



## The Great Indian Savings Puzzle<sup>☆</sup>

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### ABSTRACT

India's savings rate rose from 13% of GDP in 1970 to 38% of GDP in 2008 before steadily declining to 30% of GDP by 2019. India's savings trajectory follows a hump-shaped pattern, peaking during the Great Recession (2007–2009). We build a monetary-growth model that highlights the role of declining inflation post-2009 in explaining the hump shape in the savings rate. Falling inflation boosts future wealth, inducing households to increase consumption while lowering future savings. Consumption smoothing and risk aversion lead to higher consumption and lower savings in the initial periods as well. Consequently, household savings are low but rising in the 1990s, peaking alongside inflation in 2008, and declining thereafter. The fit improves when we allow for two types of agents: Ricardian and Rule of Thumb. Our model predicts a dynamic association between inflation and household savings that mimics the hump-shaped savings pattern observed in India and some other economies.

### 1. Introduction

Since the 1970s, there has been a secular rise in the Indian annual gross domestic savings as a percentage of GDP (what we term as the “savings rate”), which suddenly reversed in 2008. As shown by the dark blue line in Fig. 1, in the mid-1970's India's savings rate was roughly 13 percent of GDP, rising to a peak rate of 38 percent of GDP in 2008.<sup>1</sup> The pre-2008 rise in the savings rate was phenomenal as it even surpassed the savings rates of most advanced economies and BRICS nations - with

the exception of China.<sup>2</sup> However, after it peaked there has been a steady decline in the savings rate. Given this non-monotonic trend in the savings rates, this paper asks: What explains the rise and decline in the Indian savings rate? We refer to this as the “Great Indian Savings Puzzle”.

The decline in the savings rate is concerning for a variety of reasons. First, its timing in relation to the Great Recession of 2008 suggests a

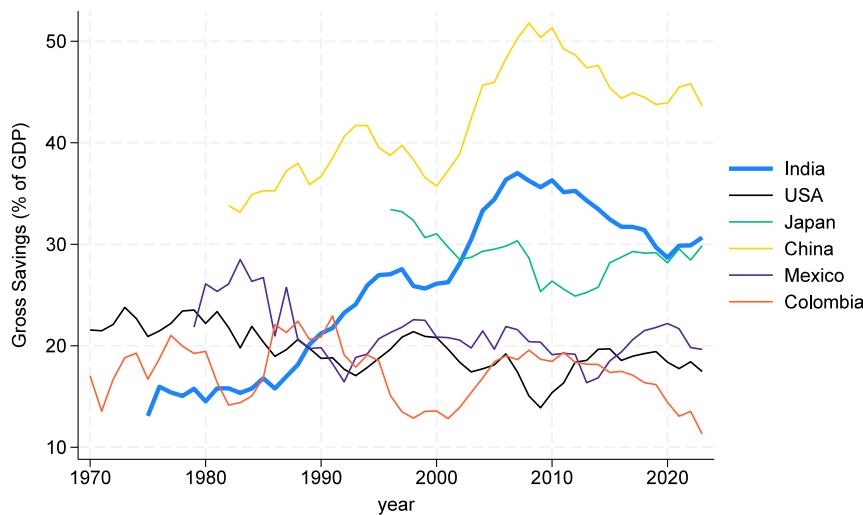
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<sup>1</sup> Our analysis ends in 2019, before the start of COVID-19. For the sake of consistency, we use data from World Development Indicators (World Bank) for plotting savings rate of the different countries in Fig. 1. However, in the rest of the paper, we use the Indian savings data from the Reserve Bank of India (RBI, 2024). For some of the other national accounts data, we refer to the National Accounts Statistics, Government of India (GOI, 2024). There are some differences between the two data sources, but the overall trajectory and magnitudes are close. Furthermore, we work with the gross savings rate instead of the net savings rates because investments with long durability require replacement with lags. Therefore, gross savings provide the source of funds for the replacement of investments due to the depreciation of the capital stock, and for new investments (see Raj, 1962).

<sup>2</sup> While the trends in the savings rate have remained stationary for most countries, both India and China experience non-monotonic trends. Both countries first witnessed a secular rise in savings rates until the mid-2000s. However, post-2008 for India and post-2010 for China, the savings rate in these two economies have remained on a declining trajectory.



**Fig. 1.** Cross country patterns of savings rate in select developed and developing nations.  
Source: WDI.

potential connection between the two, emphasizing the need to identify the underlying mechanisms.

Second, the decline in the savings rate from roughly 38 percent of GDP in 2008 to 30 percent of GDP in 2019 (an 8 percentage point decline, or a roughly 21 percentage point decline relative to the peak) also coincides with a similar decline in the relative magnitude of real GDP (RGDP) growth from about 8 percent in 2008 at peak to roughly 6.5 percent average RGDP growth between 2016 to 2019.<sup>3</sup>

Third, in India, there is a strong positive correlation between savings and investments, particularly in terms of gross capital formation or gross fixed capital formation Fig. 2. Domestic investment activity heavily relies on domestic savings, as indicated by the negligible share of the current account balance in total gross investments since the early 2000s Fig. A1. This highlights the crucial role of domestic savings in driving India's overall growth — and that a prolonged decline in the savings rate may substantially reduce potential growth in India.

Fourth, the investment rate in India has steadily declined since 2007 (from 41.9% to 30.9% during 2007–2019) which has coincided with the tapering off of the capital–output ratio after 2010 (see Figs. 2 and A.2). The slowing investment rates could be a source of a growth slowdown in the future.

To further understand the trends in the savings rate, we decompose the savings rate by the different categories (institutions) of savers — firms, households, and government. We find that the aggregate trend in savings rate is largely driven by household savings. As shown in Fig. 3(a), on average, households contribute about 62% of aggregate savings from 1950–2020.<sup>4</sup> Post-2008, the household savings rate has declined while the private corporate savings rate has stagnated. At a further dis-aggregated level, we find that household savings in both physical and financial assets have declined since 2008, with the decline in financial assets preceding that in physical assets Fig. 3(b).<sup>5</sup> Given the sizable share of household savings in gross savings, explaining the path of India's savings rate requires us to understand what drives the non-monotonicity in household savings.

<sup>3</sup> RBI reports data for a financial year, which begins in April and ends in March of the consecutive year. In this paper, we have used the first year of the financial year as the year of observation. So 2008 refers to FY 2008–09, although we use both interchangeably.

<sup>4</sup> Note that household savings include non-corporate businesses including unregistered micro, small and medium enterprises in addition to individual households.

<sup>5</sup> Broadly, physical assets include equipment, machinery, structures, and ornaments. They also include other intangibles such as intellectual property.

To understand the long-term secular trend in the gross Indian savings rate, we build a closed-economy neoclassical monetary growth model where households are the only source of savings in the economy. We show that there is a dynamic association between household savings and the inflation rate that mimics the hump-shape trajectory seen in the Indian data. What drives inflation in the model? As in Cooley and Hansen (1989), we assume that changes in the money supply influence inflation via a cash in advance constraint.<sup>6</sup> Fig. 4 shows that the M3 growth rate and the annual inflation rate are strongly correlated.<sup>7</sup> Introducing money via a cash in advance constraint allows us to generate a large deviation from neutrality that helps drive the hump in the Indian savings rate.

We proceed in stages. We first use a standard neoclassical growth model as in Fernández et al. (2019), who study savings dynamics for select Latin American economies. When we calibrate their model to India, we find that its predictions are at odds with the Indian data (and other countries with non-monotonic savings trajectories). When we extend (Fernández et al., 2019) to allow for risk aversion (a non-unitary inter-temporal elasticity of substitution), we show that this also does not give us the hump in the savings rate that is observed in the data. Our main observation from this exercise is that the analysis in Fernández et al. (2019) is better suited for economies with stationary long-run savings rates that are on their balanced growth paths.

Next, we augment the model to allow for inflation-savings dynamics via a cash-in-advance constraint on consumption and investments thereby introducing a role for inflation to drive household savings behavior.<sup>8</sup> Like before, there is a single household with CRRA preferences.

<sup>6</sup> The trend in inflation in India after 2000 can be broken down into three phases. In the first phase, which was from 2000–08, inflation was low, averaging at 4.9%, but rising. The second phase lasted between 2009–13 when inflation was high, averaging at 8.7%, and driven by exogenous shocks to oil and food prices coupled with a revival in domestic demand after the Great Financial Crisis of 2007–2009. The third phase began in 2014 with a decline in inflation and anchored inflation expectations due to the adoption of inflation targeting (see Benes et al., 2017). During this phase, i.e., 2014–2019, the average inflation was 3.8%. Our model broadly captures these trends as we will show later.

<sup>7</sup> The correlation is 0.43 which is significant at the 5% level of significance. Further, in the period 1991–2019, we reject the claim that M3 growth does not Granger cause inflation at the 10% level of significance. We recognize that fluctuations in uncertainty can play a large role in driving savings behavior. While our model assumes perfect foresight, real money holdings can be seen as a proxy for such uncertainties.

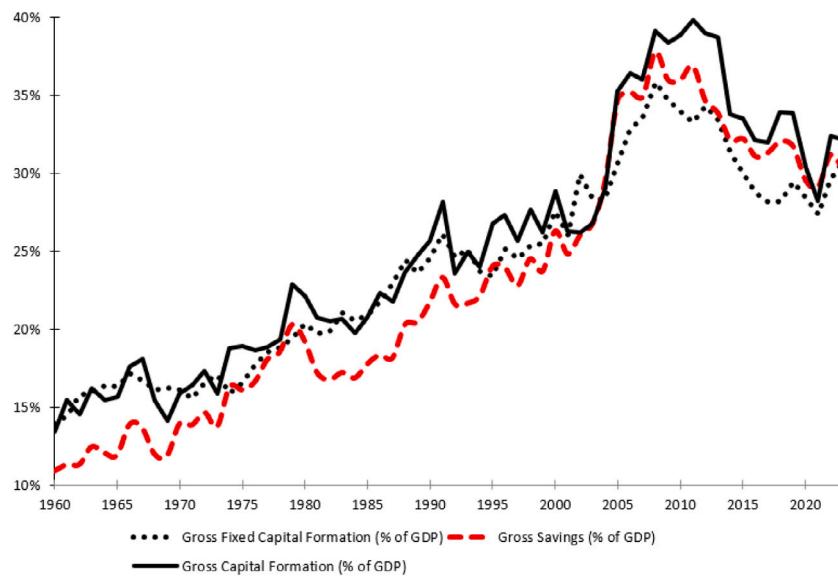


Fig. 2. investment and savings rates.

Source: National Accounts Statistics, GOI (2024).

We refer to this as the *benchmark* model. We find that the *path of inflation* plays a potential role in explaining the hump in the savings rate, though the levels of savings still do not match with the data. Intuitively, inflation has a direct bearing on the value of future wealth, i.e., a decline in inflation increases the real value of future wealth. Since households have perfect foresight, they foresee the changes in money supply and hence its effect on inflation. Anticipating low inflation in the late-2010s, they foresee low savings and high consumption in the future. To smooth consumption along the transition path, they increase consumption (or decrease savings) in the earlier part of the sample period, the early 1990s. This tendency is strengthened by risk aversion.

