A Technical Note on Savings and Savers as Stakeholders

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Savings represent that part of national income which is not spent on consumption in a year out of the disposable income. In a closed economy, the savings are equal to the total investments or capital formation. In an open economy, since there is a possibility of having a surplus or deficit current account balance, depending upon the difference between exports and imports, the total investments in the domestic economy can either exceed or fall short of the domestic savings. Countries can save more by exporting more than they import or dis-save by exporting less than they import.

In the conventional national accounting system, domestic saving falls into three broad components namely, household savings, business savings and government savings. In an open economy, the total savings would include besides these three components, the foreign savings which is equivalent to net foreign investments.

The household saving represents savings of the household sector out of the disposable income. In an economy where the financial markets have developed, savings of household sector are reflected in their investments in various financial instruments issued by intermediaries like banks and financial institutions and government, net of their liabilities. In India, apart from such savings in financial instruments, a component of physical saving is also estimated incorporating the household expenditure on house construction. Another peculiar feature in India is the purchase of gold by households on a large scale to meet exigencies of consumption and other expenditure in future (apart from such purchases being guided by social customs and at times for the purpose of accumulating unaccounted wealth). In the national accounting, such purchases of gold are not treated as part of savings but treated as consumption, but, purely from the practical point of view, since gold is a highly liquid asset, though it does not earn any return to the holder it protects the wealth of the household under the normal circumstances since the gold prices move along with other commodity prices. The only adverse point is that such purchases of gold result in savings remaining idle and not available

Business saving is that part of income of the business sector which is retained by the business for further growth, rather than being distributed as dividends to shareholders. Such retained earnings by the business strengthen the net worth and equity base of the business sector enabling them to further leverage their business for expansion.

Government's saving comes out of its total revenue net of its purchases. In simple form, government's saving is equivalent to its budgetary surplus.

Determinants of Savings

In the economic sense, the savings behaviour is the obverse of a nation's consumption behaviour. Secondly, savings may be influenced also by the investment opportunities or investment demand which in turn depends upon the growth prospects and the potential return available. Thirdly, the level of savings will also depend upon the avenues available in the economy for mobilising such

savings particularly from the household sector in the form of well-developed financial system with a variety of institutions and markets for different instruments. Last but not the least, the general thriftiness of the public as a part of nation's culture could also influence the saving behaviour in an economy.

At the macro level, Keynes proposed that the behaviour of saving is related to the nation's marginal propensity to consume which in turn depends upon the level of income of the economy. The consumption function, he proposed, relate the consumption behaviour as a less than proportionate increasing function to increase in level of total income. The savings function being the obverse of the consumption function, described the relationship as a more than proportionate increasing function to the growth in income levels. The later economists further elaborated this concept to observe that besides the current levels of income, the consumption behaviour/saving behaviour will be related also to the people's long-term income trends or the permanent income or the life cycle income. The life cycle hypothesis assumes that people save in order to smooth their consumption over their life time. A further important determinant of consumption is the wealth which is called the wealth effect. While the wealth effect would not cause sharp changes in the levels of consumption, when the fortunes of people change substantially because of economic cycles, wealth effect becomes significant.

Another important factor that could influence the level of financial saving is the political and economic stability. People will fear about the loss of their wealth when such stability does not exist. In a highly inflationary economy, people may abstain from investing in financial assets due to fear of erosion in the value and in turn could look for 'inflation hedges' like property and gold.[1] It is extremely important, therefore, that financial stability, in particular, a low level of inflation is maintained if an economy wants to sustain the level of savings flow for purposes of capital formation.

Behaviour of Household Savings in India

Household savings in general and savings in the form of financial assets in particular exhibited remarkable growth since late eighties. The aggregate household savings as share to GDP, which was only 1.5 per cent during 1970-71, went up to 4.9 per cent in 1980-81. It went up sharply to 14.2 per cent in 1990-91 and further to 19.7 per cent in 1994-95 before coming down marginally to 18.5 per cent in 1998-99. The growth of household savings during the decade of eighties has been facilitated by a simultaneous increase in physical as well as financial assets. While household savings in physical assets increased from 3 per cent of GDP in 1980-81 to 7.8 per cent in 1990-91, savings in the form of financial assets increased from 2 per cent to 6.4 per cent for the corresponding period. Financial savings during first half of the nineties registered remarkable growth from 6.4 per cent of GDP in 1990-91 to 11.9 per cent in 1994-95. However, the share of financial savings to GDP fluctuated since 1995-96.

There are evidences of compositional changes in household savings between the physical and financial assets. The share of financial savings to total saving, which was only 28.1 per cent during 1970-71, went up to 39.4 per cent in 1980-81. The above share went up sharply to 56.8 per cent in 1990-91 following high economic growth and expansion of banking network in the decade of eighties facilitating financial deepening. The share of financial savings to total saving

went up further to 59.1 per cent in 1998-99.

