

WHY NEGATIVE REAL RATES COULD NOW BE THE NORM

There is a large empirical literature of the determinants of household savings in India. In particular, it is largely believed that positive real interest rates act as an enabler of household savings if the **substitution effect**, in which saving increases as consumption is postponed to the future, dominates the **wealth effect** in which savers increase current consumption at the expense of saving. Paradoxically, in the current context, people are increasing their savings even as we are facing negative real interest rate as people are saving money as a precautionary motive. Interestingly the incremental small savings deposits has significantly slowed down as a percentage of incremental ASCB deposits in current fiscal with people keeping money more in liquid bank deposits rather than locking them in financial savings. This is intriguing as it shows financialisation of household savings happening in select instruments (perhaps in stock market too!)

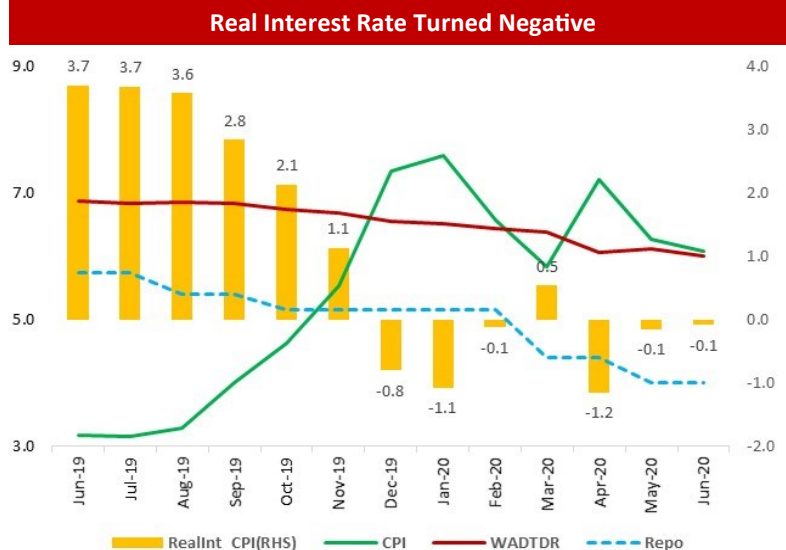
This paradox of high savings even as real interest rates have turned negative has important lessons in Indian context. Our empirical results show that for the period FY00 to FY20 a change of at least 2% in real deposit rate was required to change saving rate by 1%. This result is in conformity with earlier results also that shows large changes in real rates are always required to jumpstart household savings. In fact small changes in deposit rates hardly make any difference and hence it is always costly to keep real interest rates at high levels for a significant period. This has happened in the past also when rate cuts lagged inflation trajectory and it is thus essential that we keep real interest rates at negative right now, as such will also have a sobering impact on asset quality. We believe in the current scenario, this will be appropriate for financial markets as negative real rate is unlikely to hurt household financial savings given the uncertainty surrounding pandemic.

There is a further twist to the tale. Causality analysis in India between income per capita and savings rates shows that such causality run mostly from income to savings. This implies that high GDP growth and increase in per capita income can only significantly improve the savings rates in India in the long term. Thus the recent jump in household savings might not be sustained as it now seems that growth disruptions will continue for at least in H1 of current fiscal implying that both Q1 and Q2 growth numbers will be washouts.

Despite all this, we believe an August rate cut is unlikely. With the 115 bps reduction in repo beginning February, banks have already transmitted 72 bps to the customers on fresh loans in the interregnum which is perhaps a milestone in terms of the fastest policy rate transmission in India. Large banks have transmitted as much as 85 basis points. This has happened because of a proactive RBI using liquidity among others as a tool to serve its policy objective. We believe that the MPC could now well debate what further unconventional policy measures could be resorted to in the current circumstances to ensure financial stability is continued to be addressed.