Thus, the savings rate rises in the 1990s, peaks around 2008 and, then along with falling inflation, the savings rate declines slowly over time. We show that the benchmark model weakly matches the non-monotonic trends in the savings rate, and does not match the peak savings rate in the data. The correlation for 1991–2008 between the calibrated savings rate from the benchmark model and the data is 0.56. For the latter period, i.e., 2009–2019, the correlation is 0.88. These correlations are statistically significant at the 1 percent level.

To address the problem of low peak savings, we allow for two types of households: Ricardian, who we broadly consider as “formal” workers, and who are “savers”. Rule of Thumb households are considered as “informal” workers, who are “non-savers”. We allow for risk aversion in both households, but a cash-in-advance constraint on both consumption and investment only for Ricardian households. With an increasing ratio of formal to informal workers, the model shows a better match with the rise in the savings rate. More formal workers - who save - relative to informal workers - who do not save - magnify the trends in savings. In other words, while inflation changes the real value of wealth, with high inflation in the pre-peak sample inducing a negative wealth effect, and low inflation in the post-peak sample inducing a positive wealth effect, perfect foresight induces households to want to smooth consumption inter-temporally. This suggests that demographic factors play a key role in driving savings rates in India, especially in the pre-peak period, i.e., 1991–2008. The model also captures the drop in the savings rate subsequent to 2008 with an improvement in the

pre-peak and post-peak correlations in savings. The correlation in the pre-2008 period between model and data improves to 0.62 while that of the post-2008 period is 0.9. Both correlations are statistically significant at the 1 percent level of significance. To summarize, inflation, demographics and the TFP growth rate — all three play a key role in understanding savings dynamics, and our simple framework provides a good fit of the model to the data.

The rest of the paper is as follows. Section 2 briefly surveys the existing literature. We replicate Fernández et al. (2019) for the Indian economy in Section 3. Section 4 depicts the one-sector monetary-growth model with risk-averse agents and money supply. We calibrate the benchmark model in Section 5. Section 6 extends the benchmark model with two agents. We run some policy recommendations in Section 7 to suggest what could increase the savings rate. Finally, Section 8 concludes.

## 2. Literature

There is a large literature which looks at the determinants of the savings rate—Fernández et al. (2019) for Latin American economies, Chen et al. (2009) and İşcan (2011) for the USA, and Braun et al. (2009) and Chen et al. (2006) for Japan. By calibrating a standard neoclassical growth model, Fernández et al. (2019) and Chen et al. (2009) find that changes in TFP have played a crucial role in explaining the Latin American and American savings rates, respectively.<sup>9</sup> Even in Japan, Chen et al. (2006) find that TFP growth rates are the primary drivers of the Japanese savings trajectory while Braun et al. (2009) find that changes in demographics had an additional role to play. Mody et al. (2012) look at the changes in the US savings rate between 2007 and 2009. Empirically, they find that the precautionary savings motive, to counter the increased uncertainty since the onset of the Great Recession, explains two-fifths of the rise in the US savings rate. For China, Wei and Zhang (2011) show that conventional mechanisms like life cycle factors, precautionary savings, financial development, habit

<sup>8</sup> While India adopted inflation-targeting in 2016, towards the end of our sample period, we abstain from analyzing the impact of any specific monetary policy regime in our paper.

<sup>9</sup> Gomes (2024) builds a Keynesian model with a behavioral consumption rule and a macro-micro feedback mechanism which shifts individual savings behavior due to the economy-wide unemployment rate. In this framework, full employment can be achieved through public expenditures, without the need for niche monetary or fiscal policy measures.

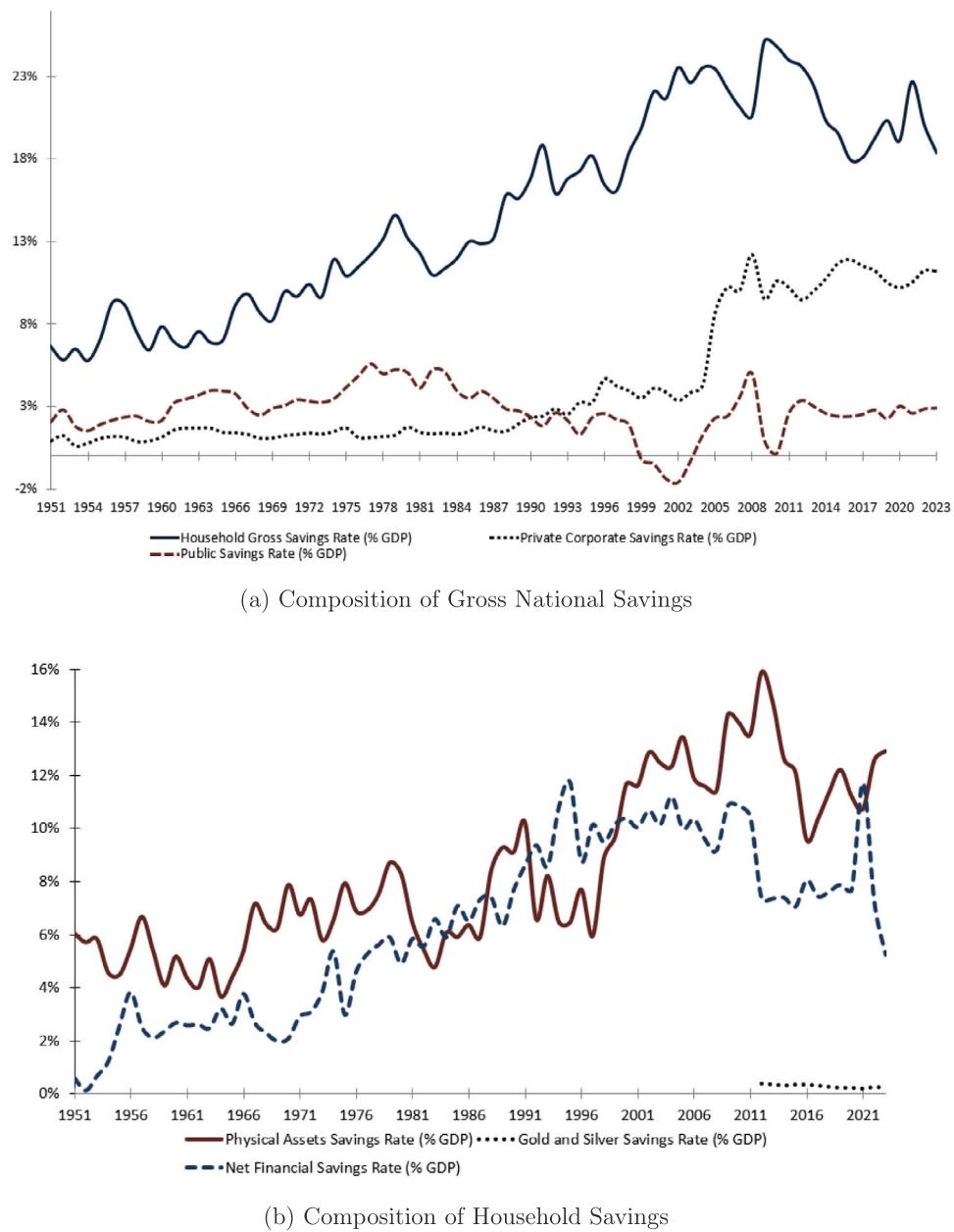


Fig. 3. Savings by institutions.

Source: RBI (2024).

formation or TFP growth are inadequate to explain the high levels of savings rate. They find that half of the 1990–2007 increase in the savings rate is driven by the need to save for their son's marriage prospects. In regions with a more skewed sex ratio, households with sons tend to save more in order to increase their son's chances of finding a bride in the marriage market.

Our paper contributes to the literature on the determinants of trends in the savings rate, especially in developing countries. To the best of our ability, we are the first paper to document and model the non-monotonic dynamics of savings rates in a major economy like India. Within the existing literature, Fernández et al. (2019) study the stationary savings trajectory of select Latin American countries and identify TFP growth as the key driver of long-run savings rate patterns during 1970–2010 for Chile, Colombia, and Mexico. The savings rates in these countries are stationary, in the sense that they appear to fluctuate around a constant level. Chen et al. (2009) discuss the declining savings

rate in the US economy. They too find TFP growth to be the most important determinant of the savings rate.

Savings constitutes the base of non-inflationary capital formation, and capital formation constitutes a critical determinant of economic growth (see Rao, 1980). Given this, there is a large literature on the dynamic interaction between savings and inflation, and the implications for output growth.<sup>10</sup> Some of the questions that guide this research are: does inflation have a short-run effect or a long-run effect on savings and what are the dynamic interactions between the two? Is inflation detrimental to savings or does it induce agents to save more? What role does risk aversion have in the inflation-savings relation? The cross-country and India specific evidence is, however, inconclusive. An early

<sup>10</sup> High inflation can have long-run adverse impacts on output growth through various channels. A key channel is exacerbating financial frictions and reducing the real returns on financial instruments, both of which dis-incentivize long-run capital formation (Choi et al., 1996).

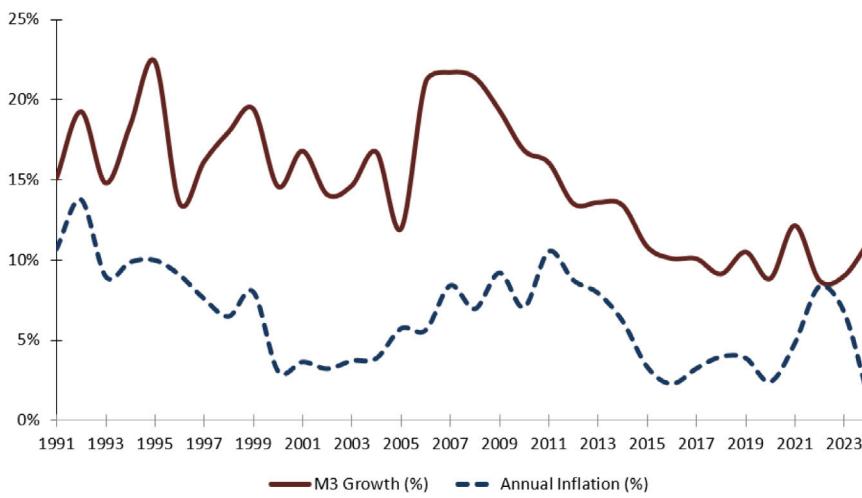


Fig. 4. M3 growth and inflation (GDP deflator).

Source: RBI (2024).

paper by [Campbell and Lovati \(1979\)](#) in the context of the US found no definitive evidence whether inflation has a long-term positive effects on savings. Other studies have found a negative association between inflation and the savings rate, i.e., [Lahiri \(1989\)](#) in the case of some Asian countries, [Dayal-Gulati and Thimann \(1997\)](#) in the case of Latin American countries, and [Dash and Kumar \(2018\)](#) in the case of India. Empirically, [Heer and Süssmuth \(2009\)](#) shows the impact of inflation on savings is not robust and depends on the sample period.<sup>11</sup> Our rationale for these extensions is located in the uniqueness of the post-reform trend in the savings rate for India, and the need for new insights into its savings dynamics.

