To make an informed judgement on capex recovery, household finance data need to be looked at

Why House Holds the Key

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Rising profitability is not a sufficient condition for triggering a capital expenditure cycle. Companies will not expand capacity unless they are confident of buoyant aggregate demand in the economy. External demand met via exports can stimulate capacity expansion. However, in the current circumstances, when the global economic conditions point towards a recession in major economies and a significant weakening of external demand, this may not be a viable alternative. Hence, we need to focus on drivers and determinants of domestic demand.

The financial position of households is, perhaps, the most important driver of domestic consumption. Advanced economies are presently reeling under multi-decade-high inflation due to post-Covid policies, which, following Keynesian logic, took recourse to extraordinary stimulation of household demand by handing out free cash to households at large.

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A large part of this additional income was, however, parked as precautionary savings by households acting in the face of uncertainty.

Consequently, such transfers created a pool of excess household savings in most advanced economies. The cumulative excess personal savings in the US peaked at 14.4% ($2.5 trillion) in Q4 2020, before easing to 13.2% in Q2 2022.

In stark contrast to such high levels of excess personal savings in rich countries, there were no excess savings in India. Based on available quarterly RBI data on household financial savings up to Q3 2021 and estimates of quarterly physical savings based on steel consumption, cement production, stamp duties and registration fees collected by states, the excess in financial savings was entirely offset by the deficiency in physical savings in India.

The same is true for Indonesia (data up to Q2 2021) and South Africa (data up to 2021). In short, the household financial position in the post-Covid period in emerging economies was vastly different from that in the advanced economies. While governments suffered, almost the entire income losses seen in 2020 and 2021 in the developed world, households bore the brunt in most emerging economies, especially in India.

The household financial position in India has been weakening for years prior to the pandemic. An analysis of household disposable income, consumption, savings and leverage confirm that for the first time in the past seven decades, consumption growth outpaced income growth during the 2010s (FY2011-FY2020). Compared to an average growth of 7.2% in private real consumption, household real disposable income grew at an average of just 6% during this decade. The corresponding numbers in the 2000s were 6.4% and 7.5%, respectively.

This was directly a result of lower savings and higher debt taken by households. Household savings declined from 30-31% of the GDP at the beginning of the 2010s to 24% in FY2020 (compared to the low of 23% in FY2016-FY2017). At the same time, household debt surged from 32% of income in FY2009-FY2011 to 42% in FY2020. So, while about 12 months of savings were enough to wipe out the entire household debt in FY2010 (or FY2011), savings of more than 1.7 years (21 months) were required to take care of household debt in FY20. This implies a deterioration of almost 75% in household finances.

The financial position of the household sector in the 2010s, thus, was comparable to a company whose revenue (income) and profits (savings) were dwindling, but the spending growth was maintained, supported by higher debt. The weakening financial position of India's household sector deteriorated further in 2020 and 2021. Growth in 2022 looks to be better on account of the base effect.

The Wages of Salary

As in the corporate sector, there was a visible divergent recovery within the household sector. Regular wage earners and the salaried class were relatively better-off vis-à-vis self-employed and casual workers. Notably, only about 23% of the total workforce is classified as regular wage earners or salaried workers, while the self-employed and entrepreneurs account for more than half of the workforce. The remaining are casual workers. As per the World Bank, more than 75% of India's workforce is in 'vulnerable employment'. This ratio is in single digits for most advanced economies.

The combination of a high share of vulnerable workforce in India, their weakening financial position even prior to the pandemic, and the serious loss of income suffered during the pandemic years poses significant downside risks to a strong recovery in private consumption. Moreover, nearly 37% of total investment is undertaken by the household sector. This is primarily in the residential property market. A weakening of household balance sheets will, thus, also imply a weak recovery in the real estate sector.

Overall, to make an informed judgement on the capex recovery in India, one has to not only understand the unlisted corporate sector but also take into account the state of household finances. Corporate investments are unlikely to witness a strong recovery unless consumption demand picks up strongly. This is difficult in the face of a weakening financial position of the household sector. Could some fiscal policy measures come into play to shore up consumption demand to reinforce the multiplier effects of the rise in public investment?

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