An Analysis of the close nexus between Savings, Investment and Gross Domestic Product in India

[1]Anila.C, [2]Dr.KM Francis, [3]Dr Sabu PJ

1. Assistant Professor (Research Scholar)
Department of Economics, Sree Keralavarma College
Thrissur, Kerala.
2 Associate Professor (Retd), Department of Economics, St.Thomas College (Autonomous), Thrissur
3. Assistant Professor, Department of Economics, St.Thomas College (Autonomous), Thrissur.

Abstract

This paper examines the relationship between India's gross domestic product, domestic saving and investment. The ups and downs in domestic saving and investment have its direct impact on the economy's growth path. For long term sustained development the nation must enhance its saving and investment potentials. Raising the saving ratio is of utmost importance as it improves the liquidity, provides fund for the nations development activities and capital formation. Higher domestic savings also helps to attract foreign investments and also to reduce the gap between saving and investment. As the household sector is the dominant sector that contributes toGDP, saving rate especially financial savings of the households need to be properly pooled and channelized into productive investment avenues. To achieve higher rate of growth with relative price stability, propensity to save and invest should be enhanced through proper policies and incentives.

Key Words: Gross Domestic Product, savings, investment, capital formation.

Introduction

Every nation strives to achieve faster rate of economic growth and thereby to attain higher levels of economic development and well being. There are various factors that contributed towards a nation's growth and one prime factor is the savings generated in the economy. Savings constitutes the difference between income and spending and Gross Domestic Saving refers to Gross Domestic Product minus final consumption expenditure. Gross capital formation and investment are a function of gross domestic savings and thus is closely linked with the increase in the productive capacity of the economy. Theoretically a two-way relation exists between economic growth and domestic savings, as the increase in savings could stimulate economic growth and in turn economic growth spurts domestic savings. There are many theories that emphasize the importance of savings and economy's growth. From the time of the classical, savings and marginal propensity to save plays a dominant role in taking the economy to higher levels. The neo classical growth theories highlight the critical role of savings in achieving steady levels of per capita capital and national income. The endogenous growth models also suggested the role of accelerated savings rate in attaining long term steady growth. Rise in Gross Domestic Savings paves way for increase in capital stock and this further creates more investment, production, employment and financial stability. Globally many empirical evidences show a positive relation between savings and economic growth especially in case of many fast developing Asian economies. Along with savings, investment also plays a potential role in fastening economic growth by influencing the productive capacity of the economy. It is an important component of aggregate demand and has a multiplier effect in enhancing employment and output. In case of developing economies a sustained accumulation of fixed capital has fastened its pace of growth and development.

Gross Domestic Product in India-An Overview

A nation's economic growth is conventionally measured as the percentage increase in its Gross Domestic Product. The GDP growth exhibits the rate of economic progress and reflects the growth path of the economy. Gross Domestic Product is the monetary value of all final goods and services produced within a country during a specified period of time. To achieve faster growth rate the economy has tried to accelerate its Gross Domestic Product and by keeping this aim the planners have charted out various measures whereby to achieve self-sustained growth .As a result of this the economy was able to progress from its poor economic base to a better position and as a developing economy it has followed a different path of development. The economic growth is the sum total of the product generated from the three main sectors of the economy-the primary, secondary and tertiary sector. In India in its initial phases the agrarian sector dominated but later on the growth rate of the tertiary sector has been faster than that of the agriculture and industrial sectors. Many demand side and supply side factors have supported the growth and development of the economy. The Gross Domestic Product in its initial phases slowly progressed and during certain years it even exhibited negative growth especially during 1965, 1972 and1979.Many studies has stated that the period of 1980's exhibited a slow pace of growth and it was not of a sustainable nature as it relied too much on deficit financing and excessive foreign borrowings. When India stepped into the era of liberalization the GDP growth was only 1.1 percent, later the condition improved and it began to progress in steady pace and peaked during 2010. From the period of 1951 to 2019 the GDP annual growth rate averaged around 6.16 per cent.