High inflation rates may also co-exist with high personal savings. [Davidson and MacKinnon \(1983\)](#) show that a positive relation may arise when measured income and savings, even when deflated by the price index, can overestimate real income and savings. An increase in inflation may coincide with higher savings because of uncertainty and pessimism regarding the future. In the case of India, [Athukorala and Sen \(2004\)](#) found that inflation positively affects the private saving rate over and above its effect operating through the real return to saving. This suggests that agents attempt to maintain a target real wealth relative to income by reducing consumption when faced with inflation. [Samantaraya and Patra \(2014\)](#), on the other hand, present an ARDL framework to understand the key determinants of household savings for the period 1971 to 2012. They show that, among other variables, inflation and the real interest rate have negative effects on household savings, both in the short and long-run.

The evidence from the theoretical literature is also ambiguous. [Sidrauski \(1967\)](#) shows that in a general equilibrium framework, money is “super-neutral”, and therefore, inflation does not affect savings in the long run. [Stockman \(1981\)](#) also shows from a model with a cash-in-advance or “CIA” constraint applied to consumption, an identical result is obtained, whereas when applied to investment, higher money growth results in lower savings. [Dotsey and Sarte \(2000\)](#) find that inflation affects long-run growth even when the CIA constraint only applies to consumption. These papers focus on a balanced growth analysis. Our focus is on the transitional dynamics of the savings path.

The inconclusive global empirical evidence on the relationship between inflation and savings, therefore, warrants a theoretical mechanism to understand the transitional dynamics of savings. As a first extension, we explore whether growth in monetary aggregates can

help explain the trends in the savings rate in India. We show that by augmenting the one-sector neoclassical growth model in [Fernández et al. \(2019\)](#) with money and two types of households, we are able to recover the non-monotonic path of savings dynamics that some countries like India and China have experienced. Therefore, the key departure of our paper is that it contributes to understanding not just the contemporaneous effects of inflation on savings, but also the dynamic interactions using a neo-classical growth model with perfect foresight.

Given the large size of the informal sector in India (see [Murthy, 2019](#)), demographic changes also play a role in terms of changing the proportion of savers and non-savers. We follow [Gabriel et al. \(2012\)](#) and [Bhattacharya and Patnaik \(2016\)](#) in terms of modeling heterogeneous households. We find that the rising share of formal workers in the economy leads to general equilibrium interactions between the ratios of savers and non-savers and inflation which gives us a potential explanation of the non-monotonic savings rate.

### 3. Fernandez et al. Calibrated to Indian data

[Fernández et al. \(2019\)](#) conducts a horse race on four exogenous variables to explain savings dynamics: the rate of growth of population, the growth rate of TFP, and two key fiscal policy variables such as the taxes on capital income, and the share of overall government expenditure in GDP. Their main result is that the dynamics of TFP growth drive savings dynamics in select Latin American economies compared to the other variables listed above.<sup>12</sup> In Fig. 5 below, we calibrate the identical model in [Fernández et al. \(2019\)](#) to Indian data (the calibrated parameter values are explained in detail in [Table 1](#)). We plot two counterfactuals in Fig. 5.

In the left panel, we assume log-linear preferences ( $\sigma = 1$ ). As the blue line shows, the calibrated savings rate declines throughout the sample period and does not replicate the hump-shaped savings pattern in the actual data (black line). In other words, the savings rate does not match the Indian data when  $\sigma = 1$ .

The right panel, Fig. 5(b), plots ([Fernández et al., 2019](#)) assuming CRRA preferences with  $\sigma > 1$ . This counterfactual (blue line) continues to be a poor fit of the actual data — the blue line overestimates the data by a large margin, with the peak savings rate happening around 2020. As can be seen in Fig. 5, while the model including risk aversion

<sup>11</sup> For instance, [Heer and Süssmuth \(2009\)](#) shows that rising inflation was also associated with decreasing savings in the US during the Greenspan and pre-Volcker eras, but with increasing savings during the Volcker era.

<sup>12</sup> While we do not outline [Fernández et al. \(2019\)](#) in our paper, our benchmark model without a cash-in-advance constraint and with  $\sigma = 1$  is equivalent to their model.

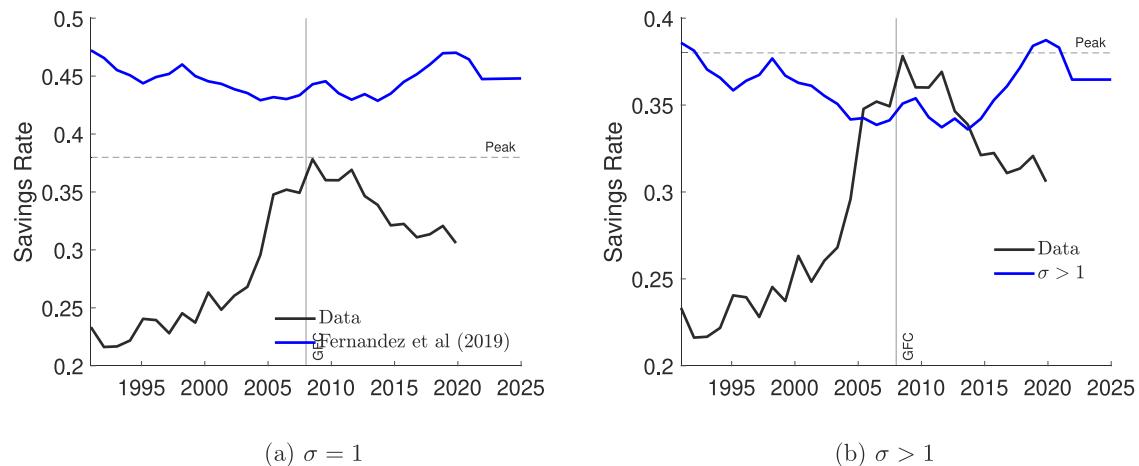


Fig. 5. Calibrating Fernández et al. (2019) to Indian Data.

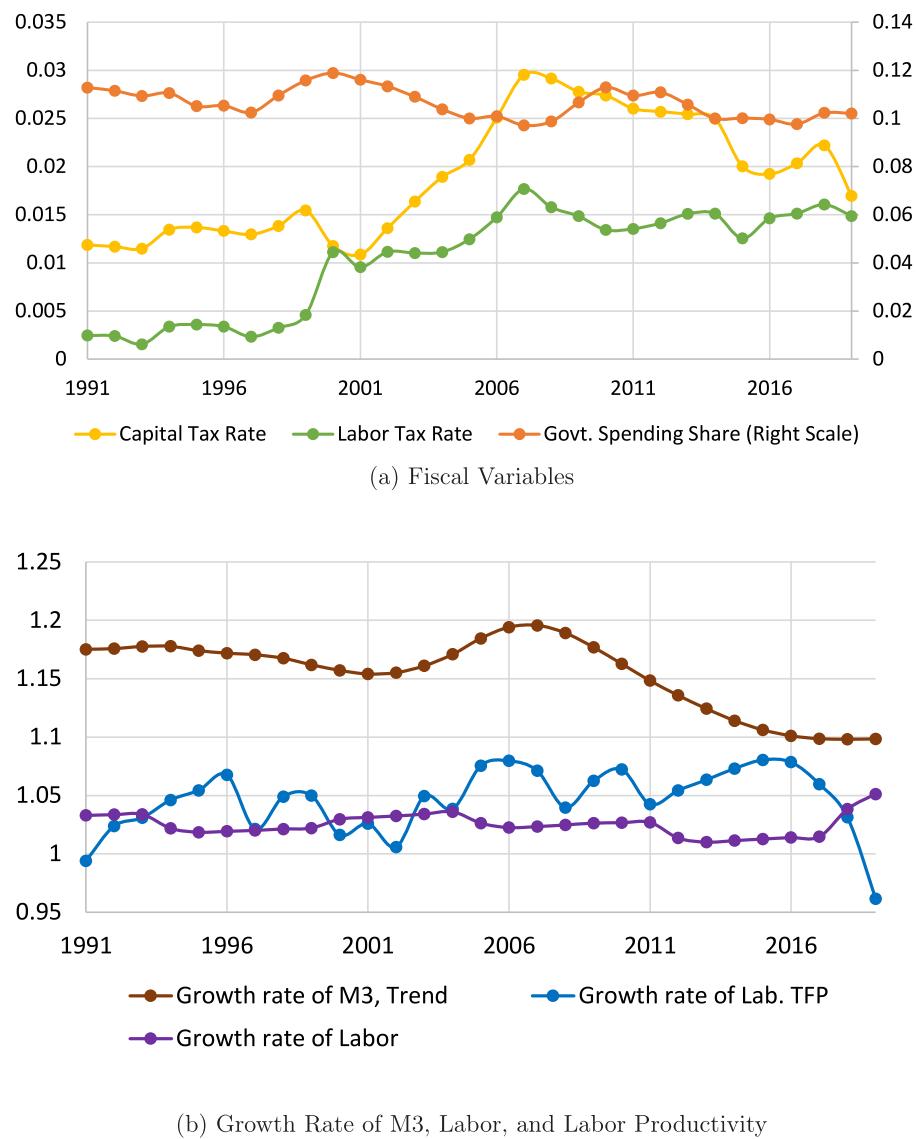


Fig. 6. Exogenous trends in potential drivers of savings.

yields some non-monotonicity in the savings rate from the model, it does not conform to the timing of the peak in the data. It is also not able to capture the steep rise in the savings rate during the pre-2008 period, and the subsequent decline.<sup>13</sup>

#### 4. The benchmark model

As mentioned in the Introduction, the hump in the savings rate could possibly be driven by inflation dynamics interacting with risk-aversion over the sample period in the Indian economy. Further, as shown in Fig. 4, we find that the M3 growth rate and inflation are strongly correlated with M3 growth *Granger causing* inflation over the sample period. We, therefore, construct a monetary-growth model with perfect foresight. We refer to this as the *benchmark* model going forward. The model is standard. Money enters via a cash-in-advance constraint on both consumption and investment as in Dotsey and Sarte (2000). This allows us to capture the impact of inflation dynamics on household savings behavior in a tractable way. Introducing money via a cash in advance constraint allows us to generate a large deviation from neutrality that helps drive the *hump* in the Indian savings rate. The other features of the model are similar to Fernández et al. (2019).

On the production side, a representative firm produces a final good using capital,  $K_t$  and labor,  $H_t$  using a Cobb-Douglas technology:

$$Y_t = K_t^\theta (A_t H_t)^{1-\theta}.$$

We assume that the labor augmenting TFP ( $A_t$ ) grows exogenously. Solving a standard static profit maximization problem with respect to labor and capital yields

$$w_t = (1 - \theta) \cdot \frac{p_t Y_t}{H_t}, \quad r_t = \theta \cdot \frac{Y_t}{K_t},$$

where  $p_t$ ,  $w_t$  and  $r_t$  are the price of the final good, the nominal wage rates and the real return to capital, respectively.