REAL INTEREST RATE IS CURRENTLY NEGATIVE

- ◆ In response to COVID-19 crisis, RBI has supported the financial markets through a number of liquidity measures, along with a 115 bps reduction in repo rate, 155 bps in reverse repo and 100 bps in CRR between March and May 2020. As a result, the system liquidity turned into absorption mode and banks have parked around on an average of Rs 4304 bn in March, Rs 7126 bn in April, Rs 7710 bn in May and Rs 6359 in July 2020, with RBI. The perpetually muted credit demand has pushed the banks to reduce their deposit rates and thereby lending rates to adjust to the new interest rate scenario.
- ◆ As per the latest available data, the WADTDR, WALR (Fresh Loans) and 1yr MCLR has reached the lowest level of 6.12%, 8.5% and 7.7% in June 2020. With the 115 bps reduction in repo, banks have transmitted 72 bps to the customers on fresh loans which is a milestone in terms of policy rate transmission in India.
- ◆ To reduce the cost of funds and rigidity in deposit structure of Indian banks, banks (both public & private) have lowered the savings bank deposits rate, which has around 40% weight in the deposits basket. This has helped banks to reduce their 1-year MCLR rate by 55 bps during March to May 2020.
- ◆ On the other hand, the supply side constraints due to the lockdown have led to a spike in CPI inflation to 7.2% in April but eased marginally to 6.1% in June. So, the real returns for savers have turned negative. If we look the CPI inflation adjusted deposit rate (i.e. Real interest rate), it has turned negative to -0.8% in Dec'19, when inflation touched 7.4% and deposits rate 6.6% and thereafter continued in the negative zone due to the uptick in inflation and downward interest rate scenario. We expect that inflation will remain at elevated levels for the next few months so the real interest rate will continue to be in the negative zone. We believe in the current scenario, this will be appropriate for financial markets as negative real rate is unlikely hurt household financial savings given the uncertainty surrounding pandemic. Interestingly, our empirical results suggest a significantly weak linkage between household savings in bank deposits and real rate of interest.



Source: SBI Research

Transmission of Policy Rate			
	February	Latest	Change (in bps)
Repo Rate	5.15	4.00	-115
WALR on Fresh Rupee Loans	9.26	8.54	-72
Wt Avg. Domestic Term Deposits (WADTDR) on O/S Deposits	6.45	6.12	-33
ASCB-MCLR (1 Year)	8.25	7.70	-55
SBI MCLR -1 Year	7.85	7.00	-85
SBI EBLR	7.85	7.00	-85
SBI MCLR -6 Month	7.80	6.95	-85

