# Indian Consumption SAGA

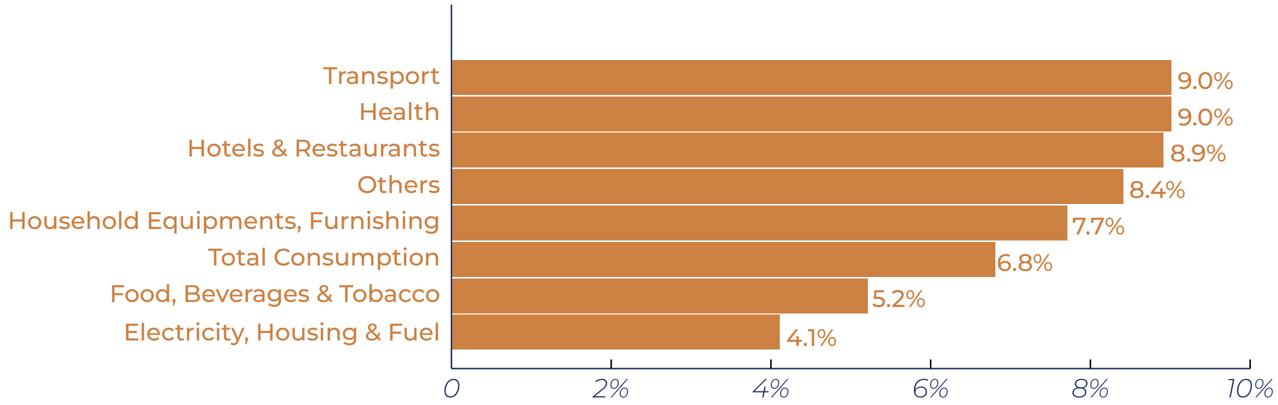
Swastik Ghadge | August 31, 2023

You might have heard this **'1.4 billion times'** that the next decade for India will be a consumption story, indeed it will be a catalyst for our growth story. If we go back in time to pre-financial reforms in India, the consumer did not have much choice due to the closed economy. Post Independence, the government resorted to **statism** curbing the economy and excessive restrictions prevailed over businesses. The term **'Personal Consumption'** was foreign to us. Consumption by preference was limited to the affluent class as opposed to the destitute base of the population. After 1991, the economy opened which enabled plethora of choices for the Indian consumer as multiple businesses came to India in different sectors. This revolutionised the Indian Consumption, and in the present world it is seen picking up and has become a crucial part of our story.

While I was trying to understand what is the psychology behind an individual's consumption and spending decisions, I came across two theories that affects consumption. In this letter, I will try and explain **'Engel's law of Consumption'** and **'The Wealth Effect'** and its relevance with the **'Indian Consumption Saga'**.

In the first theory, I'll talk about **Engel's Law of Consumption**. The term was coined by **Mr. Ernst Engel** in the year 1857, in which he stated that as household income increases, the percentage of income that a household spends on discretionary items (food, shelter) will decline, which will result in spending a greater proportion of the income on non-discretionary items (travel, recreational activities,etc). To give some perspective, if an individual's income rises from the current level the incremental amount that he/she spends on discretionary items will be less as compared to non-discretionary items.

