TD Economics

# We Were on A Break: The Year Ahead for Consumption and Income

Sri Thanabalasingam, Senior Economist | 416-413-3117

December 22, 2020

## Highlights

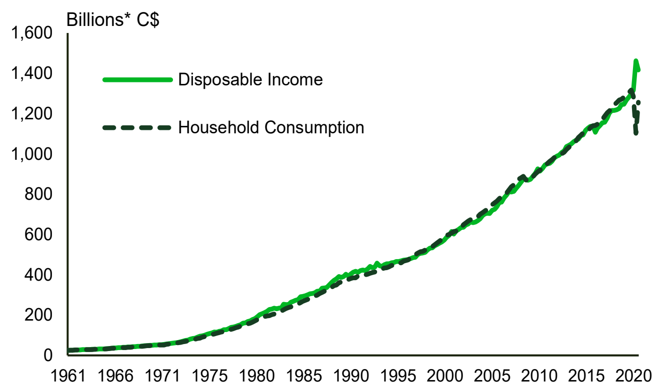
- After nearly sixty years with little deviation, the relationship between household disposable income and consumption broke down dramatically this year.
- The pandemic and the extraordinary government response sent income soaring and consumption plummeting. By the third quarter, the gap between the two stood at $40 billion, around 10 times higher than the historical average.
- Such a yawning gap between consumption and income is not sustainable, and indeed, we look for a sharp narrowing to take place next year. Expiring government supports will weigh on income, while consumption looks set to take off following widespread rollout of a vaccine.
- Still, even with a vaccine, the average household savings rate is expected to stay high relative to pre-pandemic norms. Furthermore, the income-consumption divide could remain wider than usual in 2022 and beyond.

For the past sixty years, household disposable income and consumption have been joined at the hip. Inseparable through thick and thin, the two series faced and overcame obstacles together, never deviating too far from one another (Chart 1).

Unfortunately, nothing lasts forever. The COVID-19 pandemic – and extraordinary government responses to it – threw a gigantic wrench between consumption and income, resulting in a dramatic breakdown of the relationship. By the third quarter of 2020, disposable income had risen by 9% from the end of 2019, while consumption was 5% below.

Next year could be a very different story. Hopefully we're right in our expectation that the pandemic will soon be wrestled under control. Effective vaccines are already on the scene and will probably become widely available by the second quarter of 2021. As this occurs, we anticipate that much of the yawning gap at present between income and consumption will narrow. Expiring government supports will constrain income levels even as the job market recovery continues. At the same time, returning demand and less-forced savings will likely provide a tremendous boost to consumption, particularly outlays within the pandemic-ravaged services component.

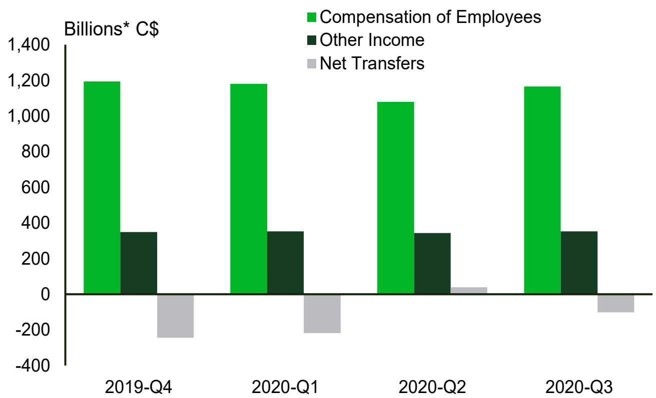
**Chart 1: Consumption and Income Have Seen an Unprecedented Divergence During the Pandemic**




*Seasonally adjusted at annual rates.
Source: Statistics Canada, TD Economics.

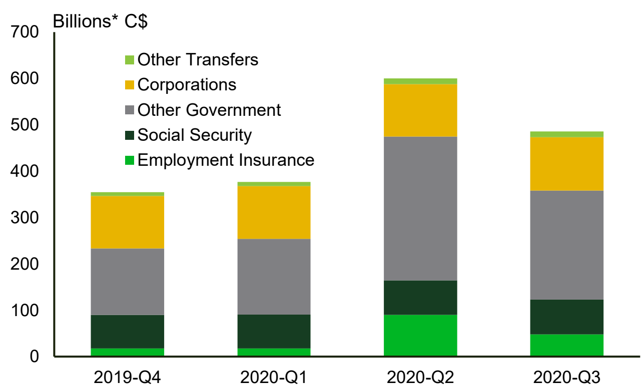
Still, we don't expect an immediate reversion to historical norms in consumption versus income as the pandemic continues to leave a mark. Amid fragile confidence and ongoing health concerns, some households may opt to keep savings high, even with newly available vaccines. With time, however, confidence will grow, and income and consumption will once again be reunited.