Source: RBI, SBI Research

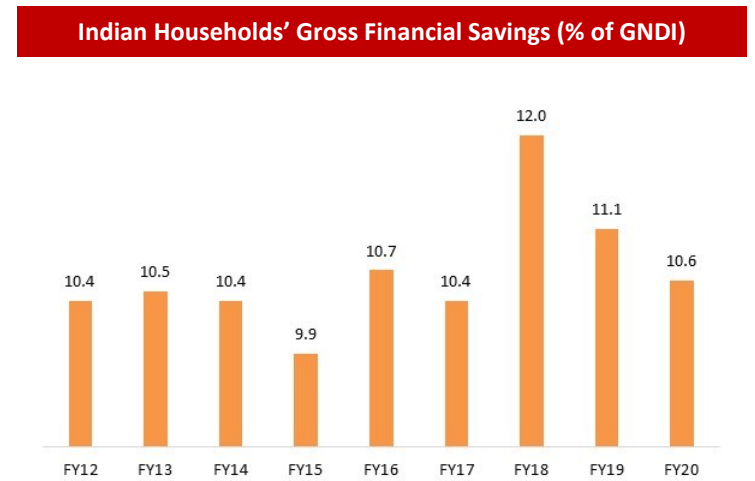
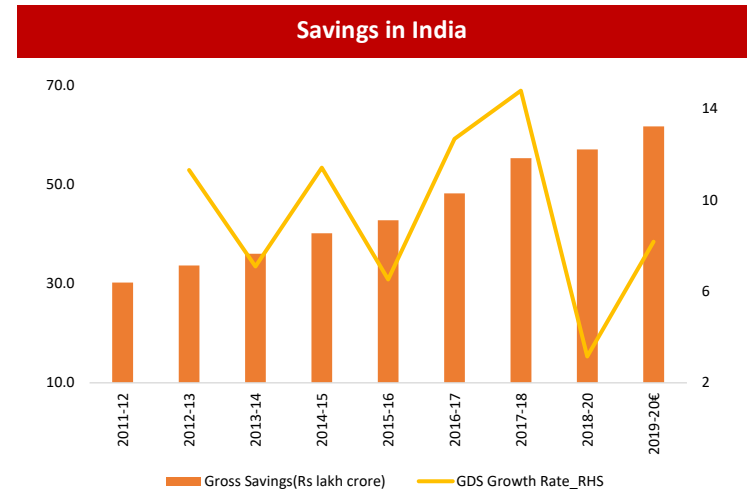
- Despite falling G-sec yield, Government has refrained from adjusting its small savings (SS) rates for Q2FY21, after sharply cutting these by 70-140 bps for the June quarter, in sync with the fall in bond yields and interest rates on bank deposits. Had the Government followed the formulas strictly, rates on different small savings instruments would now have been lower by 40-50 bps and the PPF rate would have been below 7% mark, which would have been more than 45 year low. In FY19, the incremental small savings deposits was 24% of incremental ASCB deposits. Interestingly, this trend has somehow slowed down in current fiscal with people keeping in money more in liquid bank deposits rather than locking them in financial savings (the share is now 14%)
- With Government's amendment to allow subscribers to withdraw from the EPFO fund to meet the financial requirement in this current COVID-19 crisis, as much as Rs 30,000 crore has been withdrawn in under four months starting April by 8 million subscribers of the EPFO. Out of this, 3 million withdrew Rs 8000 crore under COVID window and about 5 million withdrew RS 22,000 crore for medical reasons. The amount withdrawn between April and the third week of July is much more than the usual outgo seen over similar periods, and pandemic-related job losses, salary cuts and medical expenses explain this substantial increase. Going by the current trend, EPFO expects nearly 10 million subscribers to withdraw from their savings in the coming days. The huge outgo is likely to impact the fund's earnings in FY21.

REAL INTEREST RATE VS SAVINGS IN INDIA: THE THEORY

- The role of savings in economic growth is important. If we adopt the conventional approach towards savings and high interest rates in determining the relation between savings and lower real interest, lower interest rates make savings less lucrative as the returns are lower and encourages present day consumption.
- High real interest rates have **two opposing effects on private savings**. The **first** is the **substitution effect**, in which saving increases as consumption is postponed to the future, and the **second** is the **wealth effect** in which savers increase current consumption at the expense of saving. If we take a look at the income effect, it is a possibility that people might increase their savings in a low interest rate regime to compensate for the loss in income and especially if there is a excessive economic uncertainty regarding the future and there is absence of social security nets.
- As per McKinnon and Shaw hypothesis, developing nations practice set higher interest rates at which demand and supply clear, the wealth effect should not be so high as to overwhelm the substitution effect, thus enhancing savings and financial intermediation can help in better channeling of these savings.
- In an era of low real interest rates, however, which effect will dominate is tricky to determine. However, at what level is the overall interest rate, what are the expectations of the households regarding future inflation and stability prospects and other variables can determine, how much a lower interest rate regime can lead to change in the savings.
- If we look at the data, India's gross savings as % of GNDI was at 29.7% for FY19, the lowest since 2010-11 new base data. Household sector is an important contributor to savings in an economy but their share in overall savings has steadily declined from 68% in FY11 to 57.8% in FY17. In FY19 the share was 60.3%. If we net out the liabilities it was 73.7% in FY19. As a %of GDP, the net financial saving of the household sector declined to 6.5% of GDP in FY19 from 7.7% in FY18 and 7.4% in FY17. The financial savings have moved from deposits, especially deposits with banks to small savings deposits and pension and provident funds.

