Wealth creation: the invisible hand supported by the hand of trust

- India’s aspiration to become a $5 trillion economy depends critically on strengthening the invisible hand of markets and supporting it with the hand of trust. The invisible hand needs to be strengthened by promoting pro-business policies to (i) provide equal opportunities for new entrants, enable fair competition and ease doing business, (ii) eliminate policies that unnecessarily undermine markets through government intervention, (iii) enable trade for job creation, and (iv) efficiently scale up the banking sector to be proportionate to the size of the Indian economy

Importance of wealth creation

- ES quotes Arthashastra and Thirukural to highlight India’s age-old traditions commending wealth creation through ethical means
- Sensex took 13 years since its inception in 1986 to cross the first incremental 5000 points – but this time has reduced over the years; this high acceleration stemmed from high CAGR
- Wealth created by an entrepreneur correlates strongly with benefits that accrue to the employees of the firm, suppliers of the firm, manufacturers of capital equipment and citizens of the country (due to increased tax revenue for the govt); also helps earn forex revenues

Wealth creation through the invisible hand of markets

- “enabling the invisible hand of markets” = increasing economic openness
- Sectors that were liberalized post 1991 grew significantly faster than those that remain closed

The instruments for wealth creation

- Enhancing efficiency is crucial for wealth creation; and equal opportunity for new entrants is a key dimension of efficiency
- While number of new firms grew at a CAGR of 3.8% from 2006-14, the growth rate from 2014-18 was 12.2%
- If the economy enables fair competition, it is a pro-business economy. In contrast to this, if incumbents in the economy can extract rents from their proximity to corridors of power, it corresponds to a pro-crony economy
- By integrating ‘Assemble in India for the World’ into Make in India, India can create 4 crore well paid jobs by 2025 and 8 crore by 2030
- Authorized Economic Operators Scheme has smoothed the process for registered electronics exporters/importers
- PSBs account for 70% of the market share in Indian banking
Trust as a public good: Aristotle and Kautilya vs Machiavelli

- Trust is a public good with the characteristics of
  - non-excludability: citizens can enjoy its benefits at no explicit financial cost
  - non-rival consumption: marginal cost of supplying this public good to an extra citizen is zero
  - non-rejectable: collective supply for all citizens
  - unlike other public goods, trust grows with repeated use and therefore takes time to build

- Aristotle holds that ‘good laws make good citizens’ by inculcating habits and social virtue
- Arthashastra states that good governance is based on the following branches of knowledge: Varta (economic policy), Dandaneeti (law and enforcement), Anvikshiki (philosophical and ethical framework) and Trayi (cultural context)

Audit failures and NPA issue

- Leading indicators of stress or impending default – issues in performance of business, weakness in internal controls, non-compliance of provisions of Companies Act, Qualified/Disclaimer of audit opinion, excess managerial remuneration
- Lagging indicators of stress or impending default – default in repayment of borrowings, insufficient provisioning/impairment loss, going concern issue

Enabling trust: avoiding policies that crowd out intrinsic motivation

- Reducing information asymmetry
- Enhancing quality of supervision

Entrepreneurship and Wealth Creation at the Grassroots

- While number of new firms grew at a CAGR of 3.8% from 2006-14, the growth rate from 2014-18 was 12.2%; growth is particularly pronounced for the services sector
- India has low rates of entrepreneurship in the formal sector
- Entrepreneurial activity has a significant positive impact on Gross Domestic District Product (GDDP) – 10% increase in registration of new firms per district yields a 1.8% increase in GDDP
- Entrepreneurial capabilities in agri are not localized geographically and are distributed evenly across most districts in India; highest entrepreneurial activity in agri in Manipur, Meghalaya, MP, Assam, Tripura and Odisha
- Entrepreneurial activity in manufacturing highest in Gujarat (districts: Surendranagar, Rajkot, Bhavnagar, Surat), Meghalaya, Puducherry, Punjab, Rajasthan
  - Steps by GJ: labour reforms, reduction in compliance burden, transparent and timely processing of approval and renewal of applications, reduction in stipulated timelines for granting and renewal of manufacturing sale licenses
  - Steps by RJ: increased min membership requirement to form a union to 30% of total workforce of the firm (up from earlier 15%); no prior approval needed for retrenchment or shutting down of units in companies with <300 employees (up from earlier limit of 100 employees)
- Entrepreneurial activity in services highest in Delhi, Mizoram, UP, Kerala, A&N, Haryana
- Entrepreneurial activity in infra sector highest in Jharkhand, Arunachal, HP, Mizoram, J&K, Bihar
- Number of new firms formed in a district increases with literacy in the district, superior access to markets

