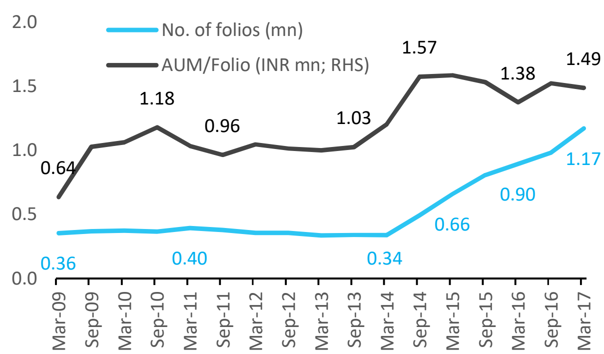
Financialization of India's savings and its implications **September 2017**

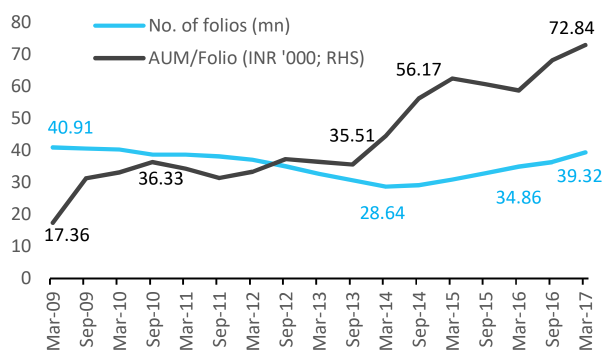
Last month, we touched upon the growing trend of systematic investments into equity mutual funds. We highlighted that the growth in the SIP book was not a recent phenomenon, but a trend that was in the making for a few years at least. We noted that mutual fund folio data reflects a sharp uptick in individual investor interest starting March 2014 (HNI folios nearly trebled between Mar'14 – Mar'16, while retail folios grew by a quarter during that period, as shown below). Thus, arguments crediting demonetisation for the increased investment into mutual funds are not completely true in our view.

Figure 1: Equity Oriented Mutual Fund Investments - HNI*



Source: AMFI, Tamohara.

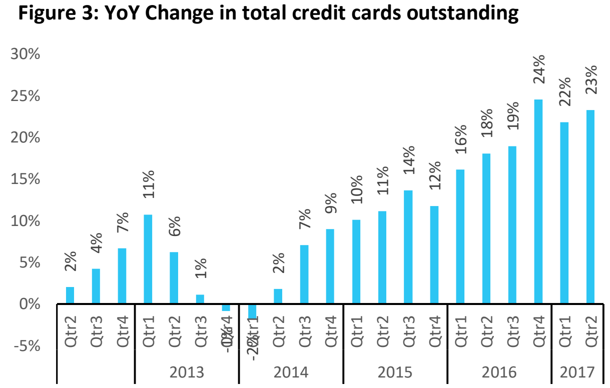
Figure 2: Equity Oriented Mutual Fund Investments - Retail



Source: AMFI, Tamohara

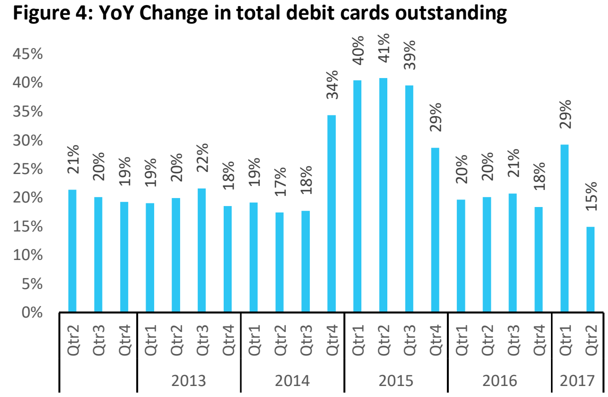
This is not a standalone development. We have noticed similar trends in other data as well. For instance, consider the data on credit and debit cards compiled by the RBI. As per this data, the total outstanding credit and debit cards were growing at a healthy pace even pre-demonetisation. In fact, the growth rate post-demonetisation is not significantly different from that of before demonetisation, especially in the case of debit cards.

Figure 3: YoY Change in total credit cards outstanding



Source: RBI, Tamohara.

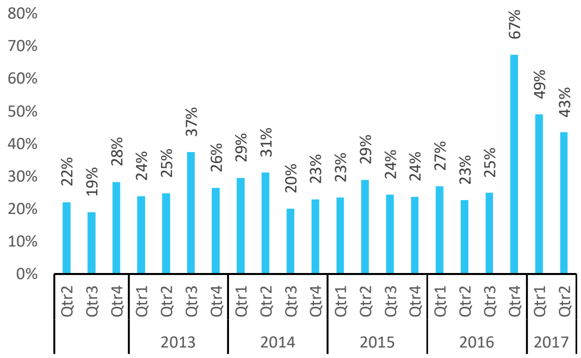
Figure 4: YoY Change in total debit cards outstanding



Source: RBI, Tamohara

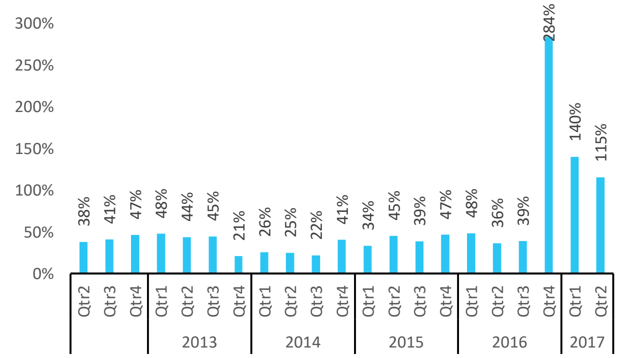
Indeed, the number of transactions on credit and debit cards saw a marked uptick post demonetisation, mainly as currency in circulation was scarce. However, even before demonetisation, the number of transactions were growing at a very healthy rate.