Small Savings Rates vs Bank Deposit Rate							
Instruments	Govt. Announced Rates			Difference (Q4FY19 minus Q2FY21)	SBI*	HDFC Bank*	ICICI Bank*
	Q4FY20	Q1FY21	Q2FY21 (Unchanged)				
Savings Deposits	4.0	4.0	4.0	0.00	2.70	3.00	3.00
PPF	7.9	7.1	7.1	-0.80	-	-	-
5 year Recurring Deposit	7.2	5.8	5.8	-1.40	5.40	5.35	5.50
1-Yr Term Deposit	6.9	5.5	5.5	-1.40	5.10	5.10	5.15
2-Yr Term Deposit	6.9	5.5	5.5	-1.40			
3-Yr Term Deposit	6.9	5.5	5.5	-1.40	5.30	5.20	5.35
5-Yr Term Deposit	7.7	6.7	6.7	-1.00	5.10	5.35	5.50
Sr. Citizen Savings Scheme	8.6	7.4	7.4	-1.20	TD Rate Plus 0.5%		
Post Office Monthly Income Scheme	7.6	6.6	6.6	-1.00			
KVP	7.6	6.9	6.9	-0.70			
NSC	7.9	6.8	6.8	-1.10			
Sukanya Samridhi A/C	8.4	7.6	7.6	-0.80			

Source: SBI Research * Latest



Source: SBI Research

Growth Rate of Component in Households in Financial Savings									
Item Description	FY13	FY14	FY15	FY16	FY17	FY18	FY19	%Share in FY13 in Gross Fin. Savings	%Share in FY19 in Gross Fin. Savings
Currency	5.0	-10.8	34.0	50.4	-266.0	-245.3	-41.8	10.5	14.1
Deposits	12.2	10.0	-8.2	5.2	51.7	-45.7	47.4	57.0	39.2
with banks	8.4	12.1	-10.0	5.1	53.7	-41.9	44.2	50.2	36.5
Shares and debentures	3.1	11.2	7.6	39.2	515.3	1.6	-56.1	1.6	3.9
mutual funds	-5.5	82.5	-3.5	30.4	700.0	-8.4	-58.3	0.8	2.9
Claims on government	-67.5	-424.3	-95.8	6911.4	70.0	34.8	28.0	-0.7	10.0
investment in small savings etc.	-66.4	-212.8	-81.0	3320.3	107.2	37.5	29.3	-0.7	9.9
Insurance funds	-8.0	13.6	46.4	-11.7	34.1	-2.9	-24.8	16.9	13.0
Provident & pension funds	63.5	13.7	7.3	52.3	12.0	13.5	7.3	14.7	19.9

Source: SBI Research, MOSPI

- Recently in a RBI monthly bulletin, a series “Quarterly Estimates of Households’ Financial Assets and Liabilities “ was published. Although there is some difference in the MOSPI released data and this data, using RBI data for FY20 in consideration we find that Indian households gross financial savings (as % of GNDI) has declined from 11.9% in FY18 to 10.6% in FY20. Although, the data does show that in the last quarter the gross financial savings have picked up in absolute terms. We believe that people’s preferences of financial assets during lockdown and in subsequent months will give a fillip to the financial savings in India and we expect a jump in financial savings in FY21, also as a result of the precautionary motive.