A representative household with  $N_t$  working age members maximizes lifetime discounted utility:

$$\sum_{t=0}^{\infty} \beta^t N_t \frac{(c_t^{1-\alpha} (\bar{h} - h_t)^\alpha)^{1-\sigma} - 1}{1 - \sigma}, \quad \alpha \in (0, 1); \sigma > 0 \quad (1)$$

where,  $c_t = C_t/N_t$  is per-capita consumption,  $h_t = H_t/N_t$  is the per-capita labor and  $\bar{h}$  is per-person time endowment.<sup>14</sup> The parameters  $\beta$ ,  $\alpha$  and

<sup>13</sup> The basic mechanism driving savings in Fernández et al. (2019) is as follows. A capital-poor economy accumulates capital over time since the marginal product of capital is high. With an increase in capital accumulation, the rate of return on capital falls, which has two off-setting effects on current consumption. On the one hand, lower rates of return lower incomes, and hence due to the income effect, current consumption falls. In a static framework, both consumption and savings are bound to decline via the income effect. But given the inter-temporal nature of the household's optimization problem, the income effect channel results in a much more significant decline in consumption, which, on the net, results in an increase in savings. This enables consumption smoothing in future periods. The other effect of a fall in the rate of return, namely the substitution effect, however, disincentivises savings in the current period as the opportunity cost of current consumption is higher. The overall impact due to a fall in the rate of return determines which effect dominates. In Fernández et al. (2019), households have log preferences, i.e., a special case of CRRA preferences with the inter-temporal elasticity of substitution being equal to 1, where the income and substitution effects cancel out. For households with  $\sigma > 1$ , the income effect dominates over the substitution effect. This also supports the findings of Samantaraya and Patra (2014) who show using an ARDL framework that inflation and the real interest rate have negative effects on household savings, both in the short and long run. The adverse effects of high real interest rates on savings suggest that the income effect dominates the substitution effect.

<sup>14</sup> To verify whether our results are theoretically robust, we also work out the case with recursive preferences, as in Epstein and Zin (2013). Preferences

$\sigma$  are the discount rate, the share of leisure in the utility function and the rate of risk aversion, respectively. The household maximizes the discounted lifetime utility function subject to a cash-in-advance (2) and a budget constraint (3):

$$c_t N_t + \psi(K_{t+1} - (1 - \delta)K_t) \leq \frac{m_t}{p_t} + (g_{M_t} - 1) \frac{M_t}{p_t}, \quad (2)$$

$$c_t N_t + K_{t+1} - (1 - \delta)K_t + \frac{\kappa}{2} K_t \left( \frac{K_{t+1}}{K_t} - n_t g_{A_t} \right)^2 + \frac{m_{t+1}}{p_t} \leq (1 - \tau_{L_t}) \frac{w_t}{p_t} h_t N_t + (r_t - \tau_{K_t} (r_t - \delta)) K_t + \frac{m_t + (g_{M_t} - 1) M_t}{p_t} + Z_t \quad (3)$$

Eq. (2) states that consumption and a portion of investment,  $\psi \in [0, 1]$ , requires cash-in-advance (CIA). This specification follows Dotsey and Sarte (2000). Real money balances are given by  $\frac{m_t}{p_t}$ ,  $m_t$  is the household's nominal money balance, and  $M_t$  is the exogenous nominal stock of money in the economy. Eq. (3) is the resource constraint faced by the household. The LHS describes household expenditure on consumption, investment (including capital adjustment costs) and future money holding. The RHS includes all income, including after-tax rental income from labor and capital, current money balances, money supply and transfers from the government ( $Z_t$ ).  $\delta \in [0, 1]$  is the rate of depreciation of capital, while  $\tau_{L_t} \in [0, 1]$  and  $\tau_{K_t} \in [0, 1]$  are the exogenous taxes on labor income and capital income, respectively.  $g_{M_t}$ ,  $n_t$  and  $g_{A_t}$  denote the growth rate of money, the growth rate of population, and the growth rate of TFP, respectively.

The first order conditions of the constrained optimization problem with respect to  $c_t$ ,  $h_t$ ,  $K_{t+1}$  and  $m_{t+1}$  respectively, yields:

$$(1 - \alpha) \beta^t c_t^{-\alpha - \gamma(1-\alpha)} (\bar{h} - h_t)^{\alpha(1-\gamma)} = \lambda_{1t} + \lambda_{2t}, \quad (4)$$

$$\alpha \beta^t c_t^{(1-\alpha)(1-\gamma)} (\bar{h} - h_t)^{-\alpha\gamma-1+\alpha} = \lambda_{2t} (1 - \tau_{L_t}) \frac{w_t}{p_t}, \quad (5)$$

$$\lambda_{1t} \psi + \lambda_{2t} = \lambda_{1t+1} \psi (1 - \delta) + \lambda_{2t+1} [1 + (1 - \tau_{K_{t+1}}) (r_{t+1} - \delta)], \quad (6)$$

$$\frac{\lambda_{1t+1} + \lambda_{2t+1}}{p_{t+1}} = \frac{\lambda_{2t}}{p_t}, \quad (7)$$

where  $\lambda_{1t}$  and  $\lambda_{2t}$  are the Lagrange multipliers for the CIA constraint and the household budget constraint, respectively.

The government budget constraint is as follows:

$$\tau_{K_t} (r_t - \delta) K_t + \tau_{L_t} \frac{w_t}{p_t} h_t N_t = \chi_t Y_t + Z_t \quad (8)$$

where  $\chi_t = G_t/Y_t$  is an exogenous variable. The economy-wide resource constraint is:

$$c_t N_t + K_{t+1} - (1 - \delta)K_t + \frac{\kappa}{2} K_t \left( \frac{K_{t+1}}{K_t} - 1 \right)^2 = (1 - \chi_t) K_t^\theta (A_t H_t)^{1-\theta} \quad (9)$$

#### Equilibrium

As is standard in the literature, TFP and money supply grow at the exogenous rate  $g_{A_t}$  and  $g_{M_t}$ , i.e.,  $A_{t+1} = g_{A_t} A_t$  and  $M_{t+1} = g_{M_t} M_t$ . The equilibrium is determined such that the firm's and the household's optimization conditions are satisfied, and the government budget and the goods market clearing conditions hold. We make the system stationary

are now given by

$$U_t = \left[ \omega_1 \left\{ \frac{(c_t^{1-\alpha} (\bar{h} - h_t)^\alpha)^{1-\sigma}}{1 - \sigma} \right\}^{\frac{1-\gamma}{\theta}} + \omega_2 (U_{t+1})^{\frac{1-\gamma}{\theta}} \right]^{\frac{\theta}{1-\gamma}},$$

where  $\omega_1 + \omega_2 = 1$  and  $\omega_1, \omega_2 \geq 0$ . While these preferences help explain India's non-monotonic savings path, the calibrated savings path peaks earlier. The calibrated results are also sensitive to parameter choices and produce lower pre- and post-peak correlations with the data compared to our benchmark model. We thank an anonymous referees for asking us to work out this case. These results are available from the authors on request.

by de-trending all variables – except labor and the returns to capital – to their normalized form. For any variable  $Z$ , its normalized form is  $\tilde{z}$ .

The stationary (de-trended) dynamic system is:

$$\begin{aligned}
 \text{CIA: } \tilde{c}_t + \psi(g_{At} n_t \tilde{k}_{t+1} - (1 - \delta) \tilde{k}_t) &= \frac{g_{Mt}}{\tilde{p}_t}, \\
 \text{Mkt. Clg.: } \tilde{c}_t + g_{At} n_t \tilde{k}_{t+1} - (1 - \delta) \tilde{k}_t + \frac{\kappa n_t g_{At} \tilde{k}_t}{2} \left( \frac{\tilde{k}_{t+1}}{\tilde{k}_t} - 1 \right)^2 \\
 &= (1 - \chi_t) \tilde{k}_t^{\theta} h_t^{1-\theta}, \\
 \text{FOC h: } \tilde{\lambda}_{2t} &= \frac{\alpha(\bar{h} - h_t)^{-\alpha\sigma-1+\alpha} (\tilde{c}_t)^{(1-\alpha)(1-\sigma)}}{(1 - \tau_{L_t}) \tilde{w}_t}, \\
 \text{FOC c: } \tilde{\lambda}_{1t} + \tilde{\lambda}_{2t} &= (1 - \alpha) (\tilde{c}_t)^{(1-\alpha)(1-\sigma)-1} (\bar{h} - h_t)^{\alpha(1-\sigma)}, \\
 \text{FOC m: } g_{At} \cdot \frac{\tilde{\lambda}_{1t+1} + \tilde{\lambda}_{2t+1}}{\tilde{\lambda}_{2t}} &= \frac{g_{Mt}}{g_{At} n_t} \frac{\tilde{p}_{t+1}}{\tilde{p}_t}, \\
 \text{FOC k: } \tilde{\lambda}_{1t} \psi - g_{At} \tilde{\lambda}_{1t+1} \psi (1 - \delta) + \tilde{\lambda}_{2t} \left( 1 + \kappa g_{At} n_t \left( \frac{\tilde{k}_{t+1}}{\tilde{k}_t} - 1 \right) \right) &= \\
 &\quad \tilde{\lambda}_{2t+1} [1 + (1 - \tau_{K_{t+1}})(r_{t+1} - \delta) \\
 &\quad + \kappa (g_{At+1} n_{t+1})^2 \frac{\tilde{k}_{t+2}}{\tilde{k}_{t+1}} \left( \frac{\tilde{k}_{t+2}}{\tilde{k}_{t+1}} - 1 \right) r \\
 &\quad - \frac{\kappa (g_{At+1} n_{t+1})^2}{2} \left( \frac{\tilde{k}_{t+2}}{\tilde{k}_{t+1}} - 1 \right)^2] \\
 \text{Firm FOCs: } \tilde{w}_t &= (1 - \theta) \left( \frac{\tilde{k}_t}{h_t} \right)^{\theta}, \quad r_t = \theta \left( \frac{\tilde{k}_t}{h_t} \right)^{-(1-\theta)}
 \end{aligned}$$

where  $g_{At} = \beta g_{At}^{(1-\alpha)(1-\sigma)-1}$  and the normalized variables are:

$$\begin{aligned}
 \tilde{k}_t &= \frac{K_t}{A_t N_t}, \quad \tilde{c}_t = \frac{c_t}{A_t}, \quad \tilde{p}_t = \frac{p_t A_t N_t}{M_t}, \quad \tilde{w}_t = \frac{w_t}{p_t A_t}, \\
 \tilde{\lambda}_{1t} &= \frac{\lambda_{1t}}{\beta^t A_t^{(1-\alpha)(1-\sigma)-1}}, \quad \tilde{\lambda}_{2t} = \frac{\lambda_{2t}}{\beta^t A_t^{(1-\alpha)(1-\sigma)-1}}.
 \end{aligned}$$

Given the exogenous variables,  $\{g_{At}, g_{Mt}, n_t, \chi_t, \tau_{K_t}, \tau_{L_t}\}_{t=0}^{\infty}$ , we get the private savings rate equals to:

$$s_t = \frac{Y_t - G_t - c_t N_t}{Y_t} = \frac{k_{t+1} g_{At} n_t - (1 - \delta) k_t}{y_t}$$

In the long run,  $\lim_{t \rightarrow \infty} [g_{At}, g_{Mt}, n_t, \chi_t, \tau_{K_t}, \tau_{L_t}] = [g_A^*, g_M^*, n^*, \chi^*, \tau_K^*, \tau_L^*]$ . We summarize the steady state in the Appendix. We have the following Proposition.

