Ecowrap

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'Be the Bank of Choice for a Transforming India'

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RATE CUTS ALONE WILL NOT WORK

We believe the current slowdown cannot be tackled by monetary policy in isolation. The contemporary issue for macroeconomists is to exclusively focus on assuring adequate aggregate demand. We believe monetary policy could only act to some extent – experience shows we have been in an era of low interest rates for a decade but that has done little to boost aggregate demand but increasing household debt (in US it increased from $12.5 trillion in Q1FY08 to $13.9 trillion in Q22019).

Rather fiscal policy needs to be a major focus now, especially given what low or negative interest rates mean for the sustainability of deficits. Interestingly, total financial liabilities of Indian households have jumped by a massive 58% in FY18 to Rs 7.4 lakh crores (after 22% jump in FY17). In fact, while household leverage has jumped 2 times in the last 5 years, disposable income has jumped by only 1.5 times, thereby putting pressure on savings. Even though the jump is not as much as in 2007 (when it jumped by 2.3 times over 2005), such a large jump is a matter of concern. **Given such a large jump in household leverage, the question is will monetary policy retain the effectiveness through large rate cuts in current scenario? Probably not and only a counter cyclical fiscal response might address the core of the current problem.**

A fiscal policy tool could solve both consumption and savings problem.

INCREASE SAVINGS THROUGH FISCAL MEANS

Abolish capital gains tax to boost financialization of savings that gained momentum in FY18, but might have lost pace in FY19.

It is widely argued that a large part of financial savings of the households is used for financing of fiscal deficit. But this only tells one part of the story, as the incremental claims of government borrowings on households have increased by only Rs 60,000 crores for the 2-year period ended FY17. During the same period, the move to incentivize household savings through increasing the ceiling of Section 80C resulted in an incremental Rs 1.8 lakh crores of household savings flowing into tax saving instruments.

INCREASE CONSUMPTION

To this end, **the Government must address demand weakness by continuing to meaningfully frontload expenditure say through PMKISAN and MGNREGA (**for eg. PM-KISAN Portal shows the number of beneficiaries is only 6.89 crore (till Jul'19) against the target of 14.6 crore due to slow validation in farmer data). The other option is to continue pursuing capital expenditure (only 32% utilized till date). However, in such a case, the Government should clearly state upfront that the additional fiscal spending is specifically for infra spending to boost demand and not for any unproductive purposes. The headline fiscal deficit should stay at 3.3 per cent, while the additional fiscal impulse for infra spending could be over and above this.

To negate any impact on bond markets, the RBI could also frontload large rate cuts in October policy and also start doing open market operations that will keep the yields in check. We also believe that the Government should go ahead with the sovereign bond.

OTHER MEASURES

Identifying alternate sources of funding for infrastructure. **In this context, setting up of a Development Financial Institution could be an effective solution.**

Introduce a performance linked compensation scheme for banking sector employees as well as operational flexibility to hire from market. The wage agreement has been delayed for a long time and a quick announcement before the festive season would help improve sentiments significantly. Address the IBC issues more forcefully. Use credit information for consumers and MSMEs for faster loan disbursement.