Policy implications for fast tracking entrepreneurship and wealth creation

- Measures to increase literacy levels rapidly through institution of more schools and colleges will spur entrepreneurship; govt could also explore privatization of education
- Better connectivity to villages through tar roads will improve entrepreneurial activity
- Policies that foster ease of doing business and flexible labour regulation foster entrepreneurial activity
Pro-business vs Pro-crony

- If the economy enables fair competition, it is a pro-business economy. In contrast to this, if incumbents in the economy can extract rents from their proximity to corridors of power, it corresponds to a pro-crony economy
- In its initial years, there was a lack of dynamism in the constitution of Sensex due to the lack of dynamism in the Indian economy in general; however, post 1991, there was a rapid emergence of new firms, new ideas, new technologies, causing a steep revision of the Sensex in 1996
  - In 1996, half of the constituents of the index were replaced
  - After 1996, the Sensex underwent more frequent revisions due to a more competitive Indian market
- Pro-business policy, i.e. liberalization, caused a spike in the number of firms churned in the years that immediately followed it – every 5 years, roughly 1/3rd of the firms in the index are replaced
- Currently, a firm is expected to stay on the index for only about 12 years
- This churn in the composition of Sensex is also referred to as Creative Destruction by ES
- Today’s Sensex is not only composed of a large number of sectors but is also far more democratic in terms of size of the companies. In 1991, the largest firm on the index was roughly 100 times the smallest in terms of market capitalization. In 2018, this ratio was only 12
- While the largest firm of 1991 constituted about 20% of the market cap of Sensex, the largest firm of 2019 contributed only 13%
- Herfindahl Index reveals an overall decline in concentration in the following 2 sectors – Financial services and IT; however, the IT sector has recently begun showing a slight increasing trend in the Herfindahl Index, indicating that there is room to increase competition in this sector
  - Herfindahl Index – measure of the size of firms in relation to the industry and an indicator of the amount of competition among them
- Pro-crony, when compared to pro-business, policies can create various indirect costs as well
  - When opportunities for crony rent-seeking exist, firms shift their focus away from growth through competition and innovation towards building political relationships, thus undermining the economy’s capacity for wealth creation
  - The rent sought by cronies are paid for by genuine businesses and citizens who are not receiving any preferential treatment; this exacerbates income inequality in the economy
- Example of pro-crony policies is discretionary allocation of natural resources in India till 2011. Competitive allocation of resources now has put an end to rent extraction
- In 2018, willful defaulters owed their lenders about ₹1.4 lakh crore
- Willful default, if left unchecked would increase the cost of borrowing for everyone else, including genuine and profitable businesses

Undermining Markets: When Government intervention hurts more than it helps

- Index of Economic Freedom by Heritage Foundation – India categorized ‘mostly unfree’ and ranked 129/186
- Global Economic Freedom Index by Fraser Institute – India ranks 79/162
- Both the above indices measure economic freedom as the freedom of choice enjoyed by individuals in acquiring and using economic goods and resources
- In addition to creating ‘deadweight loss’, an artificially high price transfers profits from consumers to producers and creates opportunities for rent seeking, and an artificially low price leads to low incentive to invest further and aggravates the scarcity of the product

Case 1: Essential Commodities Act

- Major commodity groups included in the Essential Commodities Act are
  - Petroleum and its products
  - Food stuff – edible oil and seeds, Vanaspati, pulses, sugarcane and its products, rice
  - Raw jute and jute textiles
  - Drugs – prices of essential drugs controlled by DPCO
• Powers to implement the provisions of this Act have been delegated to the States
• ECA affects the efficient development of agricultural markets by creating market distortions
• In the long term, the Act disincentivises development of storage infra thereby leading to increased volatility in prices following production/consumption shocks
• Considerable administrative effort is utilized for the enforcement of the Act
• The conviction rate under the Act is abysmally low at 2-4%
• The Act, while penalizing speculative hoarding, also ends up penalizing the much desired consumption-smoothing that storage provides
• Besides discouraging investment in modern methods of storage and in market intelligence, the lack of information on trades makes it harder for market participants to make accurate forecasts for the future
• Supporting development of commodity futures markets would help efficient discovery of market expected future prices, which can provide a better basis for private storage decisions and avoid ‘peaks’ and ‘troughs’ in prices
• Development of effective forecasting mechanisms, stable trade policies, and increasing integration of agricultural markets can serve the purpose of stabilising prices of agricultural markets more efficiently than government fiat imposed through ECA