**Chart 2A: Transfers Turned Positive In 20Q2...**




*Seasonally adjusted at annual rates.
Source: Statistics Canada, TD Economics.

**Chart 2B: ...Driven by Government Support Payments**




*Seasonally adjusted at annual rates.
Source: Statistics Canada, TD Economics.

## Income Gains Driven By Government Support Measures

The unprecedented divergence between disposable income and consumption this year reflects both a surge in income and depressed consumption. Income gains were recorded even as the economy was subject to widespread lockdowns this past spring and millions of people lost their jobs. Indeed, disposable income grew by an amazing 11% (q/q) in the second quarter and remains historically elevated.

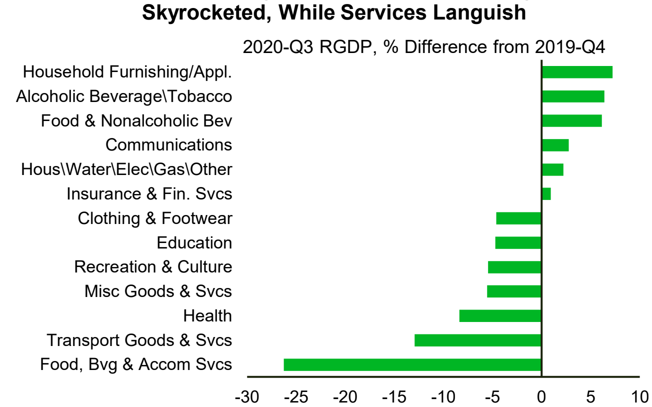
Personal disposable income is comprised of compensation of employees (mainly wages and salaries), income of unincorporated businesses, property income and transfers (all on a net basis). The transfer component has historically exerted a drag on total personal disposable income, as money paid out to nonprofit institutions, corporations, and governments has been higher than that received (Chart 2A; Chart 2B). However, for the first time since the data were recorded in 1961, government transfers to households surpassed funds collected in the second quarter on the back of CERB and other supports. What's more, the gain in net government transfers was greater than the drop in compensation due to lost employment, leading to an overall increase in disposable income.

Moving to the third quarter, disposable income declined 3% q/q as some support programs expired during the summer. Government payments to households pulled back 25% but was still an extraordinary 55% higher than the average quarterly payment in 2019. The recovering labour market provided a partial offset as employee compensation rose 8%. However, the level was still 2% below where it was at the end of 2019. All told, disposable income was still riding high in the third quarter, sitting 9% above its pre-pandemic peak.

## Consumption Held Back By Pandemic Shock

While income edged down from a stratospheric level in the third quarter, consumption staged a recovery. Spending rebounded 13% as provinces ended lockdowns and eased social distancing guidelines. Consumers who had not suffered a reduction in income or wealth, splurged on goods, especially durable goods. Spending on furniture, appliances and other household items skyrocketed (Chart 3). Barred from vacationing, Canadians spent lavishly on goods to upgrade their homes. Growth in durable goods was 38% in the third quarter. To be sure, the level of spending in this category was nearly 8% above where it was in 2019Q4.

**Chart 3: Spending on Household Furnishing Has Skyrocketed, While Services Languish**




Source: Statistics Canada, TD Economics.

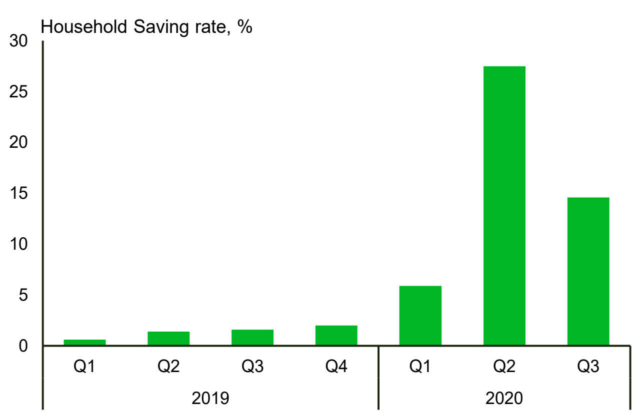
But this wasn't enough to return consumption to its pre-pandemic peak. That's because spending on services languished in the third quarter. Health worries and ongoing social distancing guidelines continued to hold down expenditure in high-touch service sectors. Spending on food, beverage, and accommodation services was down more than 25% compared to pre-pandemic levels, recreation and cultural services was 33% weaker, and transportation services was down a depressing 72%. If these three service categories were excluded from the total, consumption would be approximately right back where it was in 2019. Forced to spend less on high-touch categories, the household saving rate ballooned well into double digit territory this year (Chart 4).