SECTION 1: THE DECLINE IN HOUSEHOLD SAVINGS : SOME FALLACIES AND FACTS

FALLACIES: DECLINE IN HOUSEHOLD SAVINGS BEGAN AFTER 2008 CRISIS AND IS ALSO ATTRIBUTABLE TO DEFINITIONAL CHANGE

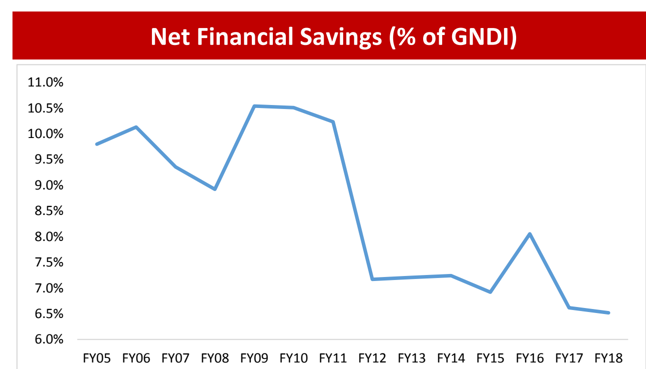
- **The decline in household financial savings is not of recent vintage**. A look at the composition of private saving in India indicates that there was a sharp decline in household financial saving rate after 2010. While it started recovering since 2012, private saving continued to decline.
- **The decline in gross household savings is primarily a result of breakdown in physical savings**. Since FY12, the gross savings (as % of GDP) had declined from by 4.1 percentage points to 30.5% in FY18. This decline was entirely contributed by decline in household sector savings (by 6.4 percentage points). **Almost this entire decline in household savings is in physical savings of the households, with only marginal decline in financial savings.**
- During the same period the private corporate savings increased by 2.1 percentage points. This decline in household savings and increase in private corporate savings is quite consistent with the findings of Report of the High Level Committee on Estimation of Saving and Investment (Chairman: Dr. C. Rangarajan) published in year 2009. It is mentioned in the report that, "***If the corporate sector's saving is going up, the household sector's savings would come down, to the extent that unincorporated entities, constituting a part of the household sector, get incorporated and such savings are reflected as corporate savings***.".

Gross Savings (% of GDP)

	2011-12	2014-15	2015-16	2016-17	2017-18	Change (FY18 over FY12)
Gross Savings	34.6	32.2	31.1	30.3	30.5	-4.1
Public	1.5	1	1.2	1.7	1.7	0.2
Private corporates	9.5	11.7	11.9	11.5	11.6	2.1
Household sector	23.6	19.6	18	17.1	17.2	-6.4
Net financial savings	7.4	7.1	8.1	6.3	6.6	-0.8
Physical savings	16.3	12.5	9.9	10.8	10.6	-5.7

Source: CSO

Net Financial Savings (% of GNDI)



Source: SBI Research

WHY HOUSEHOLD SAVINGS DECLINED?

- **High Real Interest Rate:** In India the real interest rate (RIR) has increased from 1.72% in Mar'18 to 3.39% in Mar'19 though currently it stands at 2.19%. A country-wise analysis of real interest rates indicates that India has one of the highest level of real interest rate. Our empirical analysis suggests that long-run effect of real interest rate on saving rate is negative and statistically significant at the 1% level.
- **Imposition of Capital Gains Tax:** In Union Budget 2018, Government had proposed to re-introduce long-term capital gains tax (LTCG) after a gap of 14 years, on gains arising from the transfer of listed equity shares exceeding Rs 1 Lakh at 10%, without allowing any indexation benefit.
- If we look at the data on Asset Under Management and its flows to equity segment, it suggests that post demonetization to till the introduction of LTCG tax (prior to Feb'18), the total assets grew at 36% while the flows of funds to equity grew at 68%. However, post LTCG tax, both total assets and its flow to equity segment is almost flat and the growth was less than 10%. The introduction of such tax has significantly impacted the return from household financial saving and it is most likely that gross financial savings may have stagnated in 2018-19 (especially shares & debentures).

WILL MONETARY POLICY /RATE CUTS WORK N ARRESTING CURRENT GROWTH SLOW-DOWN? : POSSIBLY NOT

- What could be that policy response? The contemporary issue for macroeconomists is to exclusively focus on assuring adequate aggregate demand. We believe monetary policy could only act to some extent – experience shows we have been in an era of low interest rates for a decade but that has done little to boost aggregate demand but increasing household debt (in US it increased from $12.5 trillion in Q1FY08 to $13.9 trillion in Q22019) Rather fiscal policy needs to be a major focus now, especially given what low or negative interest rates mean for the sustainability of deficits.
- Let us farst forward to Indian context now. Total financial liabilities of households have jumped by a massive 58% in FY18 to Rs 7.4 lakh crores (22% jump in FY17). In fact, while household leverage has jumped 2 times in the last 5 years, disposable income has jumped by only 1.5 times, thereby putting pressure on savings. Even though the jump is not as much as in 2007 (when it jumped by 2.3 times over 2005), such a large jump is a matter of concern. The good thing is however that the Gross Household Financial Savings jumped by a sharp 1.5 times over the same period (though, it could be largely because of currency with the economy remonetized)! **Given such a large jump in household leverage, the question is will monetary policy retain the effectiveness through large rate cuts in current scenario? Probably not and only a counter cyclical fiscal response might address the core of the current problem.**

