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## Look to the middle class

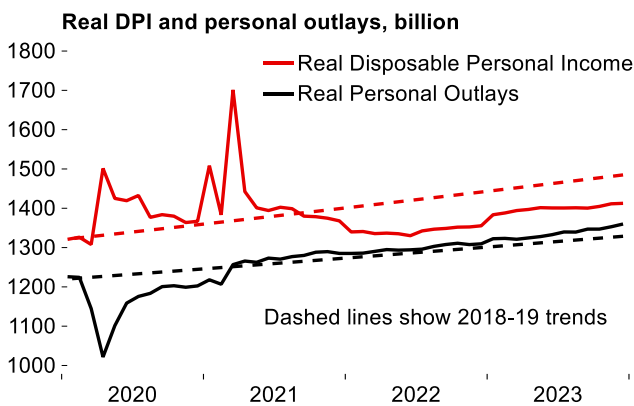
February 23, 2024

- Consumers finished 2023 off strongly, but the spending momentum is expected to slow in early 2024. Excess savings that were built up in 2020 and 2021 have likely been depleted and the household deposits to GDP ratio is approaching the pre-pandemic trend. The existing narrow gap between real incomes and outlays is less sustainable without support from surplus stock. Modest real income gains from real wage growth will help to widen the gap, but a slowdown in spending will be needed to push the savings rate back up to 5-6%.
- Consumption that was primarily savings driven has become increasingly debt driven. Consumer debt to deposit ratios are expected to reach pre-pandemic levels for most middle-income Americans, and the resumption of student loan payments is expected to be the most consequential for them. The middle 60% of earners will be primarily responsible for the expected slowdown in spending in H1 2024, while high earners are expected to keep growth in positive territory.

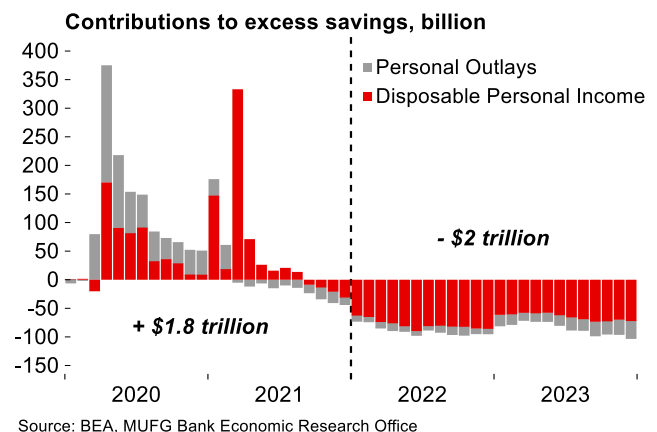
### Excess savings have likely been depleted

The accumulation of excess savings in 2020 and 2021 has likely supported strong spending growth through the Fed’s tightening cycle, but it’s not entirely clear how much, if any, is left in the US economy. Fiscal and monetary stimulus, deferred loan payments, and lockdowns allowed households to build up a stock of personal savings where disposable income was well above the pre-pandemic income trend and personal outlays were well below the pre-pandemic spending trend (Chart 1). Determining how much of this built-up stock is indeed “excess” depends entirely on how we define pre-pandemic income and spending habits.

**Chart 1:** Slower spending growth and real wage gains are expected to widen the gap between income and outlays



**Chart 2:** Inflation has eaten away real income gains in 2020 and 2021, depleting excess savings by 2023

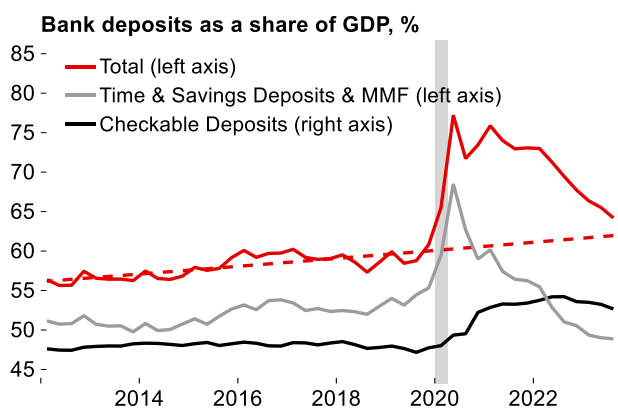


If we use the 2018-19 trends in real disposable income and outlays (Chart 1), the \$1.8 trillion in excess savings that households built up in 2020 and 2021 were fully depleted by around October of last year (Chart 2). This measure of “excess” is partially why consumption was expected to slow in Q4, but real growth exceeded consensus forecasts. Consumers may have had more left in the tank than originally thought.