The bounce back in consumption combined with the decline in disposable income narrowed the gap between the two – from a massive $90 billion (unannualized) in the second quarter to $40 billion in the third quarter. Compared to history, the gap was still 10 times higher than what we have typically observed.

## Consumption and Income Move Closer Next Year, But Differences Remain

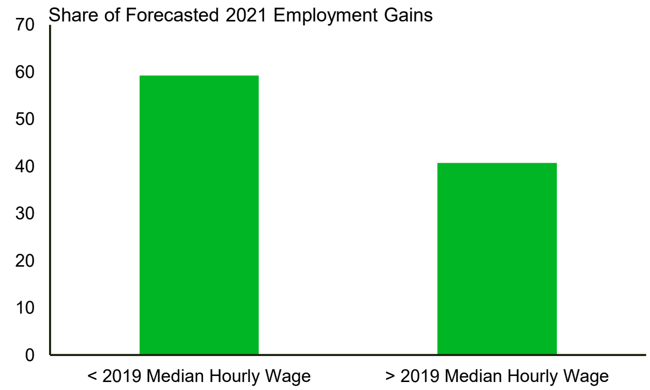
Looking ahead, the gap between consumption and income will likely continue to shrink next year, but not completely disappear. On the income side, the impending expiry of the Canada Recovery Benefit and the Canada Recovery Caregiving Benefit programs in March 2021 will significantly reduce government transfers to households. In addition, some individuals will be rolling off employment insurance benefits, exerting further downward pressure on disposable income in 2021.

**Chart 4: Unable to Spend Forced Saving Rate Higher in 2020**




Source: Statistics Canada, TD Economics.

**Chart 5: 2021 Employment Gains Are Expected to Be Concentrated in Low Paying Sectors**




Source: Statistics Canada, TD Economics.

The ongoing labour market recovery will again provide an offset but will probably not be enough to arrest the slowdown in income growth. We expect close to 60% of the jobs gained in 2021 will be in industries that pay below-average wages (Chart 5). And a sizeable share of those jobs will provide less compensation than what workers were receiving through government income support programs.

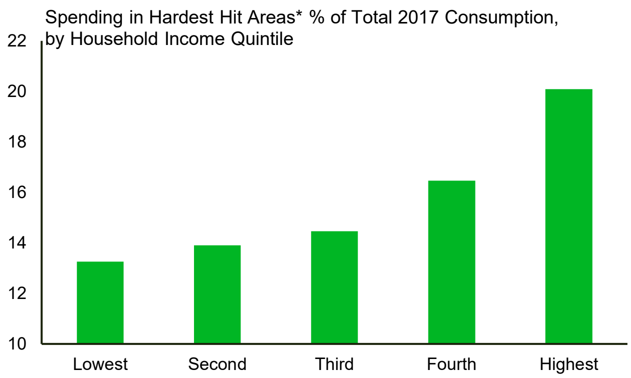
There is the possibility, of course, that governments extend benefits to households even further or introduce some new benefits. Notably, the federal government included $70-$100 billion in unallocated funding in its Fall Economic Statement (FES), some of which could be directed towards increased transfers to households beginning next year. But due to the lack of specifics, this additional stimulus has not been embedded in our disposable income forecast.