**Proposition 1.** *The steady-state savings rate is decreasing in the tax rate on capital income ( $\tau_K^*$ ), money supply growth rate ( $g_M^*$ ), and the growth rate of labor augmenting TFP ( $g_A^*$ ). It is increasing in the population growth rate ( $n^*$ ). Further, it is independent of government spending shares or the tax rate on labor income.*

**Proof.** From (A.5), (A.6) and (A.7), we get:

$$\begin{aligned}
 \frac{\tilde{\lambda}_1^*}{\tilde{\lambda}_2^*} &= \ell = \frac{g_M^*}{g_A^* n^* g_A^*} - 1, \quad \frac{\tilde{y}^*}{\tilde{k}^*} = \frac{r^*}{\theta}, \\
 1 + (1 - \tau_K^*)(r^* + \delta) &= \frac{\psi \ell (1 - g_A^*(1 - \delta)) + 1}{g_A^*}.
 \end{aligned}$$

Based on the above expressions, we get the steady state savings rate as

$$\begin{aligned}
 s^* &= (g_A^* n^* - 1 + \delta) \frac{\tilde{k}^*}{\tilde{y}^*} \\
 &= (g_A^* n^* - 1 + \delta) \theta \left[ \frac{1}{(1 - \tau_K^*)} \left[ \frac{\psi \ell (1 - g_A^*(1 - \delta)) + 1}{g_A^*} - 1 \right] - \delta \right]^{-1} \\
 &= s^* \left( \tau_K^*, g_M^*, g_A^*, n^* \right) \quad \square
 \end{aligned}$$

Note, for  $\sigma = 1$ , we have  $g_A^* = \beta/g_A^*$  and **Proposition 1** continues to hold. This matches the findings in Barro and Sala-i Martin (2004).<sup>15</sup>

## 5. Calibration

We calibrate the benchmark model to match Indian data for the years 1991–2019. We choose the post-reform period as this period is a closer proxy to a market economy (see Ghate et al., 2013). For our analysis, we focus on six major exogenous variables across different models. The variable  $\chi_t$  is matched to the government spending share as a percentage of GDP.  $\tau_{L_t}$  is equal to the ratio of total direct taxes to GDP whereas  $\tau_{K_t}$  is the ratio of total corporate taxes to GDP, all of which are calculated using the RBI Handbook of Statistics. The growth rate of labor ( $n_t$ ) is approximated by employment growth. This and labor-augmenting TFP growth ( $g_{At}$ ) data, both, are obtained from the India KLEMS database (see RBI, 2022). These variables are common with Fernández et al. (2019). From the same data source, we get the growth rate of broad money ( $g_{Mt}$ ), i.e., the M3 growth rate.<sup>16</sup>

Fig. 6 plots the exogenous variables for India. We find that the government spending share has remained flat at around 11%–12%. Labor taxes have risen over time, whereas, capital tax rates peaked around the same time as the savings rate, before declining. M3 growth has been declining after 2007. Trends in labor growth and labor augmenting TFP have, however, remained stable.

We list parameters in Table 1. The discount rate  $\beta = 0.96$  is obtained by taking the average of the inverse of the real interest rate obtained from the WDI for the period 1991–2019. The capital share  $\theta = 0.5$  is obtained from the India KLEMS database by taking the average share during the period 1991–2019. Finally,  $\alpha = 0.15$  is calibrated to obtain the average labor hours for India from the CBTED database. The total labor hours,  $\bar{h} = 2496$  is the legal requirement of the total labor endowment, based on an 8-hour working day for a six-day working week. The remaining four parameters,  $\kappa, \delta, \sigma$  and  $\psi$ , are matched to existing values in the literature.

The steady-state values of all exogenous variables are assumed to be equal to the average values during the period 1991–2019. These are summarized as starred values in Table 1. The initial normalized capital is fixed such that

$$\frac{\tilde{k}_0}{\tilde{k}^*} = \frac{K_{t=1991} / (A_{t=1991} \cdot N_{t=1991})}{K_{t=2019} / (A_{t=2019} \cdot N_{t=2019})} = 0.885.$$

Based on Table 1, we calculate the steady-state values in the Appendix. Further, we match some of the long-run moments of the data and the model in Table A.3. The match between the benchmark model and data is quite close.

We plot the savings rate for the benchmark model and data in Fig. 7.<sup>17</sup> The model shows weak non-monotonicity in the savings rate around 2008. The peak savings rate in the model arises in 2006 at 33%, much lower than what is seen in the RBI data. The correlation for 1991–2008 between the benchmark model and data is 0.88, while in the latter period, it is 0.56. The correlations are statistically significant at the 10% level of significance. The only concern is that the mid-period savings rates are much lower and the hump is not as sharp in the model relative to the data.

The benchmark model has two mechanisms driving the savings rate: (a) risk aversion, and (b) the role of inflation (via money supply). In

<sup>15</sup> In a continuous time Ramsey model with CRRA preferences, Cobb Douglas production, population growth and labor augmenting TFP growth, the steady-state savings rate depends positively on the population growth rate and negatively on the TFP growth rate (see Chapter 2, Appendix 2C, Barro and Sala-i Martin, 2004).

<sup>16</sup> Since the growth rate of M3 fluctuates a lot, we use the trend component of M3 growth in our model.

<sup>17</sup> We use MATLAB 2022b version and Dynare 5.3 versions to calibrate the model.

**Table 1**  
Parameters for the benchmark calibration.

Parameter	Value	Description	Source
$\beta$	0.96	Discount factor	Authors' Calculations; WDI
$\theta$	0.5	Capital share	India KLEMS, RBI (2022)
$\alpha$	0.12	Weight on leisure	Calibrated
$\bar{h}$	2496	Total labor hours	Legal Requirement
$\delta$	0.1	Capital deprec. rate	Feenstra et al. (2015)
$\sigma$	2	CRRA parameter	Gabriel et al. (2012)
$\kappa$	2	Cap. adj. cost parameter	Banerjee and Basu (2019)
$\psi$	1	Fraction of investment financed by cash	Cooley and Hansen (1989)
$\chi^*$	0.10	Government spending as % GDP	GOI (2024)
$\tau_K^*$	0.019	Capital tax rate	GOI (2024)
$\tau_L^*$	0.0104	Labor income tax rate	GOI (2024)
$g_M^*$	1.1545	Money supply growth rate	RBI (2024)
$n^*$	1.0252	Employment growth	India KLEMS, RBI (2022)
$g_A^*$	1.0455	Lab Aug. TFP growth	India KLEMS, RBI (2022)

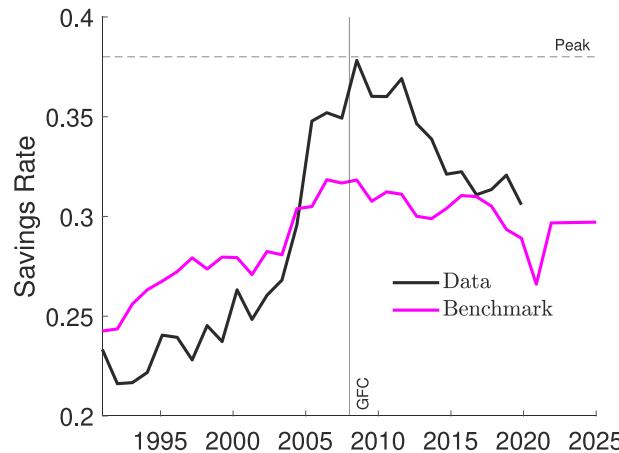


Fig. 7. Savings rate: Benchmark vs. Data.

the data, the pre-2008 period is characterized by a fall in the real rate of return on capital and high inflation. CPI inflation peaked in 2009, after which it fell steadily. Since the household can foresee the time paths of the real rate of return and inflation in our model, a high future wealth due to low future inflation and risk aversion will translate into front-loading of consumption by the household in the initial periods. Furthermore, to smooth the path of consumption in transition, the household increases its savings in the run-up to the peak of CPI inflation in 2009. Thereafter, during the phase of declining inflation, i.e., post-2009, the savings rate stagnates. We observe this in Fig. 7.

## 6. Adding heterogeneity

There is a large literature on how demographic changes play a key role in the rise of savings rates. In the context of India, see Curtis et al. (2015, 2017). In particular, Curtis et al. (2017) provides a unified framework to explain the saving patterns of Japan, China and India over the period 1955–2010. The demographic shifts (which include declining fertility and mortality, and increased longevity) change the ratio of savers to non-savers and the household size which in turn affect the savings rate. For India, they find that a reduction in family size is an important factor that explains the trends in savings rates.<sup>18</sup>

<sup>18</sup> Further, Curtis et al. (2017) forecast till 2050 and show that India's savings rate is likely to grow and remain high relative to its 2000 levels. While this quantitative life cycle model explains the long-run trends in savings rates up to 2010, it does not address the short-term (hump-shaped) changes in the savings rate witnessed for India. Given that there have been no sudden changes

To improve the fit, we now incorporate demographic changes into the benchmark model to explain both the rise and the decline in the Indian savings rate in the post-liberalization era. We consider two types of representative households - "Ricardian" and "Rule of Thumb".<sup>19</sup> The Ricardian households are made up of formal workers and are savers. They continue to remain risk-averse households as in the benchmark model, Section 4. They consume,  $c_{Rt}$ , and save in the form of investment goods and hold money balances inter-temporally. They face a CIA constraint on consumption and investment.

The rule of thumb households are assumed to be made up of informal workers and do not save.<sup>20</sup> Their consumption is denoted by,  $c_{Pt}$ . They earn less than the formal workers and consume all their earnings from wage income. At every period, the ratio of formal to informal workers is denoted by  $x_t$ .