## Household Consumption by Key Categories (Real Terms FY10-20 CAGR)

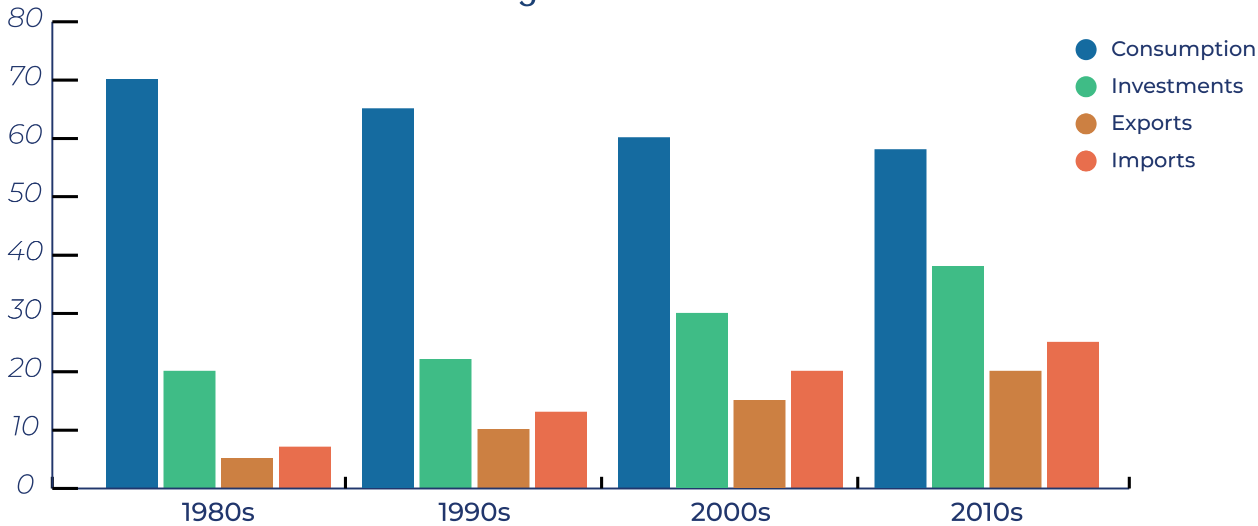



Source: The Data Book: State of India 2022

Engel's Law is not only limited to a household but also to an entire nation. Let me try and explain this, the wealthier a nation gets the smaller proportion of its labor and capital will go towards food production and the more of it will go towards manufacturing and services, resulting in an **advanced economy**.

You might be thinking, how is this relevant to the Indian consumption story? Well, it brings us to the indispensable indicator of a growing economy, the '**Age-Old GDP**'. If you see it from a historical point of view the average share of consumption in **Real GDP** terms has always been higher than other factors as shown below.

## Decadal Average Share in Real GDP



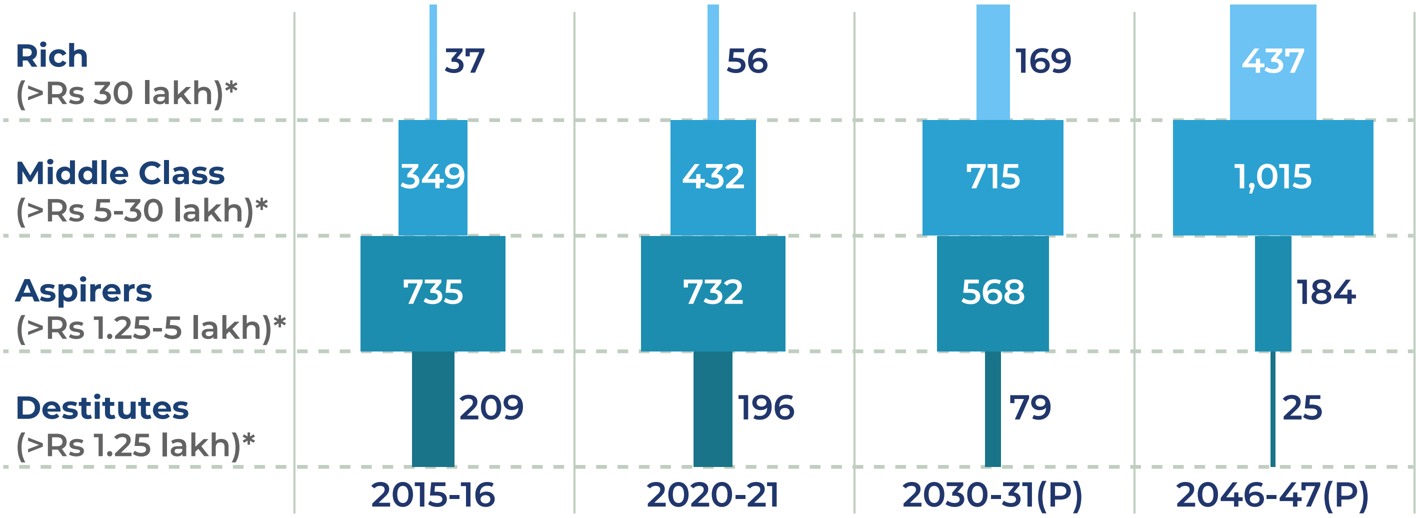

Source: The Data Book: State of India 2022

~ Consumption always had the lion's share in the GDP

Coming back to Engel's law, the major contributor to the law is Rise in Income. To justify this we can see the statistic below (Indian Income Pyramid) and the significant shift that is happening wherein the Indian Middle class which falls under annual income between Rs 5 to 30 Lakh, eventually forming a stronghold for growth.

### Indian Income Pyramid

(Population in million)




*Annual houshold income at 2020-21 prices

Source: PRICE Report on the Indian Middle Class

As Income Levels continue to rise, the expenditure on items like food will be constant, allowing a relatively higher part of the consumer's wallet to be spent on non-discretionary items – be it mobile phones, automobiles, real estate, travel, etc. we all have experienced this phenomenon yet never realized it.