Case 2: Drug Price Controls under ECA
• Prices of pharmaceutical drugs through the National Pharmaceutical Pricing Authority (NPPA) and Drug (Prices Control) Order (DPCO); DPCO is an order issued under Sec 3 of ECA; NPPA is responsible for fixing and revising the prices of pharmaceutical products as well as the enforcement of the DPCO.
• National List of Essential Medicines (NLEM) is prepared by Ministry of Health and Family Welfare
• DPCO has also been observed to increase prices of expensive drugs, reinforcing the effect opposite to what it was instituted for, i.e. making drugs affordable
• ECA needs to be repealed and replaced by market frienldy interventions like price stabilization funds, Direct Benefit Transfers (DBT) of support to consumers, incentives to innovations, increasing market integration and smooth flow of goods and services

Case 3: Govt intervention in grain markets
• Govt seeks to achieve food security while ensuring remunerative prices to producers (MSP) and safeguarding the interests of consumers by making supplies available at affordable prices
• Main objectives of FCI – purchase, store, move/transport, distribute and sell foodgrains and other foodstuffs
• The govt, as the single largest buyer of rice and wheat, is virtually a monopsonist in the domestic grain market and is a dominant player crowding out private trade - This disincetivizes the private sector to undertake long-term investments in procurement, storage and processing of these commodities.
• market prices do not offer remunerative options for the farmers and MSPs have, in effect, become the maximum prices rather than the floor price – the opposite of the aim it is intended for
• Government has also emerged as the single largest hoarder of rice and wheat
• Way forward
  • policies need to move on now to incentivize diversification and environmentally sustainable production
  • Farmers need to be be empowered through direct investment subsidies and cash transfers, which are crop neutral and do not interfere with the cropping decisions of the farmer
  • coverage of NFSA needs to be restricted to the bottom 20 per cent and the issue prices for others could be linked to the procurement prices
  • income transfers to consumers through Direct Benefit Transfers (DBT) – examples of successful conditional cash transfer schemes – Bolsa familia of Brazil, Oportunidades of Mexico, Pantawid Pamilyang Pilipino Program
Case 4: Debt waivers

- Debt overhang: situation where all current income gets used up in repaying the accumulated debt, leaving little incentives to invest either in physical or human capital

- Pros of debt waivers:
  - debt waiver helps the borrowers to come out of debt trap as it cleans their balance sheet and reduces the burden of debt servicing
  - This clean-up of borrowers’ balance sheet is likely to lead to both new investments as well as fresh fund rising as borrowers’ repayment capacity increases even if there is no change in income
  - Debt relief can help as long as they are awarded under exceptional circumstances and remain unanticipated. In such situations, a debt relief can prevent farmers going out of farming and the consequent reduction of output

- Cons of debt waivers:
  - ES observes that the 2008 debt waiver worth close to 2 per cent of the GDP did not have any meaningful real impact on the lives of the farmers
  - the disconcerting evidence is that the share of formal credit decreases for full beneficiaries when compared to partial beneficiaries, thereby defeating the very purpose of the debt waiver provided to farmers
  - an anticipated waiver may lead to moral hazard and destroy the credit culture
  - flow of bank credit to waiver beneficiaries declines after the waiver
  - waiver helps only when the beneficiaries are genuinely distressed but fuels even greater default when relief is not made conditional on genuine distress
  - costs to the exchequer are significant

- Way forward
  - there is a case for a limited relief only when distress can be identified credibly

- Markets can... Keep prices in check, Use resources efficiently, Encourage innovation, Increase consumer choice, Create wealth, Maximize aggregate welfare

- Markets cannot... Provide public goods, Prevent abuse of monopoly power, Internalize externalities, Overcome information asymmetry, Distribute wealth equitably, Ensure ethical practices

Creating jobs and growth by specializing to exports in network products

- Every man lives by exchanging – Adam Smith

- Opportunities for India
  - The US–China trade war is causing major adjustments in Global Value Chains (GVCs) and firms are now looking for alternative locations for their operations
  - Even before the trade war began, China’s image as a low-cost location for final assembly of industrial products was rapidly changing due to labour shortages and increases in wages
  - no other country can match China in the abundance of its labour, we must grab the space getting vacated in labour-intensive sectors

- India’s share in merchandise (goods) exports has grown at 13.2 per cent per annum and our share in world exports has increased from 0.6 per cent in 1991 to 1.7 per cent in 2018. Yet, even by 2018, India’s world market share remains paltry compared to 12.8 per cent for China

- India needs to focus on a group of industries, referred to as “network products”, where production processes are globally fragmented and controlled by leading Multi-National Enterprises (MNEs) within their “producer driven” global production networks. For eg. computers, electronic and electrical equipment, telecommunication equipment, road vehicles etc.
by integrating “Assemble in India for the world” into Make in India, India can raise its export market share to about 3.5 per cent by 2025 and 6 per cent by 2030 – will lead to creation of about 4 crore well paid jobs by 2025 and 8 crore jobs by 2030