Trend in saving, investment and gross domestic product

India as a developing economy needs high rates of saving and investment to achieve high levels of growth and development. Saving and investment has been the primary instruments of economic growth and increase in gross domestic product. Over the decades, the secular uptrend witnessed in domestic growth is clearly associated with the consistent trends of increasing domestic saving and capital formation. The behavior of the savings rate and economic growth in India during the reform period seems to suggest that the high growth phase is associated with higher order of increase in domestic savings. A nations saving and investment propensities play a key role in achieving targeted economic growth. Saving is the excess of income over expenditure on consumption and this when properly pooled and channelized into investment increases the productive capacity of a nation and enhances the growth process. With high capital output ratio India needs high levels of saving and investment to progress. Gross capital formation is a function of gross domestic savings and sufficient capital formation supported by appropriate volume of savings sets a self – reinforcing process in the economy.

Domestic saving and Investment of India consists of savings of household sector, private corporate sector and public sector. Among these household sector contributes the major share and occupies a position of dominance over the other institutional sectors. India's saving and investment rates have steadily increased over time but their composition has undergone a considerable change and the most noticeable trend is the growing divergence between the public and private saving. The private corporate saving and household saving has exhibited an increasing path but public saving declined from its peak level of 4.9 per cent of GDP in 1976-77 to - 2.3 per cent in 2001-02. This negative trend prolonged up to 2003-04 and later it slowly started progressing in a mild manner The household sector savings comprises of savings in the form of physical and financial assets and there has been a shift of investors' preference towards physical assets as compared to financial assets.

Table-1

Gross Domestic Product, Gross Domestic Saving and Gross Capital Formation in India

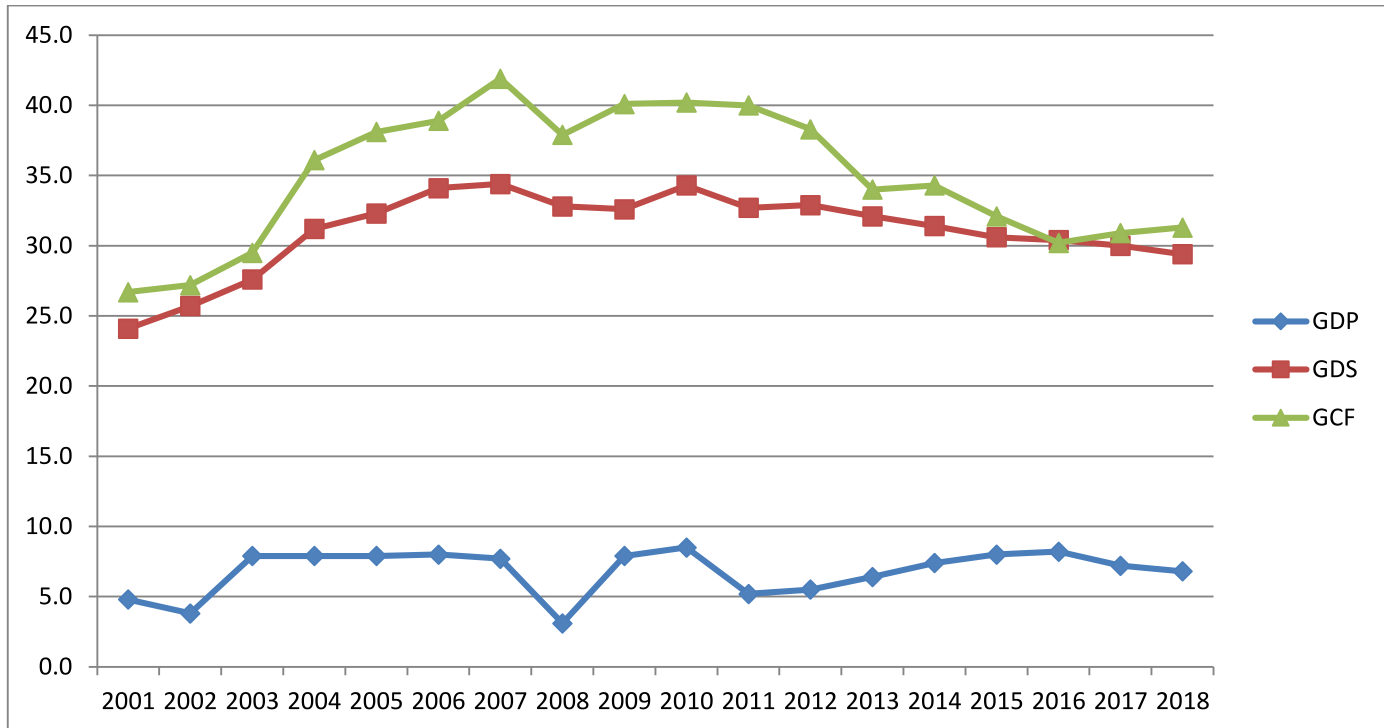
Year	Gross Domestic Product	Gross Domestic Saving (% of GDP)	Gross Capital Formation (% of GDP)
2000	3.8	24.3	26.7
2001	4.8	24.1	26.7
2002	3.8	25.7	27.2
2003	7.9	27.6	29.5
2004	7.9	31.2	36.1
2005	7.9	32.3	38.1
2006	8.0	34.1	38.9
2007	7.7	34.4	41.9
2008	3.1	32.8	37.9
2009	7.9	32.6	40.1
2010	8.5	34.3	40.2
2011	5.2	32.7	40.0
2012	5.5	32.9	38.3
2013	6.4	32.1	34.0
2014	7.4	31.4	34.3
2015	8.0	30.6	32.1
2016	8.2	30.4	30.2
2017	7.2	30.0	30.9
2018	6.8	29.4	31.3