As regard the composition of financial savings of household sector among various instruments, such as, Currency, Deposit, Shares and Debentures, Claim on Government, Insurance Funds and Pension and Provident Fund, it was observed that the share of Currency, Deposits and Shares and Debentures exhibited a declining trend in late nineties as compared to their trend in early nineties. On the other hand, the share of Insurance funds, Pension and Provident Fund and the Claim on Government increased sharply in the later half of nineties. The share of Pension and Provident Fund had gone up from 16.7 per cent in 1993-94 to 23.1 per cent in 1999-00, Insurance Fund from 8.7 per cent to 12.1 per cent and Claim on Government from 6.3 per cent to 12.2 per cent during this period. It indicates that household had increasingly preferred savings in the form of safe and contractual, in particular long-term financial assets as opposed to their preference towards deposit and capital market based instruments in the early 1990s.

Both household savings and the business savings can be considerably influenced by the incentive structure, fiscal or otherwise. Fiscal incentives for long-term savings like social security and for ploughing back of profits for investment purposes by business sector could add to incentives for additional savings.

While providing incentives to increase the savings rate in an economy, economists debate about two approaches namely, income-oriented approach and price-oriented approach. Income-oriented approaches include changing the monetary fiscal policy mix by lowering government and private consumption while stimulating investment through lower interest rates. Thus, macro economists who believed that large federal deficits in the United States were behind the decline in national saving in 1980s advocated reduction of the deficit as the cure.

Other economists emphasised price-oriented measures as economic incentives to increase savings and investments. Such measures would include raising the rate of return to investor or saving by lowering taxes or raising the reward for investments by offering investment and additional depreciation allowances. The 1980s in the United States witnessed the experiment of the price-oriented measures and consequently, the real after tax returns rose sharply during this period. But, the experience showed that the supply side approach of 1980s did not bring about the desired impact on savings or investment rate in the United States. It was the Clinton package as a part of Budget Act of 1993, providing a decrease in the federal budget deficit through an income-oriented approach of increasing tax, lowering government spending which brought about a turnaround in restoring the fiscal balance and providing a boost to the general levels of investment (Samuelson and Nardhaus, Economics',1995). Government's savings is essentially a function of the fiscal policy.

Foreign savings depend broadly upon the level of development of the economy. If the economic growth has already reached a plateau, the additional investment opportunities in the domestic economy may be limited and as a result of which, savings may flow to countries which are relatively at lower levels of development and where the investment opportunities and possibilities of earning higher returns on investments are brighter. This encourages capital flows across countries distributing the investible funds to most productive uses. It must however, be recognised that a nation which finances investments through foreign saving is only trading off

between the current consumption and future consumption and at one stage in the future, the nation should be able to service such inflows of capital. In the long run, it will be possible only by strengthening its export earnings.

Stability Factors

If the level of savings in the economy is to be sustained and effectively used for productive purposes, maintaining financial stability becomes very important. In a totally destabilised environment, the incentive to save particularly through intermediating financial system vanishes requiring radical steps like inflation indexing of all financial contracts. Stability in particular is very important in respect of long-term savings since investment projects of longer term like infrastructure etc. can be undertaken only with the availability of long-term savings.

The stakeholding of savers as an important element of the financial system arises again in the context of stability conditions. For instance, a banking system which cannot protect the interest of depositors cannot remain viable and a run on even one or two banks can cause the contagion effect of the collapse of the entire banking or payment system. Similarly, the capital market activity cannot be sustained unless the integrity of the market in terms of pricing, allocation and settlement are governed by best practices. From these angles, depositor protection and investor protection gains significance for maintaining the viability and soundness of the banking and payment systems and the functioning of capital markets.

Not all savings are routed through the intermediation of financial markets. In India, for instance, companies apart from raising capital through issue of shares, also accept deposits directly from the public. Government apart from raising borrowings through marketable instruments like government securities including treasury bills also directly mobilise funds from the public by way of collections through small savings schemes and provident funds. The nature of flow of savings from the group of savers to the investor group, in business or government, determines the risks involved both on the savers side and the investors' side. These risks encompassing credit risk, market risk, operational risk, settlement risk etc. are expected to be captured by both the savers and investors in the financial system which is information efficient and with little imperfections. The market prices of the financial products depending upon risk and return profiles accordingly allocate the savings through the intermediaries to final investors.

It could thus be seen that the sustainability of the savings and investment process in an economy depends essentially upon the effective use of savings for investment purposes and generation of surplus through capital formation which is distributed to savers by way of interest or dividend. An inefficient investment activity causes a drag on the financial system by contributing to higher levels of non-performing assets and adds to the burden causing real interest rates to rise. Uncertainties about returns from investors could also cause uncertainties about returns to savers.

