

Slowdown or slump?

Chief economist's comment

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- The world economy is a weird place. In advanced economies, unemployment is astonishingly low. Real wage growth is extraordinarily negative. Consumer spending is resilient.
- This weirdness is partly explained by advanced economy consumers' willingness to reduce how much they save each month, with lower savings giving more spending power to mitigate the effects of higher inflation.
- A soft landing depends on real wages stabilizing before the savings run out. If savings rates rise (or stop falling) with real wages this negative, an economic slump is likely.
- Why might savings rise? If fear of unemployment increases, precautionary savings would take place. In a social media age, the risk of tweeting the economy into a slump is real.
- Alternatively, the unusual determination of consumers to go on holiday, in spite of significant price increases, may start a process of demand destruction if consumers begin to save in September and October to repay the cost of their vacations.
- The risk is that policymakers are caught by surprise. Consumers seem likely to change behavior more rapidly than in previous economic cycles.



Source: Getty Images

The global economy was always expected to slow over the course of 2022. The advanced economy post-pandemic consumer surge could not last, and did not last. The question is whether that slowdown becomes a slump—a period of significantly below-trend growth. The question is more than usually difficult to answer, because the world economy is still weird. Normal economic relationships do not hold.

The US economy shows the weirdness very well. The unemployment rate is just 0.1% above the low of the last 50 years. The job openings rate is more than double its pre-

pandemic average. This signals a very strong labor market. And yet real average weekly earnings and the real wage component of the employment cost index are falling at the fastest rate on record. The labor market may be strong, but it is not translating into pay bargaining in real terms (which is what a wage cost-price spiral would require). For example, in the wage cost-price spiral of the 1970s, US real wages kept rising (apart from the period when President Nixon directly interfered in the labor market with wage controls).

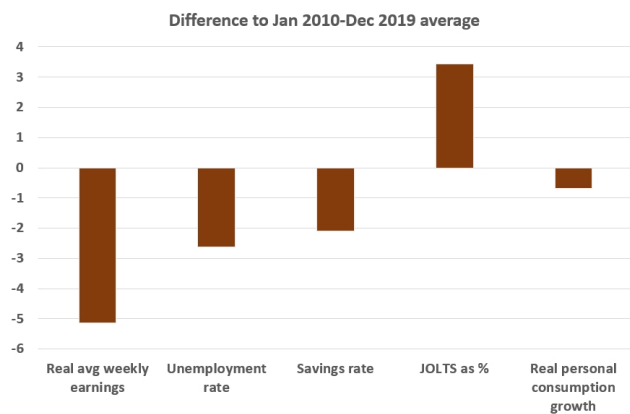
Falling real earnings, on average price measures, means that workers have less and less spending power.¹ Despite

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the negative real earnings trend, real consumer spending growth is still positive (although it has slowed), and spending growth is only slightly less than the pre-pandemic average. Less spending power is accompanied by *more* spending.

The US economy – really weird

Real earnings well below normal, unemployment well below normal, consumption still growing more or less normal

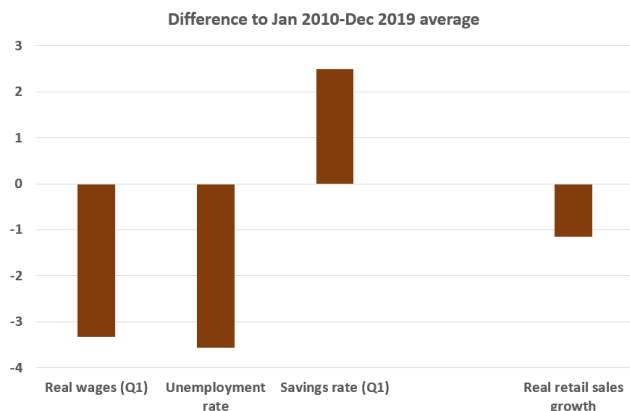


Source: Haver, UBS

It is the same story in the euro area. Unemployment is the lowest in the history of the monetary union. The job vacancy rate is the highest on record. Real incomes are falling, but real consumption is still positive

The Eurozone economy – also weird

Real earnings growth well below normal, savings off recent highs, consumption a little below normal



Source: Haver, UBS

This weird economic mix is important, because it contains the critical factor that divides a slowdown from a slump. The way negative real income growth and positive real spending coexist is through reduced savings. The US savings rate is well below pre-pandemic norms. Eurozone households are saving a little more than before the pandemic, but the savings rate has fallen from a high of 24.9% down to 15%.

The cut in how much is saved each month allows an increase in consumption.

