What ails India’s household economy?

The household sector is the largest segment of the Indian economy. In 2015-16, it accounted for 43.6% of gross value added (GVA) in the economy, while the private non-financial corporate sector, the second largest segment, accounted for 34.9%. The health of the household sector, therefore, is the key to the health of the economy. Note that the household sector in the national accounts is a catch-all term that includes, apart from individuals, all non-government, non-corporate enterprises like farm and non-farm businesses, unincorporated establishments such as sole proprietorships and partnerships and non-profit institutions like charitable trusts, religious endowments and educational institutions. To a large extent, therefore, it will reflect conditions in the informal sector, in the millions of small farms and shops and micro businesses across the country. In recent years, the share of the household sector in GVA has been falling—from 45.8% of GVA in 2013-14 to 43.6% in 2015-16.

We often hear that the key to a sustainable rise in economic growth is the revival of investment. The received wisdom is that the investment drought is because capacity utilization in industry is low and firms are, therefore, unwilling to add to capex.

True, that is part of the reason. Gross capital formation of the private non-financial corporate sector has indeed come down, but the drop isn’t much. As a percentage of GDP, gross capital formation of this sector fell from 12.9% in 2011-12 to 12.6% by 2015-16, the latest year for which disaggregated data are available. Moreover, that’s offset by the rise in the government’s gross capital formation over the period.

But, as Axis Bank economist Saugata Bhattacharya has pointed out, the real investment problem lies with the household sector. Between 2011-12 and 2015-16, the gross capital formation of the household sector went down from 15.9% of GDP to 10.9%. Almost the entire fall in the gross capital formation/GDP ratio is accounted for the by the household sector. Why did that happen?

Has the income of the household sector come down in the last few years? Not really. True, growth in disposable income at current prices has slowed, but then inflation too has come down. Nevertheless, household disposable income has come down from 80.5% of GDP in 2011-12 to 78.4% of GDP by 2015-16, mirroring the fall in its share of GVA.

What may be more important, though, is that households are saving less—savings as a percentage of gross household disposable income fell from 29.4% in 2011-12 to 24.4% by 2015-16. In other words, it is not only that household disposable income as a proportion of GDP has come down, but also that households are consuming more out of their disposable income and saving less.

Why would they be doing that? Gaurav Kapur, chief economist at IndusInd Bank, believes that higher consumption could be related to lower inflation, as households no longer need to save so much to combat long-term inflation. He also says that lower subsidies to households could be a reason for lower savings.

Whatever may be the reason, there’s another twist in the tale. Households are also utilizing less of their savings for capital formation. In fact, capital formation as a percentage of household gross savings has come down from 67.3% in 2011-12 to 57% in 2015-16.

One reason for this is because households are moving away from physical savings, typically in housing, to financial savings. As is well known, the proportion of financial savings in total household savings has moved up in recent years. That is a good thing, but the fact remains that

total household savings as a percentage of GDP has been coming down, as mentioned above.

To fathom why household capital expenditure (capex) is struggling, we must dig deeper and look at gross fixed assets formation (GFCF) in the household sector by type of industry. The three biggest sources of capex in the household sector are “real estate, ownership of dwelling and professional services”, trade and agriculture.

The only year that saw addition to gross fixed assets in agriculture was 2013-14, when there was a decent monsoon. The back to back drought years of 2014-15 and 2015-16 led to a fall in investment in fixed assets in farms. The conclusion is rather obvious: fixed asset growth in agriculture is closely related to the monsoons.

The trade sector has seen growth in fixed assets every year except for 2013-14, although the rate of growth fell in 2015-16. The real estate sector, however, saw a sharp fall in fixed assets growth in 2015-16, probably as a result of the shift towards financial savings. Note that, in 2015-16, the private corporate sector’s investment in real estate was enormous, so the fall in household investment in real estate that year had little to do with the overall state of the sector.

In 2015-16, the sectors that saw the largest fall in fixed assets investment were, in order of magnitude, “real estate, ownership of dwelling and professional services”, farming, construction and manufacturing. Of these, the fall in the real estate category was far in excess of the others.

What of the future? The monsoon was kind in 2016-17, so capital formation in agriculture must already have gathered pace. But the outlook for household investment in other sectors is less sanguine. The disruptions to economic activity seen in 2016-17 and in the current fiscal year are widely believed to have affected the informal sector the hardest. The shift of household savings from physical to financial assets continues. Given this background, the prospects of a quick revival of household capex in real estate, construction or manufacturing are rather dim. That doesn’t augur well for a speedy revival of overall investment in the economy.

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