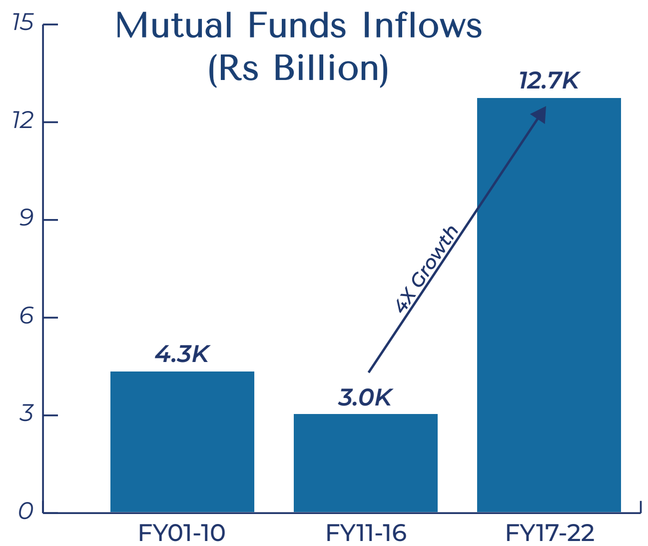
Sharing my personal experience here, when I started working almost 3 years back my expenses for leisure activities were limited, going to the movies twice a month, dining outside once a month, and traveling once a year. Now that my income has risen over the years my expenses have risen simultaneously, along with the existing expenses there is now an addition of taking OTT subscriptions (Netflix, Amazon Prime), watching almost every new release, dining outside & ordering food online have drastically grown (thanks to Zomato and Swiggy), travelling has increased almost twice or thrice a year (sometimes the weekend trips to the outskirts of Mumbai). I'm sure that each one of you can resonate with me, thus proving Engel's law and its relevance even after 165 years.

The second theory highlights **'The Wealth Effect'**.

'It is a behavioral economics theory suggesting that people spend more as the value of their asset rises'

The idea is that people (Consumers) feel more financially secure and confident about their wealth when their assets appreciate in value. It covers the saving & investing aspects which were missed in Engel's law of consumption. To understand this theory, let us go through the transition of saving ways of a household. Earlier it was through fixed deposits (the most preferred way) but now there is a progression of savings towards investing. We both are an integral part of this shift because of our understanding of savings and investments. Let us understand this through the new age way of savings i.e. Mutual Funds.

If you see the trend of inflow in the Mutual Funds industry over the years, then you would be stunned!



Source: The Data Book: State of India 2022

It indicates that Indians are not only spending towards consumption but also towards investments. Earlier almost 56% of the AUM of the mutual fund industry came from only three cities Mumbai, Delhi, and Bangalore which is not the same anymore. States like Uttar Pradesh, Tamil Nadu, and West Bengal have seen significant increases in the inflow of funds. SIPs have become an innate part of discussions and gain a mind share. People consider the SIP amount while calculating their monthly expenditure.

I vividly remember discussing SIPs with my former boss, where I raised a question 'Why he considered SIPs as a necessity?'.

To which he replied "Everyone will tell you that investing in Mutual funds is a better option because of the compounding returns it generates. But one of the most ignored reasons is future spending". He further elaborated the point by explaining how he could use the invested money for any unforeseen health expenses, children's education, travel and so on. Intrigued by his perspective, I tried digging more to find data that proves the **Wealth Effect**.

Here's the data that shows a relation between Household Savings and Aggregate Household Consumption.

| y/e March (₹ Bn) | 2005 | 2012 | 2015 | 2020 | 2021 | Growth in Multiples |
|---|---|---|---|---|---|---|
| Aggregate Household Consumption | 18,674 | 49,360 | 72,817 | 1,22,987 | 1,20,150 | 6x |
| Physical Assets | 4,288 | 14,230 | 15,587 | 23,167 | 20,869 | 5x |
| Financial Savings | 3,191 | 6,426 | 8,804 | 16,125 | 23,037 | 8x |

It proves that as households accumulates assets (physical+financial) the overall consumption parallelly increases, thus corroborating the interrelationship between both theories.

The **Indian Consumption Saga** has seen many turn of events during its course, which brings us to this inflection point. **The Wealth Effect** and **Engel's Law of Consumption** are two of the many factors that shapes the spending decisions of an individual. I am not claiming that these two theories will work going forward, but will be an incentivise other factors. The businesses that gives importance to the phrase '**Customer is King**', and understand the '**Consumption Story of India**' will definitely write the next phase of the saga. Hereby concluding my letter, hope you enjoyed it and was a value add to your knowledge. I will look out for more such theories and stories for you all, Until then Happy Investing.

---------- Thank You for reading! See you Next Month! ----------

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