If we extend the pre-pandemic trends back to 2015 to define “excess,” then around \$780 billion would have still been left in the economy by October, and slightly less if we shorten the trend to 2016, and even less if we go shorten it further to 2017. Using one of these alternative definitions would help explain why consumption was stronger than expected in Q4. But with that said, it would be a safer bet to assume excess savings have been fully depleted by now.

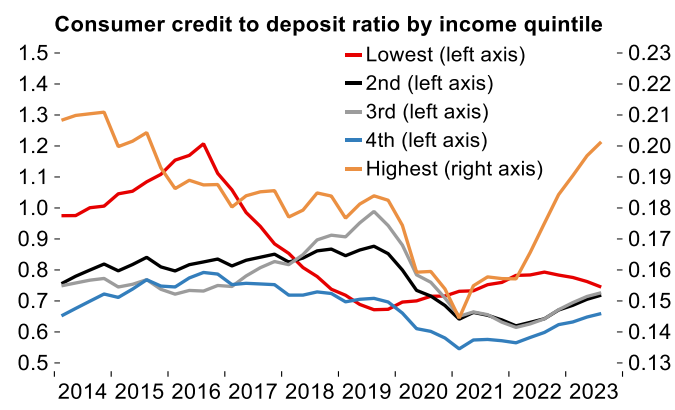
When looking at bank deposits relative to GDP, the trend suggests that there is little to no excess left. As of Q3 2023, household bank deposits as a share of GDP hovered slightly above the pre-pandemic trend after rising sharply in 2020 and 2021 (Chart 3). Checkable deposits remain elevated, but time and savings deposits and money market funds have fallen precipitously, supporting our view that savings have helped sustain spending. And once the Q4 data are released, we expect that the total bank deposit ratio will have reached the pre-pandemic trend.

**Chart 3: Household bank deposits relative to GDP have fallen back down to pre-pandemic levels**



Source: Federal Reserve, MUFG Bank Economic Research Office

**Chart 4: Credit to deposit ratios are expected to weigh on consumption growth, especially for middle earners**



Source: Federal Reserve, MUFG Bank Economic Research Office

However, that isn't to say that consumption will come to a grinding halt. Household spending habits that took years to build are hard to break, especially when the labor market is at full employment. Consumption that was primarily savings driven in 2020 and 2021 has increasingly become debt driven. This is likely to continue with depleted excess savings, but at some point, consumer debt levels will be too high to sustain spending. What constitutes “too high” is now the pressing question.

The general rule of thumb in this post-2020 era has been to compare levels and rates to that before the pandemic. In this case, it may be an appropriate comparison because credit ratios were largely steady from 2014-2019, at least for most income groups. Shown in Chart 4, consumer credit to deposit ratios were flat for the 2<sup>nd</sup> and 4<sup>th</sup> income quintiles and slightly upward trending for the 3<sup>rd</sup> income quintile from 2014-2019. They have since been growing and may reach their respective pre-pandemic level in the first half of 2024, where household deleveraging is expected to follow.

If that isn't convincing enough, the resumption of student loan payments is expected to add more downward pressure on consumption and accelerate how soon households cut back on debt financed spending. This will especially be the case for the middle 60% of earners.

Income quintiles two through four account for 68% of outstanding student loan debt and for nearly 60% of monthly payments on that debt.<sup>1</sup> Payments resumed in October 2023, but some lagged effects are expected where the impact may not materialize until Q1 of this year. In addition, credit card delinquency rates continue to trend upward, and they have exceeded the pre-pandemic rate for middle- and low-income Americans.<sup>2</sup> This is also the case for auto loans, where delinquency rates have surpassed 2019 rates, but they remain relatively low by historical standards.<sup>3</sup>

A depleted stock of savings and added debt pressure are expected to weigh on spending in the first half of this year. The middle 60% of earners (quintiles 2-4) accounted for over 50% of total average annual expenditures in 2022, and they will likely be the primary group responsible for the expected slowdown in spending in the first half of 2024.

The ends of the income distribution will likely be less of a factor on consumption in 2024. On the bottom end is the lowest income quintile, whose credit to deposit ratio is more volatile and who only accounted for around 9% of total expenditures in 2022. Lower income households are much more rate sensitive given their high propensity to consume. A much greater share of their disposable income goes toward consumption. When rates rise, as did in 2016 and 2022, debt financed consumption is relatively quick to fall (Chart 4). Credit card and auto loan delinquency rates are also rising fastest for low-income groups, given their high interest rate sensitivity. But their low share of overall spending means they will be much less consequential to overall consumption.

