Possibility of a Level-Up in Household Saving Rate Following COVID-19

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As Korea, like other major economies, sees a contraction in domestic consumption this year due to the COVID-19 crisis, its household saving rate is expected to rise significantly. A higher saving rate in general is a positive development in that it leads to greater corporate funding and subsequently increased productivity. However, when investment is unlikely to rise due to elevated uncertainty, a higher saving rate could aggravate economic sluggishness by reducing consumption expenditure. It is true that the higher domestic household saving rate this year is mainly attributable to a contraction in spending related to face-to-face services, such as tourism and food & accommodation, affected by enhanced social distancing measures. However, the elevated household saving rate is expected to return to its previous level to a certain extent, driven by pent-up demand (a lagged materialization of suppressed demand).

Nevertheless, a prolonged economic slump could cause a level-up of the saving rate, as households show behavioral changes in the form of heightened propensity to save and income inequality worsens. First of all, a continued slowdown of employment and income coupled with a reduction in government income assistance could lead to a decline in households' expected future income, and subsequently to increased precautionary savings. Meanwhile, if access to financial institution loans becomes limited due to heightened credit risk in the overall economy, households could save more so as to reduce debt and secure future income capacity. Moreover, if the crisis persists, the income level of low-income groups could decline more sharply compared to that of high-income groups. Given the low-income households' lower propensity to save, the propensity to save for households overall could rise due to the composition effect.

The level-up of the saving rate as explained above could lead to a continued consumption slump, possibly reducing the effectiveness of stimulus aimed at boosting domestic demand in response to sluggish consumption. Also, economic volatility could escalate as a result of a decline in the share of consumption, which has relatively low volatility, in the economy. In the longer-term horizon, as savings (fund supply) start to exceed fund demand for investment, the secular stagnation of low growth, low inflation and low interest rates could become the new normal.

This paper looks into the economic impact of households' higher propensity to save, using dynamic stochastic general equilibrium (DSGE) model analysis. The change of households' time preference, reflecting the change in propensity to save, implies that households have been showing higher preference for future utility since the global financial crisis. Based on impulse response analysis, this paper also finds that a higher preference for future utility results in a decline in current consumption, leading to an employment contraction and downward pressure on inflation.

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