Figure 5: YoY Change in total credit cards transactions at PoS



Source: RBI, Tamohara.

Figure 6: YoY Change in total debit card transactions at PoS

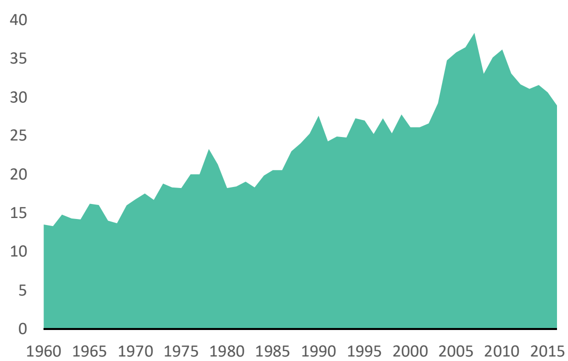


Source: RBI, Tamohara

Tellingly, the above data points indicate an increasing trend of financialization in the economy. In our view, the acceptance of financial products seems to be increasing at a rapid pace, with steps like the JAM (Jan Dhan, Aadhaar and Mobile) trinity and demonetisation only increasing the rate of acceptance. For a capital starved, growing economy like India, this phenomenon has far reaching implications in the long run.

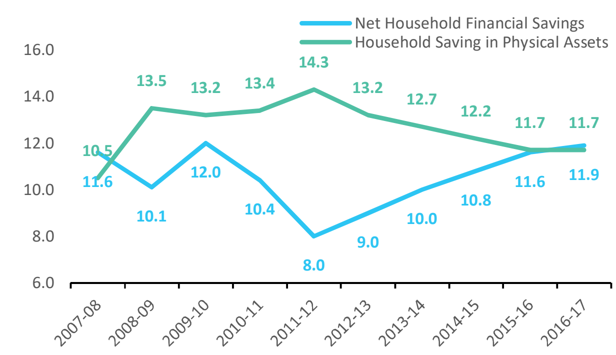
Over the last few decades, India has transformed into a high savings rate economy. However, a large part of the household savings (around 55% on average between 2008-2016) have been invested into physical assets like gold and real estate. This trend has been reversing in the recent years, with FY17 witnessing a higher share of savings being invested in financial assets compared to physical assets. Further, within financial assets, the share of deposits has steadily declined over the last few years (from 56% in FY12 to 41% in FY16), except in FY17, which we believe is mainly because of demonetisation.

Figure 7: India Gross Domestic Saving/GDP (%)



Source: RBI, Tamohara.

Figure 8: Composition of Household Saving (% of GDP)



Source: CSO, Tamohara

In addition to the usual productivity related benefit of higher financial savings compared to physical savings, we believe that this trend will also have an impact on the tax revenues of the Government. At around 11%, India's tax revenues as a percentage of the GDP remain very low, compared to economies like Malaysia (14%) and Thailand (16%), as well as to the global average of 15%. Steps like demonetisation, the Goods & Service tax, as well as the increasing financialization will ensure more transparency in tax collection and curb the creation of undisclosed income. Already, the income tax department has reported a 24% growth in the number of income tax returns filed in 2017, compared to under 10% in the preceding year. The quantum of tax collections also witnessed a sharp rise - advance tax paid by individuals increased by close to 42% till August 5, while personal income tax through self-assessment saw a 34% rise. In our view, a successful widening of the tax base and an increase in tax collections will not only help fund higher Government expenditure towards economic growth, but also lead to lowering of tax rates in the economy in the medium term.

The trend in savings and investments has implications for the equity markets as well. After all, it is unusual to not have seen a sharp correction in prices despite foreign investors having sold over INR 127bn of equities in the month of August. Similarly, between October 2016 and January 2017, foreign investors had sold equities worth INR 319bn, with the market barely correcting. This is largely on account of buying by domestic institutions, especially mutual funds. Gross monthly flows into the equity schemes of mutual funds have crossed over INR 300bn (INR 200bn net of redemptions), an amount that is only marginally below the average annual FII investments in to India during the 2003-2006 period. Such large flows can act as a cushion against any large scale selling by foreign investors, thus reducing market volatility. On the other hand, persistent large inflows can also distort valuations over time. After all, bubbles are formed when too much money chases too few assets.

To sum it up, it is ironical that with a savings rate of around 30% of GDP, which is one of the highest in the world, India has been characterized as a country with lower financial resources. In the past, Indian households have preferred channelizing a large portion of their savings in to physical assets such as gold and real estate. Partly, a persistently high inflation (and consequent negative real returns) has been responsible for the higher allocation to physical assets over financial assets.

A confluence of factors like Government policies, inflation targeting by the central bank, and demographics are, in our view, responsible for the initial signs of the reversal of these trends. We believe that an uptick in GDP growth (leading to better sentiment, improving job prospects and higher wage growth) along with lower inflation can help this trend sustain over the medium term. It is, after all, no coincidence that in the past decade, a higher allocation to financial assets (~10% of GDP) coincided with higher GDP growth between the 2005-2009 period.

Until next month,
On behalf of Team Tamohara,
Tejas Gutka

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