REAL INTEREST RATE VS SAVINGS IN INDIA: EMPIRICAL RESULTS

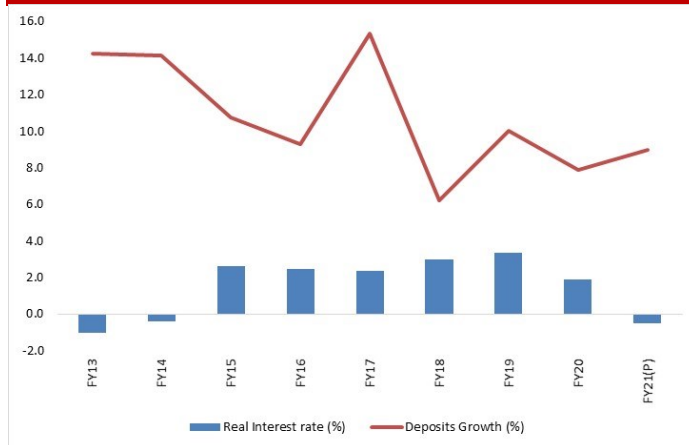
- However, what does the data say? Empirical evidences in economic literature for India are mixed regarding the impact of real interest on financial savings. Some economists have found savings to be insignificantly related to real interest rates, while others have found a very small but positive interest rate elasticity of savings.
- We analysed for the period FY00 to FY20 in Indian context and the results indicate that the substitution effect of real interest rate is more than the wealth effect leading to overall positive impact of higher interest rates on savings rates. The estimated model suggests that a change of at least 2% in real deposit rate to change saving rate by 1%. Thus small changes will hardly make any difference and hence it may be costly to keep real interest rates at high levels for a significant period. This has happened in the past also when rate cuts lagged inflation trajectory and it is thus essential that we keep real interest rates at negative right now, as such will have a sobering impact on asset quality .
- Additionally, causality analysis in India between income per capita and savings rates shows that such causality run mostly from income to savings. This implies that high GDP growth and increase in per capita income can only significantly improve the savings rates in India.
- Households will continue to be a major source of savings in the coming future despite the lower interest rates to cope with the uncertainty ridden world. However, for savings to sustain high gross domestic product (GDP) growth and increase in per capita income are needed. The pandemic has caused disruptions of such scale that what behaviour people will adopt is difficult to ascertain.
- The COVID Pandemic has prompted Central Banks to further cut interest rates and to ease liquidity conditions to support consumption. With real consumption set to be adversely impacted, Governments and Central Banks in respective countries will be more concerned with the welfare implications of the pandemic on real consumption.

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Cross Country Change in Policy Rate & Inflation						
Country	Central Bank Policy Rate			Inflation Rate		
	Jan'20	Jun'20	Change (%)	Jan 2020	Jun 2020	Change (%)
Argentina	50.00	38.00	-12.00	52.86	42.76	-10.10
Brazil	4.50	2.25	-2.25	4.19	2.13	-2.06
Canada	1.75	0.25	-1.50	2.40	0.66	-1.73
China	4.15	3.85	-0.30	5.40	2.50	-2.90
Euro area	0.00	0.00	0.00	1.72	0.70	-1.02
Hong Kong SAR	2.00	0.50	-1.50	1.40	0.70	-0.70
India	5.15	4.00	-1.15	7.59	6.09	-1.50
Indonesia	5.00	4.25	-0.75	2.68	1.96	-0.72
Japan	-0.10	-0.10	0.00	0.69	0.10	-0.59
Korea	1.25	0.50	-0.75	1.49	-0.01	-1.50
Malaysia	2.75	2.00	-0.75	1.58	-1.89	-3.47
Mexico	7.25	5.00	-2.25	3.24	3.33	0.10
Philippines	4.00	2.25	-1.75	2.94	2.50	-0.44
Russia	6.25	4.50	-1.75	2.42	3.21	0.79
Saudi Arabia	2.25	1.00	-1.25	0.73	0.52	-0.20
South Africa	6.25	3.75	-2.50	4.49	2.05	-2.43
Thailand	1.25	0.50	-0.75	1.05	-1.57	-2.63
Turkey	11.25	8.25	-3.00	12.15	12.62	0.47
United Kingdom	0.75	0.10	-0.65	1.80	0.60	-1.20
United States	1.63	0.13	-1.50	2.49	0.65	-1.84

Source: BIS, SBI Research

Real Interest Rate vs ASCBs Deposits Growth Rate



Source: SBI Research

Contact Details:

Dr. Soumya Kanti Ghosh
 Group Chief Economic Adviser
 State Bank of India, Corporate Centre
 M C Road, Nariman Point
 Mumbai - 400021
 Email: soumya.ghosh@sbi.co.in
 gcea.erd@sbi.co.in
 Phone: 022-22742440
 @kantisoumya