**Reasons for India’s export underperformance vis-à-vis China**
- high diversification combined with low specialization implies that India is spreading its exports thinly over many products and partners, leading to its lacklustre performance compared to China
- Quantity manufactured in India is low as compared to that in China
- Low level of participation in Global Value Chains
- Low market penetration in high income countries

**Way forward**
- Reaping gains from participation in GVCs: India can reap rich dividends by adopting policies aimed at strengthening its participation in GVCs
- Given our comparative advantage in labour-intensive activities and the imperative of creating employment for a growing labour force, there are two groups of industries that hold the greatest potential for export growth and job creation
  - labour-intensive industries such as textiles, clothing, footwear and toys
  - India has huge potential to emerge as a major hub for final assembly in a range of products, referred to as “network products” - NP exports accounts for a very small share (10 per cent in 2018) in India’s export basket
    - **Automobile sector** - While assembled motor vehicles constitute the bulk of India’s automobile exports, parts and accessories account for the lion’s share of total automobile imports. This pattern is consistent with the emergence of India as an assembly centre for automobiles.
    - **Mobile phones** - India toppled Vietnam to become the second largest manufacturer of mobile phones globally following China in 2018 with a world share of 11 per cent
- Are Free Trade Agreements beneficial? - from the perspective of trade balance, India has clearly “gained” in terms of 0.7 per cent increase in trade surplus per year for manufactured products and of 2.3 per cent increase in trade surplus per year for total merchandise.

**Targeting Ease of Doing Business in India**
- parameters of EoDB where India lags - Starting a Business, Registering Property, Paying Taxes, and Enforcing Contracts
- Authorized Economic Operator (AEO): programme under the aegis of the World Customs Organization (WCO) SAFE Framework of Standards to secure and facilitate Global Trade. The programme aims to enhance international supply chain security and facilitate movement of goods

**Golden jubilee of bank nationalization: taking stock**
- PSBs account for 70 per cent of the market share in banking
- credit growth among PSBs has declined significantly since 2013 and has also been anaemic since 2016
- in 2019, PSBs’ collective loss— largely due to bad loans—amounted to over ₹ 66,000 crores
- PSBs account for 85 per cent of reported bank frauds while their gross non-performing assets (NPAs) equal ₹ 7.4 lakh crores which is more than 150 per cent of the total infrastructure spend in 2019
- As of March 2019, PSBs had ₹ 80 lakh crore in deposits, held ₹ 20 lakh crore in government bonds, and made loans and advances of ₹ 58 lakh crore
- PSBs enjoy less strategic and operating freedom because of majority government ownership
• The majority ownership of the government and its writ on bank functioning also results in an implicit promise of the bailout of bank liabilities which is an implicit cost to the taxpayer.

• The majority ownership by the government also subjects PSB officers to scrutiny of their decisions by the central vigilance commission and the comptroller auditor general. Hence, officers of state-run banks are wary of taking risks in lending or in renegotiating bad debt, due to fears of harassment under the veil of vigilance investigations

Benefits of nationalization

• allocations of banking resources to rural areas, agriculture, and priority sectors increased the steps taken by the government in recent years

• RBI’s 4:1 formula where a bank was required to open 4 rural branches to obtain a license to open an urban branch between years 1977 and 1991

• In 2019 public sector banks reported gross and net NPAs of ₹ 7.4 lakh crore and ₹ 4.4 lakh crore respectively, amounting to about 80 per cent of the NPAs of India's banking system

• gross NPAs of PSBs amount to a significant 11.59 per cent of their gross advances, although a slightly encouraging trend is that the NPA ratio is below the 14.58 per cent ratio in 2018

Way forward

• The survey proposes establishment of a GSTN like entity, called PSBN (PSB Network), to use technology to screen and monitor borrowers comprehensively and at length
  
  o PSBN would utilize other Government sources and service providers to develop AI-ML ratings models for corporates. The AI-ML models can not only be employed when screening the corporate for a fresh loan but also for constantly monitoring the corporate borrower so that PSBs can truly act as delegated monitors
  
  o Benefits of PSBN
    ▪ it would take advantage of the data that all PSBs have of the last 50 years to create better underwriting solutions
    ▪ this would reduce the burden of NPAs, apart from helping them in fraud prevention
    ▪ PSBs would be able to make quicker decisions, process loan applications faster, and reduce turn-around-times (TAT) -> increase competitiveness