COUNTERCYCLICAL FISCAL TOOL COULD BOOST SAVINGS AND CONSUMPTION BOTH

BOOST SAVINGS

- **Abolition of capital gains tax:** We believe by abolishing capital gain tax will boost financial saving of household and encourage people to invest more in financial assets than physical assets. Past trend also suggest, financial assets have grown at a faster pace than last year and a bulk of this comes from equity. **We expect this pattern to remain inclined to equities and removing LTCG tax will again give a boost to financialization of savings that gained momentum in FY18, but might have lost pace in FY19.**
- **Incentivize households to save more say by increase Section 80C/ PPF limit:** When Government notified increase in PPF limit by Rs 50,000 to Rs 1,50,000 in Aug'14, its impact on household savings was enormous. During FY15 over FY14, Provident and Pension Funds increased by merely Rs 13,000 crore but during FY16 over FY15, it increased by more than Rs 1 lakh crore. We believe that an increase in PPF limit by even Rs 50,000 for individual households will lead to additional savings of more than Rs 1 lakh crore compared to the revenue foregone of Rs 10,000 crore. Even we add up the extra interest burden of around Rs 8,500 core (@ 8.5% on Rs 1 lakh crore), the total revenue foregone is only Rs 20,000 crore compared to Rs 1 lakh crore jump in savings (**incentive saving multiplier is at least 5 times more!)**

Country-wise Real Interest Rate (%)

Country	Central Bank Policy Rate (%)	CPI (% YoY)	Real Central Bank Policy Rate (%)
Brazil	6.00	3.43	2.57
Philippines	4.25	1.69	2.56
India	**5.40**	**3.21**	**2.19**
Indonesia	5.50	3.49	2.01
Malaysia	3.00	1.42	1.58
China	4.35	2.80	1.55
US	2.13	1.75	0.38
Canada	1.75	2.01	-0.26
Australia	1.00	1.60	-0.60
Japan	-0.10	0.55	-0.65
New Zealand	1.00	1.70	-0.70
UK	0.75	2.10	-1.35
Eurozone	-0.40	1.10	-1.50

Source: SBI Research

Asset under Management (In Rs Lakh Crore)

	Dec-16	Jan-18	Jul-19	Growth (Jan'18/Dec'16)	Growth (Jul'19/Jan'18)
Total Assets	164.6	224.1	245.4	36%	9%
Equity	42.0	70.4	71.6	68%	2%

Source: SBI Research, AMFI

Financial Saving of the Household Sector

Item	FY12	FY15	FY16	FY17	FY18
As % of GNDI					
A. Gross financial saving	10.4	9.9	10.7	9.2	10.8
Of which:					
1. Currency	1.2	1.0	1.4	-2.0	-
2. Deposits	6.0	4.8	4.6	6.3	-
3. Shares and debentures	0.2	0.2	0.3	0.2	-
4. Claims on government	-0.2	0.0	0.5	0.4	-
5. Insurance funds	2.2	2.4	1.9	2.3	-
6. Provident and pension funds	1.1	1.5	2.1	2.0	-
B. Financial liabilities	3.2	3.0	2.7	3.0	4.3
C. Net financial saving (A-B)	7.2	6.9	7.9	6.2	6.5
In Rs Lakh Crore					
A. Gross financial saving	9.4	12.5	15.2	14.1	18.7
Of which:					
1. Currency	1.1	1.3	2.0	-3.1	-
2. Deposits	5.4	6.1	6.5	9.7	-
3. Shares and debentures	0.2	0.2	0.4	0.4	-
4. Claims on government	-0.2	0.0	0.7	0.6	-
5. Insurance funds	2.0	3.0	2.7	3.5	-
6. Provident and pension funds	1.0	1.9	2.9	3.0	-
B. Financial liabilities	2.9	3.8	3.9	4.7	7.4
C. Net financial saving (A-B)	6.5	8.7	11.3	9.4	11.2
Memo:					
GNDI (Rs lakh crore)	90	127	140	156	173

Source: CSO; SBI Research, Note: Figures may not match with RBI AR 2018-19 due to rounding-off: GNDI: Gross National Disposable Income

- **It is widely argued that a large part of financial savings of the households is used for financing of fiscal deficit**. But this only tells one part of the story, as the incremental claims of government borrowings on households have increased by only Rs 60,000 crores for the 2-year period ended FY17. During the same period, the move to incentivize household savings through increasing the ceiling of Section 80C resulted in an incremental Rs 1.8 lakh crores of household savings flowing into tax saving instruments.