The informal worker maximizes the following lifetime utility function:

$$\sum_{i=0}^{\infty} \beta^i N_{Pt} \frac{(c_{Pt}^{1-\alpha} (\bar{h} - h_{Pt})^{\alpha})^{1-\gamma} - 1}{1-\gamma}$$

subject to the budget constraint  $w_{Pt} h_{Pt} N_{Pt} = p_t c_{Pt} N_{Pt}$ . Note,  $N_{Pt} = L_t / (1 + x_t)$  is the size of the informal sector, while  $L_t$  is the total labor force in the economy.  $h_{Pt}$  is the per-capita labor hours supplied by the worker who earns  $w_{Pt}$  which goes into the consumption of the final good,  $c_{Pt}$ . The first-order conditions are:

$$h_{Pt} = (1 - \alpha) \bar{h}, \quad p_t c_{Pt} = (1 - \alpha) w_{Pt} \bar{h}. \quad (10)$$

Firms produce final output using composite labor and capital. Composite labor aggregates both formal and informal labor. To allow for formal and informal labor to be substitutes or complements, we assume that the production function is a nested CES function similar to Ghate et al. (2016).

$$Y_t = K_t^{\theta} \left( A_t (a H_{Rt}^{\rho} + (1-a) H_{Pt}^{\rho})^{\frac{1}{\rho}} \right)^{1-\theta}, \quad \rho < 1, \quad \theta \in (0, 1)$$

in the age distribution of India's population or fertility rates, these factors are unlikely to explain the sudden decline in the Indian savings rate post-2008. As the 2008-decline in savings rate has been persistent, having heterogeneous (in our model, two types) agents seems like a natural next step to incorporate into the model.

<sup>19</sup> See Gabriel et al. (2012), Bhattacharya and Patnaik (2016), and Banerjee et al. (2020) for two-agent DSGE models in the Indian context.

<sup>20</sup> Typically, in the literature, liquidity-constrained households, which form a sizable share of households in emerging and developing economies, undertake savings for pre-cautionary purposes. However, given that their incomes are stationary and stochastic, they save as often as they dissipate. Therefore, in the net, they may not contribute sufficiently to aggregate savings behavior (see Deaton, 1991). In this paper, however, we do not assume stochastic incomes.

where  $1/(1-\rho)$  is the elasticity of substitution between the two types of labor, and  $a \in [0, 1]$  is the share of formal households in the production function.  $p_t$  is the price of the final good. The first-order conditions of the firm's problem are

$$r_t K_t = \theta Y_t, \quad w_{Rt} \frac{(aH_{Rt}^\rho + (1-a)H_{Pt}^\rho)}{H_{Rt}^{\rho-1}} = a(1-\theta)p_t Y_t,$$

$$\frac{w_{Pt}}{w_{Rt}} = \frac{1-a}{a} \left( \frac{H_{Pt}}{H_{Rt}} \right)^{\rho-1}.$$

Finally, the goods market condition is given by

$$c_{Rt} N_{Rt} + c_{Pt} N_{Pt} + K_{t+1} - (1-\delta)K_t + \frac{\kappa}{2} K_t \left( \frac{K_{t+1}}{K_t} - 1 \right)^2 = (1-\chi_t)Y_t.$$

As in the benchmark economy, we derive the equilibrium conditions for the de-trended economy. We also make the system stationary by de-trending all variables – except formal and informal labor, and the returns to capital – to their normalized form. Therefore, as in the benchmark economy, for any variable  $Z$ , its normalized form is  $\bar{z}$ . The stationary (or de-trended) dynamic system is:

$$\begin{aligned} \text{Prod Fun: } & \bar{y}_t = \tilde{k}_t^\theta (a(h_{Rt}x_t)^\rho + (1-a)h_{Pt}^\rho)^{\frac{1-\theta}{\rho}}, \\ \text{Firm Focs: } & r_t \tilde{k}_t = \theta \bar{y}_t, \quad \tilde{w}_{Pt} h_{Pt} \left( a \left( \frac{h_{Rt}x_t}{h_{Pt}} \right)^\rho + (1-a) \right) = (1-a)(1-\theta)\bar{y}_t, \\ & \frac{\tilde{w}_{Pt}}{\tilde{w}_{Rt}} = \frac{1-a}{a} \left( \frac{h_{Pt}}{h_{Rt}x_t} \right)^{\rho-1}, \\ \text{Poor Hh: } & h_{Pt} = (1-\alpha)\bar{h}, \quad \tilde{c}_{Pt} = (1-\alpha)\tilde{w}_{Pt}\bar{h}, \\ \text{CIA: } & \tilde{c}_{Rt}x_t + \psi(g_{At}g_{Nt}p_t)\tilde{k}_{t+1} - (1-\delta)\tilde{k}_t = \frac{g_{Mt}}{\tilde{p}_t}, \\ \text{Mkt. Clg.: } & \tilde{c}_{Rt}x_t + \tilde{c}_{Pt} + g_{At}g_{Nt}p_t\tilde{k}_{t+1} - (1-\delta)\tilde{k}_t \\ & + \frac{\kappa(g_{Nt}p_tg_{At})^2}{2}\tilde{k}_t \left( \frac{\tilde{k}_{t+1}}{\tilde{k}_t} - 1 \right)^2 = (1-\chi_t)\tilde{k}_t^\theta h_t^{1-\theta}, \\ \text{FOC } h_R: & \alpha \tilde{c}_{Rt}^{(1-\alpha)(1-\gamma)} (\bar{h} - h_{Rt})^{-a\gamma-1+\alpha} = \tilde{\lambda}_{2t}(1-\tau_{Lt})\tilde{w}_{Rt} \\ \text{FOC } c_R: & (1-\alpha)\tilde{c}_{Rt}^{(1-\alpha)(1-\gamma)-1} (\bar{h} - h_{Rt})^{\alpha(1-\gamma)} = \tilde{\lambda}_{1t} + \tilde{\lambda}_{2t} \\ \text{FOC } m: & \frac{g_{Mt}}{g_{At}g_{Nt}p_t} \frac{\tilde{\lambda}_{2t}}{\tilde{p}_t} = g_{At} \frac{\tilde{\lambda}_{1t+1} + \tilde{\lambda}_{2t+1}}{\tilde{p}_{t+1}} \\ \text{FOC } k: & \tilde{\lambda}_{1t}\psi - g_{At}\lambda_{1t+1}\psi(1-\delta) + \tilde{\lambda}_{2t} \left( 1 + \kappa g_{At}g_{Nt}p_t \left( \frac{\tilde{k}_{t+1}}{\tilde{k}_t} - 1 \right) \right) = \\ & g_{At}\tilde{\lambda}_{2t+1} \left[ 1 + (1-\tau_{Kt+1})(r_{t+1} - \delta) + \kappa (g_{At+1}g_{Nt+1})^2 \frac{\tilde{k}_{t+2}}{\tilde{k}_{t+1}} \left( \frac{\tilde{k}_{t+2}}{\tilde{k}_{t+1}} - 1 \right) \right] \\ & - \frac{\kappa(g_{At+1}g_{Nt+1})^2}{2} \left( \frac{\tilde{k}_{t+2}}{\tilde{k}_{t+1}} - 1 \right)^2 \end{aligned}$$

where  $g_{Nt}p_t = n_t(1+x_t)/(1+x_{t+1})$ . Here, the detrending is done by dividing a variable by  $A_t N_{Pt}$ . We solve the steady state in the Appendix. Note, the savings rate expression is the same in the Benchmark and **Proposition 1** holds as well. Thus, we find that the steady-state savings rate is independent of the new exogenous variable ( $x^*$ ).

### Calibration

We use the data on regular workers as a proxy for the size of households that are Ricardian. The remaining workers, which include casual workers and self-employed workers, constitute Rule of Thumb workers. As seen in Fig. 8, broadly the ratio of regular to other workers has been increasing since the 1990s.<sup>21</sup> Mehrotra (2019) finds that the

<sup>21</sup> This data series is based on calculations using several rounds of the NSS and PLFS data. The Worker participation rates (WPR) based on usual principal and subsidiary status are obtained from the 50th (1993–94), 55th (1999–2000), 61st (2007–08), 66th (2009–10), and 68th (2011–12) NSS rounds and three PLFS rounds (2017–18, 2018–19, 2019–20). The WPRs are then applied to the census population to derive the total number of persons

**Table 2**  
Fit of heterogeneous agent model with data.

Variable	Targeted or Untargeted	Two Hh model	Data
$[h_P^*, h_R^*]$	Targeted	[2048.3, 2196.5]	Annual avg working hrs is 2098
$\frac{w^* L^*}{p^* y^*}$	Targeted	0.5	Average labor share is 0.5
$\frac{k^*}{y^*}$	Untargeted	1.74	Average capital–output ratio is 3.09
$\frac{c^*}{y^*}$	Untargeted	0.60	Average consump–output ratio is 0.60

number of casual wage workers (an important indicator of informal employment) increased between 2004–05 and 2011–12 (from 132.5 million to 141.9 million) before declining to 116 million in 2017–18. Hence a decline in the relative share of contractual workers in the sample period indicates that the size of the regular workers is increasing more rapidly than the casual workers. The three additional parameters in this model are related to the labor composite and the steady state share of formal to informal workers. Their values are  $\rho = -0.1$ ,  $a = 0.6$  and  $x^* = 0.3211$ .<sup>22</sup> Further, we assume that the risk aversion of both types of households is the same, i.e.  $\gamma = \sigma = 2$ , as in Gabriel et al. (2012).

In Table 2, we show that the heterogeneous agent model shows a good fit with the data. The targeted moments, steady state annual working hours and labor share of output, match closely. We look at two un-targeted moments — the capital–output ratio and consumption–output ratio at the steady state. The capital–output ratio is close but less than its value in the Indian data. The fit in the consumption–output ratio is better.

Fig. 9 plots the savings rate of the model with heterogeneous agents. Compared to the benchmark economy, we find that including both types of agents is able to better track the dynamics of the savings rate. It also sharply captures the drop in the savings rate in the post-2008 period. The correlation in the pre-2008 period between model and data is 0.62 while that of the post-2008 period is 0.9. Both correlations are statistically significant at the 1% level of significance. The rising share of formal workers in the economy implies that the general equilibrium interactions between the ratio of savers to non-savers and inflation is able to provide a plausible explanation for the dynamics of the savings rate.<sup>23</sup>

How does adding two types of households change the mechanism? We decompose the savings rate pattern stemming from different exogenous variables. In Fig. 10, the green line depicts the savings rate when only demographics ( $x_t$ ) change as per data and all other exogenous variables are kept at their steady-state values. This is also the case for other lines. The pink line shows the savings rate trajectory if only the fiscal

employed for benchmark years. The data for the non-benchmark years are interpolated to create the time series for 1990–91 to 2019–20. The total number of people employed is further distributed to regular salaried and other workers. Other workers include casual and self-employed workers. Following NSSO and PLFS classifications, regular workers correspond to activity status code 31. Casual workers correspond to activity status codes 41 and 51. Finally, the self-employed workers correspond to activity status codes 11, 12 and 21.

<sup>22</sup> Unlike other exogenous variables, the ratio of regular to other workers shows a strong upward trajectory. Hence, the long-run value of  $x_t$  is assumed to be the last period value of the regular-to-other-workers ratio.

<sup>23</sup> The dynamics of savings are robust to a variety of separate extensions: a cash in advance constraint on poor household in addition to rich households; allowing for subsistence consumption for both poor and rich households; and habits in consumption for both households. In each case, we find that the results obtained from these extensions are qualitatively consistent with those obtained in Section 6. These results are available from the authors on request.