All categories of savers are not equally affected by destabilising factors like inflation. For instance, business saving in the form of retained earnings when it is ploughed back into investment activity may not be so much effected, because, the profits generally grow with inflation. However, the savers who have contracted savings at fixed rates of interest would find that their wealth gets eroded because of inflation. Thus, inflation in general, is viewed as an

unfair distributor of wealth between profit earners and ordinary savers. It is in this context, the savers of the household sector, particularly savings and investments by salary earners, professionals and self-employed contributing to generally the bulk of savings of the community, require some special attention protecting their wealth against any considerable erosion in wealth on account of destabilising factors like a banking failure or market failure or high levels of inflation. This protection comes either through the mechanism of insurance like deposit insurance or investors protection legislations according special rights to capital market investments or protecting the wealth of small savers against inflation by inflation indexing of the return.

Considering the overall safety conditions like those of the small savings, raised directly by the government, they may be viewed as completely risk free because, government undertakes the responsibility of repayment directly to the public. Similar is the case with provident fund collections entering into the budgetary mechanism of the government. Though the government may not be using these funds for specified or earmarked projects or purposes, there is an implicit guarantee of the government to repay these amounts to the savers. However, another factor which will determine the savers' interest as stakeholders is the return on such funds deployed with the government. If the returns are decided purely on market based conditions arising out of returns of pre-determined portfolio, then the risk on account of return is borne by the markets. If on the other hand, government uses these funds for multifarious purposes without any funding requirement, then it becomes the obligation of the government to ensure that the savers' interests are protected. Inefficient use of such funds by the Government and the consequent increase in the burden of repayment liabilities of government may contribute to inter-generational inequities besides contributing to increase in real interest rates.

Protecting Savers' Interests

What manner of fixing the return on savings will protect the savers' interest? Economists generally argue that savers should get effective real return of say at least 2 to 3 per cent to sustain their interest in savings and also if their wealth is to remain intact. Broadly speaking, economists relate the maximum realisable real rate of return for an economy to the real return on capital, or putting in the other way, real rate of growth in the economy. The difference between the real return on investment and the real return for savers will depend upon the efficiency of the financial system in minimising its transactions or intermediation costs. If the long-term growth rate of the economy, let us say is about 6 per cent, the transactional/intermediation cost would be around 3 per cent, then the real return to savers may have to be around 3 per cent. There are two ways of protecting the real return on savings. First, the real return could be fixed and the nominal returns could be indexed to a measure of inflation. On the other hand, such funds can be invested in inflation indexed bonds issued by the government which will in turn ensure real return to savers' funds.

In this regard, it would be worth noting that it was the Chakravarty Committee (1985) which addressed the issue of fixing a real return on financial instruments even within an administered interest rate regime. The Committee in particular emphasised the need for rewarding the small savers in the interest of social justice. To quote,

"In the interest of social justice, the monetary system should pay special attention to small savers, whose meager savings come truly out of foregone 'essential' consumption, the low level of their consumption notwithstanding, unlike savings of the better-off sections of society. Saving schemes designed for small savers should clearly take cognizance of the fact that they are generally unable to take advantage of fiscal incentives in view of their low incomes and hence deserve a higher nominal return on their savings than other savers. The contribution of small savers to the savings pool could grow to significant amounts, considering their large numbers, if they are adequately compensated for their savings which, in the absence of social security arrangements, they surely need to accumulate over their working life."

On this basis, they recommended that the long dated government securities should carry a real rate of return of 3 per cent per annum and bank deposits with a maturity of above 5 years a real return of not less than 2 per cent per annum and even 91 day treasury bills should carry a marginal rate of positive real rate of return.

As regards the stakeholding of savers, it is the long-term savings which becomes very important. Such long-term savings would include investments in instruments of very long maturity, say more than 10 years or collections through provident funds through the working life of an employee which provide at the end of maturity a lump sum amount for generating further annuities for safety or promise of fixed annuities after maturity period. The provident fund and pension schemes offer such opportunities to savers.

In sum, the protection of savers' interest as stakeholders in the financial system can be achieved by first, maintaining the integrity of banking, payment and settlement and capital market functions by implementing macro policies for financial stability including inflation control and second, ensuring a real return on long term savings through measures like inflation indexing.

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[1] "If the gross saving rate in the economy does not increase, the real rates of interest in the economy will tend to increase, and it will be difficult to finance higher investment rates in a non-inflationary manner. While the saving rate, particularly of the household sector, may or may not respond positively to nominal interest rates and negatively to the rate of inflation, statistical studies show that financial saving of the household sector deflated by prices or the ratio of financial saving to total saving of the household sector both respond quite strongly and positively to nominal interest rates and equally strongly but negatively to the rate of inflation. This result can be interpreted as showing that when the inflation rate increases or is expected to increase, unaccompanied by a corresponding increase in the interest rates on financial assets, households look for other inflation hedges as stores of value." (Vikas Chitre et al., 'Inflation, Interest Rates and Index Linked Bonds', 1986)