BOOST CONSUMPTION THROUGH FISCAL MEASURES

- Even as the RBI will continue to cut rates, since the problem is of demand with consumption expenditure declining by Rs 1.5 lakh crores on a sequential basis, the trade off between revenue foregone for any given fiscal expansion is much larger in favour of former/ consumption decline. While the commitment to fiscal prudence is always important, without a counter cyclical response the core of the current problems will not be addressed.
- **To this end, the Government must address demand weakness by continuing to meaningfully frontload expenditure say through PM-KISAN and MGNREGA**.
- PM-KISAN Portal shows the number of beneficiaries under the scheme is only 6.89 crore against the target of 14.6 crore due to slow validation in farmer data. This process has to speedup to boost rural demand.
- Data from MGNREGA website indicate that against the total release from Centre of Rs 45,903 crore (till 13 Sep), the total expenditure is around 73% only (i.e. Rs 33,420 crore).
- Any attempt to cut back on expenditure to balance fiscal at this will be severely detrimental to growth. **The other option is to continue pursuing capital expenditure.** In Union Budget, the Government has estimated capital expenditure to the tune of Rs 3,38,085 crore and till July'19 (Apr-Jul'19), it has frontloaded only 31.8% of the allotted amount against previous year figure of 37.1% during the same period .
- It may be also noted that private investment share has declined significantly from 50 per cent in value terms during 2007-14 to 30 per cent during 2015-19. However, in such a case, the Government should clearly state upfront that the additional fiscal spending is specifically for infra spending to boost demand and not for any unproductive purposes. The headline fiscal deficit should stay at 3.3 per cent, while the additional fiscal impulse for infra spending could over and above this.
- Addressing sector specific issues in construction (real estate sector being classified under infrastructure), steel, cement, capital goods and fertiliser. A detailed incentive programme for homebuyers should be unveiled quickly.

WHAT ABOUT BOND YIELDS THEN?

- One consequence that the Government could be wary of because of such fiscal push is the impact on bond markets. In this context, the RBI could also frontload large rate cuts in October policy and also start doing open market operations that will keep the yields in check. We also believe that the Government should go ahead with the sovereign bond. The Government could partly hedge the borrowings and thereby decide to not bring back the dollar proceeds into the country and instead keep it at any of designated ASCBs outside the country. This will take care of the problem of RBI sterilisation. This could also solve the problem of hedging.

OTHER MEASURES

- It is now time to address the IBC issues more forcefully. The FPIs should be allowed to acquire stressed rupee assets directly instead of going through the ARCs. Also allow eligible ECB investors to fund acquisition of stressed companies both under and outside IBC. This could be done in conjunction with RBI.
- Introduce a performance linked compensation scheme for banking sector employees as well as operational flexibility to hire from market. The wage agreement has been delayed for a long time and a quick announcement before the festive season would help improve sentiments significantly.
- Identifying alternate sources of funding for infrastructure. **In this context, setting up of a Development Financial Institution could be an effective solution.**
- Creation of an Unique Enterprise ID for fetching all details pertaining to MSME. This would help in faster loan disbursement to MSME sector. The consumers as discussed could also be a part of a faster loan disbursement process and the CIBIL scores could be used as effective instrument for better targeting.

Financial Progress under MGNREGA (Rs crore)

FY	Total Center Release	Total Expenditure
FY20*	45,903	33,420
FY19	62,167	69,624
FY18	55,660	63,649
FY17	47,412	58,063
FY16	35,975	44,003

Source: SBI Research, * as on 13.09.2019

Cost Structure and Number of Beneficiaries under PM KISAN (In Crore)

As per Agricultural Census 2015-16	Total
Number of Operational Holdings	14.6
Income Support of Rs 6,000 per farmer per year	Rs 87600
Total Number of Beneficiaries Received 1st + 2nd Instalment as on 26.08.2019	6.9
Total Number of operating KCC accounts as on 31.03.2018	6.9

Source: SBI Research

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