A tectonic shift in household savings and investment

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India's savings patterns are likely to see a tectonic shift, with far-reaching implications for the economy and financial system. We expect Indian savers (households) to diversify away from real estate, gold, bank deposits and cash into longer-term investment such as mutual funds and pension products. This, in turn, will provide productive capital to fund infrastructure and business investment in India. It will also provide the domestic liquidity to both debt and equity market going ahead and may keep the valuations rich for an extended period of time.

India's high savings rate has been a crucial driver of its economic boom, providing productive capital and helping to fuel a virtuous cycle of higher growth, higher income and higher savings. Domestic Savings in India has shown an uneven uptrend up until FY08-09, led by the rising private savings. Between FY57-58 to FY08-09 (~50 years), Savings as a % of GDP rose from 10% to 40% of GDP. From the peak of FY09, domestic savings fell to 30% of GDP (FY17). Both household (from 23% of GDP to 19%) and corporate savings (from 17% to 14% of GDP) fell during the period. Weak corporate earnings (from 2014 to 2016), near double-digit inflation (2008 to 2014) leading to negative real rates, high fiscal deficit and issues of policy paralysis explains the fall in savings. Nevertheless, the rate still compares very favourably with other emerging economies—with a few exceptions such as China (45%), Korea (37%) and Taiwan (35%). Further, looking ahead, as the macro fundamentals are improving, savings are projected to rise.

Households account for majority of savings in India

Domestic savings has been dominated by household savings (60-70% share) and particularly physical household savings. Saving in physical assets, which had a whopping share of almost 90% of total household saving in 1950s, has come down to around 40% in late 1990s, only to rise back to 57% by FY15-16. In fact, the last five year period (FY12 to FY16) has seen the lowest financial savings by the household (average of 36% of total household savings and 41% as of FY16).

In the present scenario when corporate profitability has reduced and Indian government is likely to stay in deficit mode, household savings will therefore continue to remain crucial to sustaining a strong savings rate.

India Households save in the form of cash and bank deposits; this will change

Households in India have traditionally preferred to invest low risk assets with bank deposits and currency accounting for 50-60% of gross financial savings. This also explains why bank credit is key source of funding business investment in India, leading to gross asset-liability mismatch and hence current situation of NPAs. Investment in equities, both direct and via mutual fund, gained traction for a short period of FY86 -96 and then in FY06-08 but owing to couple of instances of stock market scams, retail investors have typically shied away from equities. Investments in other long-term financial products (particularly insurance and pension funds) have also been low (around 30% of gross financial savings and 4-5% of GDP) suggesting a weak penetration of these products in India. This is worrying because longer-term financial savings is fundamental to fund higher investment and growth in India. We expect this to change for the better.

Demography and weak social security system warrants higher savings in India

64% of Indian population fall in working age group (15-64 years) and the ratio is likely to stay favourable for next few decades, implying larger pool of savers than dis-savers in India. Additionally, India is one of those few economies with declining age-dependency ratio. Falling age-dependency increases the proportion of income available to save. However, weak job-prospects dent the demography impact. As of census survey 2011, 40% of Indian population are employed. This means that while the working age population is 64%, only 40% are employed (either willingly or unwillingly) implying the higher dependency and implying that demography factors will take longer to play out (as economy grows and per-capita income improve).

On the other hand, the woeful inadequacy of India's social security systems dictates that personal savings remain vital to meet long-term needs such as home buying, children's education, retirement and healthcare. Lastly, while the retail loans are rising fast and needs to be watched out, many Indians still remain averse to taking loans (household debt is 10% of GDP). All these factors put an automatic floor to the savings rate in India. Since early 2000, 'marginal propensity to save (household savings as a % of household disposable income)' has stabilized around 25% and is likely to stay put.

Cyclical Factors too, favour higher savings

In the near-term, improving growth and hence per-capita income coupled with lowering inflation and better macro-stability augur well for saving. Further, real-rates have turned positive for three years now. Analysis suggests that financial savings is positively correlated with real rates.

In fact, owing to these positive developments, net financial savings grew by 18% in FY16. While the data for aggregate household savings in FY17 is yet not available, lead indicators paint a healthy picture. For instance, **Mutual Fund AUM has depicted 28% CAGR in last two and a half years with Asset Under Management (AUM) size doubling from Rs. 10 trillion in Jan 2015 to Rs. 20 trillion as of June 2017 end**.

Insurance sector premium collection is posting a CAGR of 26% in last three years compared to de-growth in years before (FY13 and FY14).

Inflows are also coming through the National Pension Scheme (NPS, very similar to 401k in US) and The Employee Provident Fund Organisation (EPFO)- the two key pension fund schemes in India. In FY16, EPFO had flows of Rs 1.02 trillion and AUM of Rs 6.34 trillion.

Financial Savings to at least double over next five years

These favourable trends are likely to continue in the coming years and Indian financial savings is likely to see a structural ascent. We build a scenario where we expect nominal GDP to grow by 11% over next five years and households to continue saving 25% of disposable income on a net basis. Of this, owing to structural correction in Indian real estate market and contained inflation, falling inflationary expectations and hence attractive real rates, demand for physical assets should come down. We expect a 50-50 mix between physical-financial savings over next five years. **Plugging these numbers yield the overall financial savings of Rs. 120 trillion in next five years (FY18- FY22) compared to Rs.~50 trillion between FY13 to FY17.**

Further, banks' term-deposit returns presently hover around 7% (depending on tenor) compared to historical trend of double digit returns (FD rates were as high as 20% in 1990s). Given the view of contained inflation, term-deposits will gradually loose traction and households will be forced to search for higher yields. We expect the long-term financial products to be a structural beneficiary here as already evidenced in rising SIPs, premium collection and pension fund deposits. The financial literacy initiatives being adopted by the financial regulators and measures to enhance the regulatory guidelines for the financial investments are also helping to lure the households to channelize their money away from the traditional products.

Mutual Fund Industry to be the biggest beneficiary

We estimate that domestic mutual funds will be the largest beneficiary to a coming boom in financial savings. As discussed previously, Mutual Fund AUM has grown by Rs. 10 trillion in last 3 years (29% CAGR) with retail investors accounting for 50% of the incremental contribution. Over the next 10 years, even if we assume that the growth moderates from 29% to 15% CAGR, the AUM is likely to grow by another 18 trillion over next five year. The key driver here is a focus on systematic investment plans (SIPs). Flows via SIPs have grown at a 33% CAGR over the past five years, and at a 50% CAGR over the trailing three years.

These developments are favourable from the point of funding the business investment and long-term infrastructure investments in India, particularly when the country is keen to contain its current account deficit to 2% of GDP and below. As an aside, the improving domestic liquidity explains the rising valuation premium in India. The financial savings ascent can keep India's relative multiples higher for long and equity market less vulnerable to FII flows, thus reducing the Indian equity correlations with the other emerging markets. **A caveat here is that, rising economic growth and healthy market returns are absolutely critical for equity ascent of household financial savings as households respond very quickly to unfavourable returns.** Retail investors are typically fast fleeting. Any deep market turmoil will drive them back to the safety of bank deposits, reducing the amount of capital available to mutual fund and other longer-term financial products and possibly risk the growth of the financial-services industry as a whole.

To sum, Household savings and particularly financial savings is crucial to sustaining a strong growth in India. We see that the tide has turned in favour and financial savings to double over next five years and get increasingly channelized towards longer-term financial products. We expect Mutual Fund to be one of the significant beneficiaries of this turn of tide. This would not only deepen and stabilise the financial markets but also help fund India's infrastructure needs.