On the top end of the distribution is the highest income quintile, whose ratio is growing rapidly but remains very low in comparison to the other groups (Chart 4). The highest income quintile accounted for nearly 40% of total average annual expenditures in 2022, but high earners tend to have a low propensity to consume (evidenced with lower debt financed spending). Rising consumer debt to deposit ratios are less concerning at this point given the low level, and delinquency rates remain at or near pre-pandemic rates. Student loan payments are also expected to have less of an impact on spending for high income households, despite accounting for 26% of outstanding student loan debt and 39% of monthly payments on that debt.

The effects of high interest rates will eventually feed into higher income groups if the Fed continues its “higher for longer” stance well into the summer, but middle-income Americans will precipitate the slowdown in overall consumption. The first rate cut will probably not occur until there is coincident evidence of high debt burdens on high income groups, likely around this summer.

### **Real wages will help to widen the gap**

Helping to widen the gap between real incomes and outlays are recent real wage gains. Median wages from the Atlanta Fed’s Wage Growth Tracker now exhibit stronger growth than median CPI for all income quartiles (Chart 5). Real wage gains were much less of an issue for lower income households (1<sup>st</sup> quartile) given the severity of labor shortages in in-person and manual services occupations. More consequential are real wage gains for middle income households (2<sup>nd</sup> and 3<sup>rd</sup> quartile), where wage growth has only recently begun to outpace inflation and the propensity to consume is greater than high income households.

But even with real wage gains, consumption will still likely have to slow. Modest growth in real incomes will not be enough to bring savings rates up to a sustainable level without support from surplus stock and with relatively low consumer sentiment. The last

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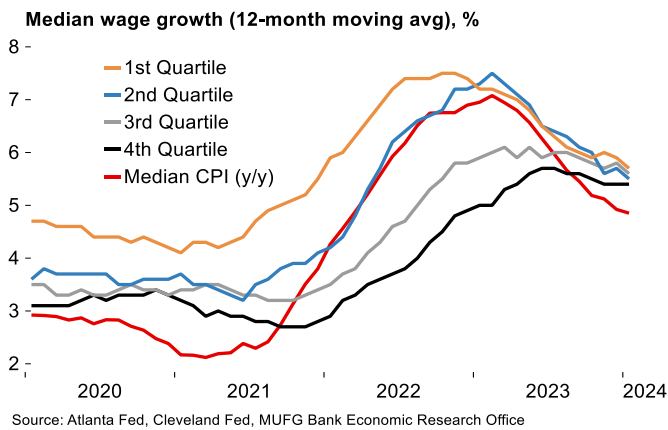
<sup>1</sup> [Who owes the most in student loans: New data from the Fed | Brookings](#)

<sup>2</sup> [Credit Card Delinquencies Continue to Rise—Who Is Missing Payments?](#)

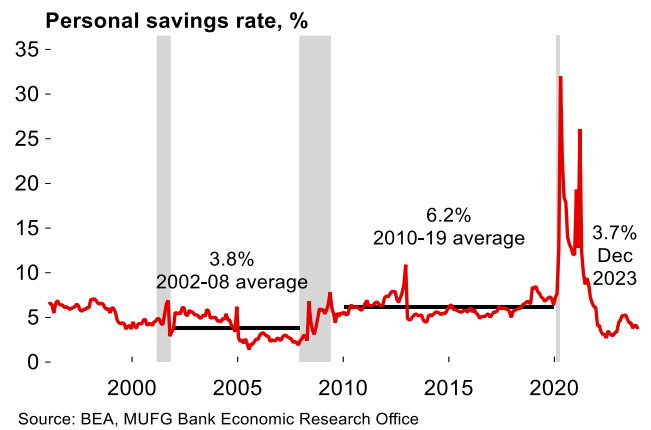
<sup>3</sup> [Auto Loan Delinquency Revs Up as Car Prices Stress Budgets](#)

time savings rates were this low was in the years before the 2008 recession (Chart 6), a time when consumer sentiment around economic conditions was much higher. The Current Economic Conditions Index from the University of Michigan was nearly 40% higher in 2002-08 relative to the December 2023 level. Consumer spending will likely slow in 2024 for households to rebuild savings rates back between 5-6%.

**Chart 5: Real wage gains will drive real income growth, but not by enough to sustain current spending growth**



**Chart 6: A slowdown in consumption will be needed to push the savings rate up to a sustainable level**



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