Source: The World Bank- National Accounts Data.

A significant positive relationship between gross domestic product, saving rate and capital formation can be observed during the period 1950-51 to 2018-19. During this period saving rate has steadily increased over time, from an extremely low base of 9.0 percent to 29.4 percent and investment rate from 10.7 percent to 31.3 percent. During the period 2000-2018 the gross domestic product increased from 3.8 percent and reached 8 percent in 2006 and this growth is closely linked with the increase in the domestic saving and capital formation both showed an increase of 10-11 percent. Indian economy surpassed the global recession mainly because of the domestic savings and investment that more or less maintained its consistency. During 2011-12 there was a slump in the growth rate mainly due to the fall in savings and capital formation. Again the economy slowly started reviving but the momentum is less mainly because of the dip in domestic saving and especially gross capital formation lagging behind.

Figure – 1

Growth path of India's Gross Domestic Product, Gross Domestic Saving and Gross Capital Formation



Source: World Bank- National Accounts Data.

The growth path clearly shows the correlation between economy's gross domestic product, saving and investment. The economic growth is mainly investment led and domestic fixed capital formation plays an important role. The fall in saving and gross capital formation has decreased the pace of growth. The household sector savings declined, especially financial savings but it was somewhat coped up with increase in private corporate sector and public sector savings during the period 2014-18.The investment rate has fallen over the years mainly due to the fall in financial savings of the household The financial savings of the households are the most important source of fund to generate more capital formation as such more financial inclusive measures need to be promoted. There is a need for the efficient intermediation of the financial sector to channelize savings into financial assets and paving way for their optimal allocation.

Saving-Investment Gap

As far as developing economies are concerned the saving investment gap is important as it is an important factor in determining the long term development process. This gap has to be filled with domestic flows as foreign inflows are usually short term and cannot sustain long term growth. In India the saving investment gap has slowly declined over the years and it shows the progressive macroeconomic base. During 2000-2001 the saving investment gap was -2.4 then it slowly declined but it peaked during the recessionary phases but again declined. Even though the household sector has shown a decline in savings the private corporate sector has picked up to fill the gap. Through more vibrant policy measures there should be an increase in domestic savings and its flow into productive investment channels so as to fill the saving investment gap and to sustain stable economic progress.

Conclusion

India being a fast developing economy must make use of its domestic potentials in the most optimal manner to attain a stable long term growth path. In this process saving and investment play a crucial role, as such macroeconomic policies and measures should be taken to enhance the flow of domestic saving and capital formation. Growth in gross domestic savings and investment has led to growth of gross domestic product, as such it is mandatory that sufficient attention needs to be paid to stimulate these variables and to boost up the economy. The household sector is the most robust sector, proper financial inclusion measures should be taken to increase

the financial savings of the households. Through efficient financial intermediation and diversification savings should be channelized to investment in infrastructure, industries, technology and other relevant areas to increase the capital formation and to reduce the saving investment gap. Thus proper structural reforms and policies should be adopted to support domestic demand, strengthen saving and investment and thereby to improve the growth path of the economy.

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