the spender of last resort.

Market implications

The U.S. recovery is already pulling ahead of Europe, and this additional fiscal stimulus package is set to **further boost U.S. aggregate demand, which could put some pressure on inflation in the short term. On the other hand, inflation is likely to remain sluggish in Europe** as fundamentals are not pointing toward a fast closure of the output gap and inflationary pressures building up. Base effects and other technical factors are adding to this divergence, pushing U.S. inflation up and EU inflation down in the coming months.

It follows that inflation dynamics should diverge, potentially strongly, between the U.S. and the EU, and with them, interest-rate differentials and the euro-dollar exchange rate, which should appreciate. Other factors, such as the massive current account deficit in the U.S. and surplus in the EU, as well as safe haven flows, are driving markets to expect a depreciating dollar, but **if our consumption divergence story is confirmed, there cannot much downside for the dollar broadly.**

[5] See for example for Europe: "Wealth effect on consumption during the sovereign debt crisis: households heterogeneity in the euro area", ECB working paper n.2357, January 2020; and for the US: "The Distribution of Wealth and the Marginal Propensity to Consume", Quantitative Economics, Vol.8(2) 2017.

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**As of December 31, 2020*
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