• To enable employees to become owners in the banks and thereby incentivise them to embrace risk-taking and innovation continually, a portion of the government stakes can be transferred to employees exhibiting good performance across all levels of the organization through Employee Stock Option Plans (ESOPs).
  
  o employees who own shares are incentivized to increase market value of equity

• PSBs need to enable cutting-edge recruitment practices that allow lateral entry of professionals and recruitment of professionally trained talent at the entry level

Financial fragility in the NBFC sector

• Shadow banking comprises a set of activities, markets, contracts and institutions that operate partially (or fully) outside the traditional commercial banking sector and are either lightly regulated or not regulated at all

• Financial institutions rely on short-term financing to fund long-term investments. This reliance on short-term funding causes an asset liability management (ALM) problem because asset side shocks expose financial institutions to the risk of being unable to finance their business.

• Risks from Asset Liability Management mismatch
  
  o arises in most financial institutions due to a mismatch in the duration of assets and liabilities
  
  o Liabilities are of much shorter duration than assets which tend to be of longer duration, especially loans given to the housing sector.
  
  o This mismatch implies that an NBFC must maintain a minimum amount of cash or cash-equivalent assets to meet its short-term obligations
o ALM risk arises if the future contractual cash inflows from loan assets are not enough to meet the future contractual cash outflows from debt obligations

- Firms in the NBFC sector are susceptible to rollover risk when they rely too much on the short-term wholesale funding market for financing their investments in the real sector.

Privatization and wealth creation

- Benefits of privatization
  o **net worth** of privatized firms increased from ₹ 700 crore before privatization to ₹ 2992 crore after privatization, signalling significant improvement in financial health and increased wealth creation for the shareholders
  o **net profit** of privatized firms increased from ₹ 100 crore before privatization to ₹ 555 after privatization compared to the peer firms
  o **gross revenue** of privatized firms increased from ₹ 1560 crore to before privatization to ₹ 4653 crore after privatization, signalling increase in income from sales of goods and other non-financial activities
  o **ROE** of privatized firms increased from 9.6 per cent before privatization to 18.3 per cent after privatization, reflecting increase in firm’s efficiency at generating profits from every unit of shareholders’ equity
  o **net profit margin** of privatized firms increased from (-3.24) per cent before privatization to 0.65 per cent after privatization, reflecting that out of a rupee that is generated as income, the share of after-tax profit in the income increases
  o **growth rate of sales** of privatized firms increased from 14.7 per cent before privatization to 22.3 per cent after privatization
  o increase of ₹ 21.34 lakh in **gross profit per employee** due to privatization

- Way forward
  o Aggressive disinvestment, preferably through the route of strategic sale, should be utilized to bring in higher profitability, promote efficiency, increase competitiveness and to promote professionalism in management in CPSEs
  o Focus of the strategic disinvestment needs to be to exit from non-strategic business. This would, in turn, unlock capital for use elsewhere, especially in public infrastructure like roads, power transmission lines, sewage systems, irrigation systems, railways and urban infrastructure
  o Government can transfer its stake in the listed CPSEs to a separate corporate entity. This entity would be managed by an independent board and would be mandated to divest the Government stake in these CPSEs over a period of time. This will lend professionalism and autonomy to the disinvestment programme which, in turn, would improve the economic performance of the CPSEs.

Is India’s GDP growth overstated? No!

- Quote: Correlation is the basis of superstition and causation the foundation of science
- concerns about the veracity of India’s GDP growth rates may generate substantial concerns not only to investors but also to policymakers
- The need to invest in ramping up India’s statistical infrastructure is undoubted. In this context, the setting up of the 28-member Standing Committee on Economic Statistics (SCES) headed by India’s former Chief Statistician is important

Thalinomics: The Economics of a Plate of Food in India

- an attempt to quantify what a common person pays for a Thali across India
- Initiatives for enhancing productivity of agriculture and efficiency of agricultural markets
- PM-Annadaata Aaay Sanrakshan Abhiyaan (PM-AASHA)
- PMKSY-Per Drop More Crop
- PM Fasal Bima Yojana
- Soil Health Card
- e-NAM
- National Food Security Mission
- National Food Security Act

- In terms of vegetarian Thali, it is found that, an individual who would have spent around 70 per cent of his/her daily wage on two Thalis for a household of five in 2006-07 is able to afford same number of Thalis from around 50 per cent of his daily wage in 2019-20

- In 2019-20 (April-October, 2019), the most affordable Thali was in Jharkhand; two vegetarian Thalis for a household of five in Jharkhand required about 25 per cent of a worker’s daily wage. Non-vegetarian Thali was also most affordable in Jharkhand