Fig. 8. Ratio of regular to other workers.

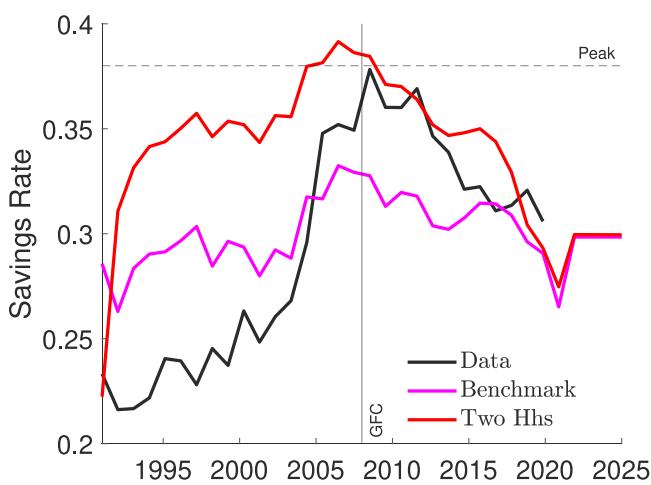


Fig. 9. The role of heterogeneity: Two-Household economy.

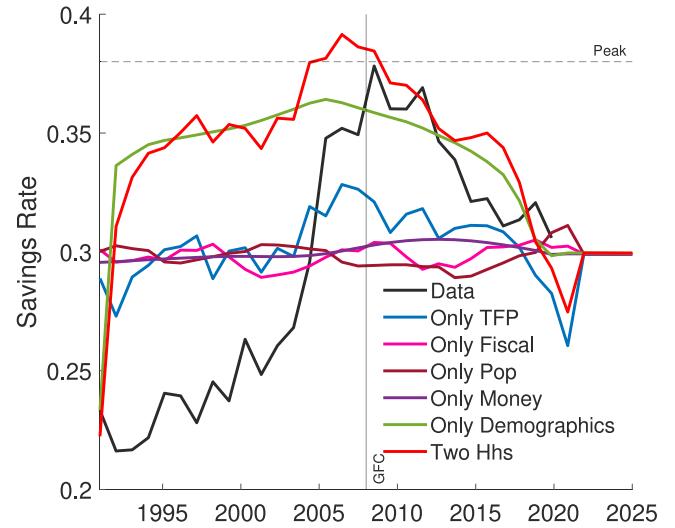


Fig. 10. Savings decomposition: Two-Household economy.

variables ( $\chi_t, \tau_{Kt}, \tau_{Lt}$ ) changed as per data while all other exogenous variables were constant. The hump in the savings rate is clearly driven by demographics, however, the short-term perturbations are explained by changes in the TFP growth rate. Inflation, demographics and the TFP growth rate — all three play a key role in understanding savings dynamics. As we saw before, the neo-classical growth model without money was inadequate in explaining the savings rate (as seen in Fig. 5(b)). A monetary growth model with a TFP growth rate (and other exogenous variables) partially explains the hump-shaped savings rate pattern, but the hump is less pronounced and at a lower level (as seen in the Benchmark, Fig. 7). To this model, when we add the growing proportion of savers to non-savers, the model matches the level in the Indian savings rate data quite well.

Post 2008, as inflation went down in India gradually, so did the need for household savings. Further, the role of greater formalization of the Indian economy pre-2008, which results in an increasing share of savers, magnifies the savings rate behavior and explains the pre-2008 rise in the savings rate. Due to declining inflation post-2008, Ricardian households reduce savings which, because of their rising demographic share, leads to a more pronounced decline in the savings rate. Thus,

the ratio of the savers to non-savers magnifies the steeper rise and a sharper fall in the savings rate.

In sum, the dynamics of savings in this model is similar to that in the benchmark model, only the magnitude of effects has changed due to an increasing proportion of savers to non-savers. Relative to the benchmark economy, there are fewer savers but their proportion grows over time. As a result, we obtain lower savings rates for the initial periods compared to the benchmark model, but over time the model savings rate is closer to the data. We see this dynamic effect in Fig. 9.

## 7. Policy recommendations

Since we are able to match the dynamics of savings rates in India reasonably well, we ask: what policy changes could arrest the decline of the savings rate? We know from [Proposition 1](#), that both *lower* capital taxes,  $\tau_K$ , and a *lower* growth rate of money supply,  $g_M$ , increase the *steady state* savings rate. Households have perfect foresight over both of these variables. As a result, changes induced

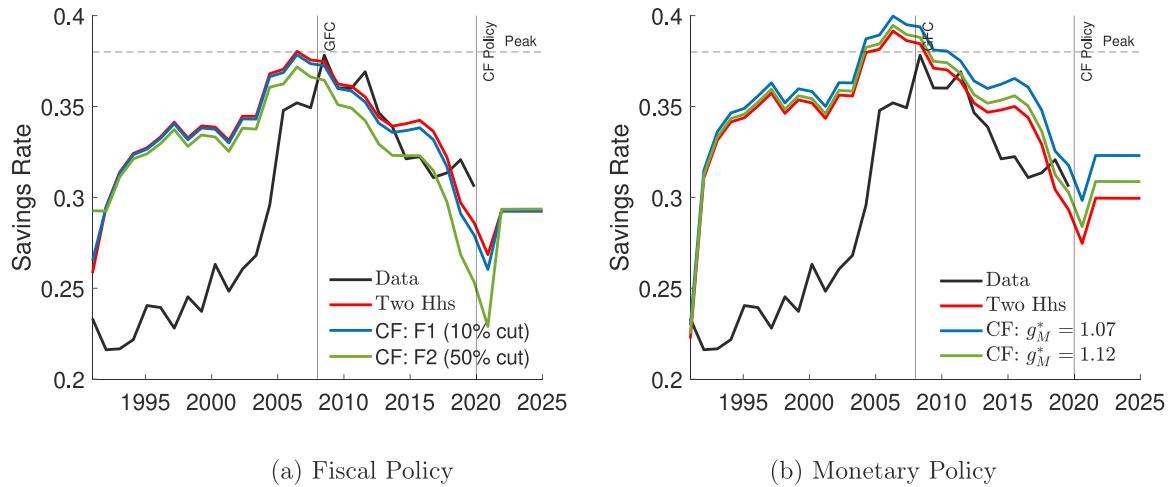


Fig. 11. Two household model counterfactuals: With different long-run policies.

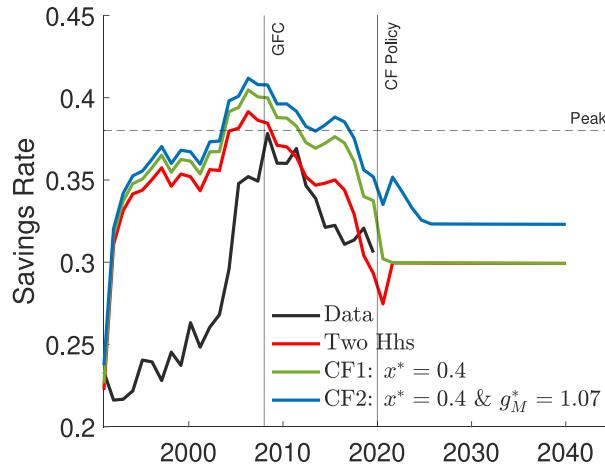


Fig. 12. Two household model counterfactuals: Demographics interacts with long-run monetary policy.

by these variables on the steady state savings rate, which households foresee, induce changes along the transitional savings path as well. This is key to understanding the policy effects of changes in  $\tau_K$  and  $g_M$ .

In Fig. 11, we show the effects of these policy changes. In the first policy experiment, on the left hand panel, we cut the long-run tax rates and the share of government spending by 10 percent (Counterfactual CF F1) and then 50 percent (Counter-factual CF F2). This allows us to isolate the effect of the increase in households' disposable income through fiscal policy. From Proposition 1, the decline in the capital income tax rate *increases* the steady-state savings rate ( $s^*$ ) in both cases by a very small amount. Because of an increase in the household's disposable income due to a cut in the tax rates and government spending, on the transition path, the income effect dominates which drives consumption to be higher and savings to be lower. The substitution effect, on the other hand, induces households to forego current consumption and save more. The stronger income effect on savings comes from the bigger tax cut experiment (CF2), which explains why the savings rate falls more in magnitude relative to the smaller tax cut.

As can be seen in the right-hand side panel of Fig. 11, monetary policy (through  $g_M$ ) changes has a bigger impact on the steady state savings rate. From a baseline M3 growth of 15 percent (red line), we reduce M3 growth to 7 percent (blue line) and 12 percent (green line). Given the parameterization of the model, the steady state savings rate increases by 1–2 percentage points, which is larger than the increase in the steady state savings rate from the fiscal policy experiment. The effect of  $g_M$  on the savings rate can be broken down into its impact on the steady state savings rate and the transitional impact. A decline in M3 growth implies lower inflation in the steady state. This leads to a higher steady state capital–output ratio, and a higher steady state savings rate from Proposition 1. The transitional path of the savings rate shifts outward (parallel) because the household has perfect foresight of every period, including the steady state. To smooth consumption, the household adjusts (raises) its savings rate in every period to reach the higher steady state savings. Therefore, monetary policy affects the transitional savings path through a combination of perfect foresight and the effect that it has on the steady state savings rate. Importantly, the path of the savings rate in transition continues to have a non-monotonic shape, adjusting for declining inflation post 2008 relative to earlier

periods, remaining consistent with our original thesis that the savings rate increases with a decline in inflation.

In another policy experiment in [Fig. 12](#), we arbitrarily increase the steady-state share of formal to informal workers ( $x^*$  increases to 0.4 from 0.32). This increases the savings rate throughout the time period. This, along with a lower steady-state growth rate of money supply, has stronger short-term effects in increasing the savings rate, as can be seen in the blue line.

Although the model is highly stylized, these experiments suggest that monetary policy changes that control inflation, interacting with a larger share of formal workers, have a greater impact than fiscal policy on savings dynamics. Even then, the effects are weak in the two-household economy.

## 8. Conclusion

Household savings in India, while rising until 2008, declined consistently until 2019, and are low today. The standard neoclassical growth model does not explain the non-monotonic trajectory of the savings rates experienced by some large economies. Motivated by this, we build a stylized monetary-growth model to explain the dynamic interactions between savings and inflation to mimic the hump-shaped trajectory of the savings rate in the Indian economy since 1991. We show that the savings dynamics in India after 1991 can be explained by a model that incorporates inflation – introduced via a cash-in-advance constraint on consumption and investment – and the presence of informal and formal households. These variables jointly interact with exogenous fiscal policy variables and total factor productivity growth to affect savings dynamics. Introducing money via a cash in advance constraint allows us to generate a large deviation from neutrality that helps drive

the *hump* in the Indian savings rate. Post 2008, as inflation went down in India gradually, so did the need for household savings as the real value of wealth rose. In the benchmark model, the decline in inflation interacts with TFP changes to explain a weak rise and then a fall in the savings rate. The rise in formal workers strengthens the non-monotonicity. Greater formalization of the Indian economy pre-2008, which results in an increasing share of savers, helps explain the sharp pre-2008 rise in the savings rate and the subsequent decline.