Slowdown versus slump

It is the savings (and borrowing) behavior of consumers that is likely to make the difference between a slowdown and a slump. In a slowdown scenario, the rate of real income growth will move to zero, *before* the savings run out. In this scenario, reduced savings (or increased borrowing, which economists consider to be a negative savings rate) will fund consumption until real income growth stops being a consumption drag.

In the slump scenario, something causes the savings rate to rise before real incomes have stabilized. In that situation, the reality of a negative real income becomes apparent to consumers, and consumers can no longer defy the gravity of not having enough money to keep growing their spending.

Triggers for slowing and slumping

The slowdown scenario is most likely if inflation rates slow. Slowing inflation rates require a slowdown (but not a slump) in demand. Normally, inflation is dominated by labor costs, which account for around 70% of an advanced economy's CPI basket. Unusually, since the pandemic, inflation has not been really driven by labor costs (which is why the wage share of GDP is stagnant or falling). It is profits, driven by pricing power, driven by demand that is driving inflation. So demand needs to moderate, at least in some parts of the economy, to create disinflation.

Where demand has slowed, inflation has also slowed—the transitory inflation story worked for things like consumer durable goods, which (in the US at least) are undergoing the most rapid disinflation episode in over 70 years. The difficulty for policymakers is finessing enough of a decline in demand to slow inflation, without triggering the slump scenario.

The slump scenario could be triggered in one of two ways. The “animal spirits” of consumers could change, leading to an increased desire to save. A sudden rise in fear around job security could do this, for instance. This is where the unpredictable role of social media comes in. It is perfectly possible for an economy to tweet itself into recession (it is, perhaps, less likely that an economy would TikTok dance its way into a recession). If a social media narrative around recession risks increases job insecurity, then the narrative could become self-fulfilling as consumers raise their savings rate.

The alternative path to a slump is a variation of demand destruction. One of the most significant nonessential things

consumers spend money on is going on holiday. In 2019, US households spent the equivalent 5.1% of GDP on holidays. In Europe, 2019 total tourism spending by citizens was 3.4% of GDP.²

The cost of going on holiday has risen significantly in 2022 (e.g., airfares, accommodation, and food away from home). However, consumers today are unusually reluctant to respond to this by reducing demand. After the hours spent at home during the pandemic, consumers are desperate to spend hours in overcrowded airports experiencing the thrill of travel—whatever the price. To descend to economic jargon, in 2022 the price elasticity of demand for going on holiday has fallen. This means that consumers are allocating a larger share of their budgets to travel and borrowing or reducing savings in the process. It is possible that in September or October consumer spending will fall, as households seek to increase their savings to pay for the past pleasure of going on holiday over the summer months.

Fast reactions

With both job insecurity and demand destruction, a key risk in the post pandemic world is that consumers may change their behavior faster than has been the case in the past. Social media has accelerated the spread of fear far beyond what was imaginable in the pre-Twitter world. The significant shift in consumers' spending behavior for holidays means that past consumption patterns are unlikely to be helpful in predicting the future.

Those central banks that remain ignorant of the speed of change risk overtightening policy. The higher interest rates themselves are unlikely to push savings higher, but the increased cost of credit could reduce borrowing (dissaving), and stories of a determination to slow the economy may raise fears around job security. Agility may become an increasingly important characteristic of central bank policy.

Slowdown or slump?

The balance between the expected economic slowdown and a wholesale economic slump is finely poised. Normal economic relationships have shifted, leaving policymakers uncertain about how the economy will respond to their actions. Too hasty a process of tightening, or continued erratic behavior by central banks, could push the global economy into the slump scenario. The difference between a slowdown and a slump rests on consumer behavior. September and October are likely to be critical times as economists learn whether consumers will translate the fears fostered by social media into job insecurity, and whether determination to go on holiday at any price nevertheless comes at a cost.

¹ There are problems with all price measures. It is certainly true that the cost of living of consumers can be lower than consumer price inflation suggests—people who do not drive cars face a lower inflation rate and therefore a higher (less negative) real wage rate across most advanced economies; US homeowners also experience less inflation and thus a higher (less negative) real wage rate than headline CPI would imply. This matters when it comes to spending power—if consumers never buy the things that are rising most in price, they will be able to continue to consume other items. Nonetheless, the overall wage share of GDP is falling for most economies, implying that on average people are experiencing a decline in spending power.

² In 2019, US holidaymakers spent USD 1,026 billion within the US, and at least USD 102 billion on imports of "other personal travel" services. Euro area tourists spent EUR 479 billion, most of which was intra-European travel. (Sources: World Travel and Tourism Council, US balance of payments, Eurostat)

Appendix

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