While income levels likely ease, consumption is set to take off for several different reasons:

### 1) Positive Vaccine Developments

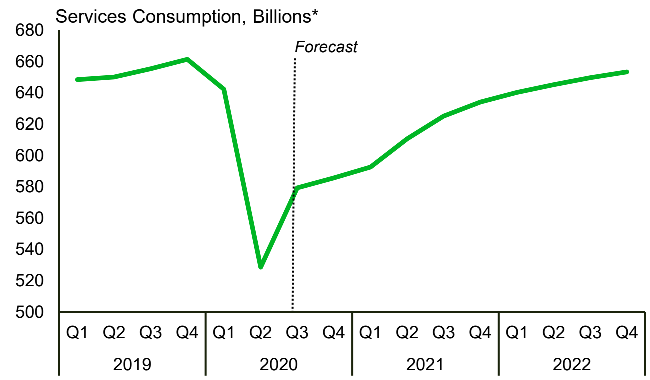
Recent vaccine developments are very encouraging and suggest that an end is in sight for the pandemic. But the crisis does not need to end entirely for consumption to make up lost ground. By inoculating vulnerable segments of the population, consumers could gain more confidence and governments would unwind long-standing restrictions on businesses and social gatherings. Allowed to operate at a higher capacity, businesses could support recovering consumer demand.

**Chart 6: Wealthier Households Spend More in Areas Hardest Hit by the Pandemic**




*Included areas are restaurants, other accommodation, clothing, and recreation services.
Source: Statistics Canada, TD Economics.

**Chart 7: Services Consumption To Gradually Recover**




*2012 Chained Canadian dollars.
Source: Statistics Canada, TD Economics.

## 2) Pent-up Demand

As noted earlier, the pandemic forced households to shift away from spending in high-touch services in the short-term. But as a vaccine makes it safer to engage in these activities, demand will return. And while there is some uncertainty around the extent to which the spending rebound in services will materialize, we suspect that many Canadians will promptly take advantage of social gatherings, tourism, restaurant dining and other activities that they have missed for the better part of a year. Moreover, cold winter months will have contributed to a build-up of pandemic fatigue, which will further contribute to strong services spending growth through most of next year.

## 3) Elevated Savings

Backstopping the rebound in consumption are elevated savings. Canadians have accumulated excess savings of almost $150 billion over the second and third quarters of 2020.[1] Most of these savings are likely attributed to wealthier households who have historically spent more in areas that were hardest hit by the pandemic (Chart 6). According to 2017 Survey of Household Spending data (latest available data), households in the top two income quintiles spent nearly 20% of total consumption expenditure on restaurants, other accommodations, clothing, and recreation services. Put another way, households in the two highest income quintiles spent 70% more in these areas than all other households combined. A widely available vaccine will allow for households to normalize spending patterns, while also spending more of their savings.

## 4) Higher Household Wealth

A steady rise in the wealth of Canadian households during the pandemic period augurs for greater spending in 2021. Recently released household wealth data show that by the end of the third quarter, household assets were 5% higher than what they were at the end of 2019. The exuberance of the housing market through the pandemic period lifted the value of residential and land assets, fueling wealth gains so far through 2020. These advances may flow through to stronger spending growth next year.

However, households will probably not return to historic patterns of spending and saving right away. Some households may opt to keep savings elevated even with a vaccine. It may take higher levels of confidence to alleviate health concerns and boost spending. Given the perceived apprehension, we have projected the personal savings rate to stay elevated relative to history over the forecast horizon.

There is also the issue of supply constraints. Struggling businesses will close or have already shutdown, while others have significantly reduced operating capacity. With less supply, households have fewer avenues to spend, which could limit the upside on consumption growth. For example, airlines suspended numerous flights and laid off thousands of people over the last several months. Even if demand for travel returns quickly, it will take time to get flights up and running again. As such, following a bump in the second quarter of next year, we have incorporated a gradual improvement in services consumption in our latest forecast.

Still, we expect consumption to be by far the most important driver of economic growth in 2021 and 2022. Averaging an annual growth rate of 4.6%, consumption is projected to propel the Canadian economy's recovery over the medium term. As a result, the divide between income and consumption will narrow to $18 billion in 2021 and $13 billion in 2022. Relative to history, however, income would remain far higher than consumption, suggesting further upside to longer term spending growth.

## Concluding Thoughts

Repairing broken relationships is not easy. The rockier it is, the harder it is to fix. Income and consumption had a turbulent 2020, but the future looks brighter. The vaccine will aid the consumption recovery, while expiring government supports normalize income levels. While this will shorten the distance between the two, it probably won't close the gap next year or the year after. It may take a little while longer for this to occur. Until then, consumption and income are set to enjoy an extended, but amicable, break.

## Endnotes

1. Excess savings are calculated as actual savings less average quarterly savings over 2018-2019.