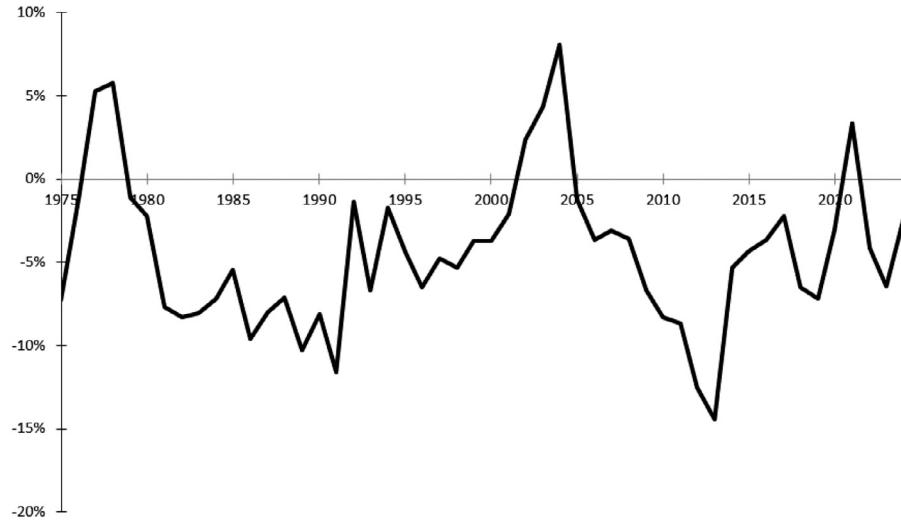
Our paper identifies a mechanism - that the path of inflation and savings are dynamically associated - and when coupled with risk aversion and household heterogeneity - these features mimic the hump-shaped pattern of savings seen in the Indian data. The framework offers a potential explanation of the Great Indian Savings Puzzle. Future work can empirically test the non-linear dynamic interaction of household savings and inflation in developing countries, as identified in our model. We have also not incorporated savings in physical assets in the model, whose fluctuations in value may have large wealth effects, and therefore impact household savings. In addition, the reduction in savings could have been influenced by the transition to easily available credit as various forms of borrowing instruments came into existence, and household liabilities rose in the early 2010s. This led to over-consumption and reduced savings, suggesting a less important role for inflation. We leave these extensions for future work.

## Declaration of competing interest

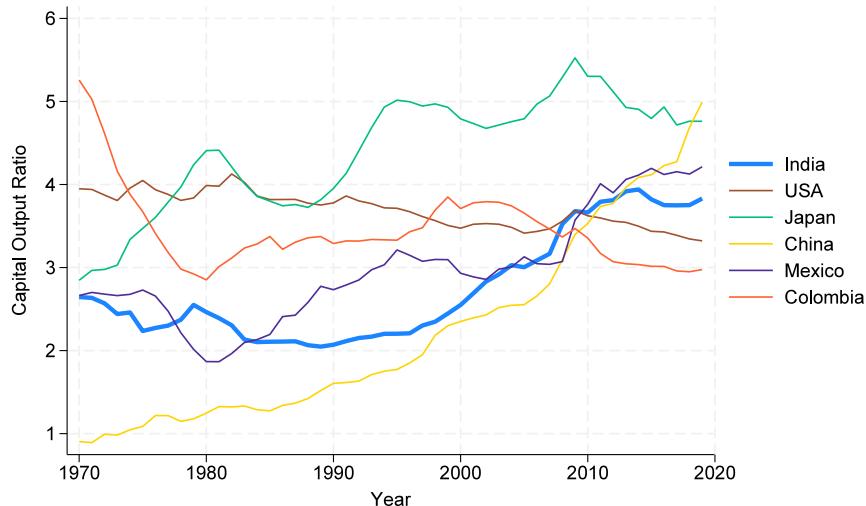
The authors declare that they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this paper.

## Appendix A

### Supplementary Charts



**Fig. A.1.** The current account balance as a percentage of gross investment in India.  
Source: National Accounts Statistics, GOI (2024).



**Fig. A.2.** Capital to output ratio.  
Source: Penn World Tables.

### Benchmark Model

The steady-state values based on the Indian economy for the Benchmark are listed in [Table A.2](#).

**Table A.1**

Steady state system of equations: Benchmark.

Name	Equation	
CIA:	$\tilde{c} + \psi \tilde{k} (g_A n - (1 - \delta)) = \frac{g_M}{\tilde{p}}$	(A.1)
Mkt. Clg.:	$\tilde{c} + g_A n \tilde{k} - (1 - \delta) \tilde{k} = (1 - \chi) \tilde{k}^\theta h^{1-\theta}$	(A.2)
FOC h:	$\tilde{\lambda}_2 = \frac{\alpha(\tilde{h} - h)^{-\alpha\sigma-1+\alpha} (\tilde{c})^{(1-\alpha)(1-\sigma)}}{(1 - \tau_L) \tilde{w}}$	(A.3)
FOC c:	$\tilde{\lambda}_1 + \tilde{\lambda}_2 = (1 - \alpha) (\tilde{c})^{(1-\alpha)(1-\sigma)-1} (\tilde{h} - h)^{\alpha(1-\sigma)}$	(A.4)
FOC m:	$g_A \cdot \frac{\tilde{\lambda}_1 + \tilde{\lambda}_2}{\tilde{\lambda}_2} = \frac{g_M}{g_A n}$	(A.5)
FOC k:	$\tilde{\lambda}_1 \psi - g_A \tilde{\lambda}_1 \psi (1 - \delta) + \tilde{\lambda}_2 r = g_A \tilde{\lambda}_2 [1 + (1 - \tau_K) (r - \delta)]$	(A.6)
Firm FOCs:	$\tilde{w} = (1 - \theta) \left( \frac{k}{h} \right)^\theta, \quad r = \theta \left( \frac{k}{h} \right)^{-(1-\theta)}$	(A.7)

**Table A.2**  
Steady state values: benchmark.

$\tilde{k}^*$	6269.55	$h^*$	2079.72
$\tilde{c}^*$	2148.97	$r^*$	0.288
$\tilde{w}^*$	0.87	$\tilde{p}^*$	0.0003
$s^*$	29.84%	$\pi^*$	1.07711

**Table A.3**  
Fit of benchmark model with data.

Variable	Targeted or Untargeted	Fernández et al. (2019) with $\sigma > 1$	Benchmark	Data
$h^*$	Targeted	2179	2080	Annual avg working hrs is 2098
$\frac{w^* L^*}{p^* y^*}$	Targeted	0.5	0.5	Average labor share is 0.5
$\frac{k^*}{y^*}$	Untargeted	2.12	1.74	Average capital-output ratio is 3.09
$\frac{c^*}{y^*}$	Untargeted	0.53	0.60	Average consump-output ratio is 0.60

**Table A.4**  
Steady state system of equations: Two household economy.

Name	Equation	
Prod Fun:	$\tilde{y} = \tilde{k}^\theta (a(h_R x)^\rho + (1-a)h_P^\rho)^{\frac{1-\theta}{\rho}}$	(A.8)
Firm. Focs:	$r\tilde{k} = \theta\tilde{y}, \quad \tilde{w}_P h_P \left( a \left( \frac{h_R x}{h_P} \right)^\rho + (1-a) \right) = (1-a)(1-\theta)\tilde{y}$	(A.9)
	$\frac{\tilde{w}_P}{\tilde{w}_R} = \frac{1-a}{a} \left( \frac{h_P}{h_R x} \right)^{\rho-1}$	(A.10)
Poor Hh:	$h_P = (1-\alpha)\tilde{h}, \quad \tilde{c}_P = (1-\alpha)\tilde{w}_P \tilde{h}$	(A.11)
CIA:	$\tilde{c}_R x + \psi(g_A g_{NP} \tilde{k} - (1-\delta)\tilde{k}) = \frac{g_M}{\tilde{p}}$	(A.12)
Mkt. Clg.:	$\tilde{c}_R x + \tilde{c}_P + g_A n \tilde{k} - (1-\delta)\tilde{k} = (1-\chi)\tilde{k}^\theta h^{1-\theta}$	(A.13)
FOC $h_R$ :	$\alpha \tilde{c}_R^{(1-\alpha)(1-\gamma)} (\tilde{h} - h_R)^{-\alpha\gamma-1+\alpha} = \tilde{\lambda}_2 (1 - \tau_L) \tilde{w}_R$	(A.14)
FOC $c_R$ :	$(1-\alpha) \tilde{c}_R^{(1-\alpha)(1-\gamma)-1} (\tilde{h} - h_R)^{\alpha(1-\gamma)} = \tilde{\lambda}_1 + \tilde{\lambda}_2 (1 + \tau_c)$	(A.15)
FOC $m$ :	$\frac{g_M}{g_A g_{NP}} \frac{\tilde{\lambda}_2}{\tilde{p}} = g_A \frac{\tilde{\lambda}_1 + \tilde{\lambda}_2}{\tilde{p}}$	(A.16)
FOC $k$ :	$\tilde{\lambda}_1 \psi - g_A \tilde{\lambda}_1 \psi (1-\delta) + \tilde{\lambda}_2 = g_A \tilde{\lambda}_2 [1 + (1 - \tau_K)(r - \delta)]$	(A.17)

In Table A.3, we show that the Benchmark model shows a good fit with data in other variables. The targeted moments, steady state annual working hours and labor share of output, match closely. We look at two untargeted moments — capital-output ratio and consumption-output ratio. The capital-output ratio is close to 2, both in the model and data. The fit in the consumption-output ratio is better (see Table A.4).

### Heterogeneous Agent Model

The steady-state values based on the Indian economy for the two-household economy are listed in Table A.5.

We also construct capital,  $K_t$  by applying the perpetual inventory method to the annual Gross Fixed Capital Formation obtained from the RBI Handbook of Statistics and assuming an annual depreciation rate to be 10% (see Feenstra et al., 2015). Consumption data is obtained directly from the RBI Handbook of Statistics. The total annual working hours were obtained from the Conference Board Total Economy Database (CBTED).

**Table A.5**  
Steady state values: Heterogeneous households.

$\tilde{k}^*$	3172.75	$h^*$	1047.12
$r^*$	0.287	$\tilde{p}^*$	0.0009
$h_P^*$	2196.48	$h_R^*$	2048.3
$\tilde{c}_P^*$	338.512	$\tilde{c}_R^*$	2319.69
$\tilde{w}_P^*$	0.15	$\tilde{w}_R^*$	0.87
$s^*$	29.91%	$\pi^*$	1.07711

### Appendix B. Supplementary data

Supplementary material related to this article can be found online at <https://doi.org/10.1016/j.econmod.2025.107096>.

## Data availability

We have shared all the datasets and the codes as online supplementary material.

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