Modi 2.0: revisiting relationship capitalism

Deepanshu Mohan asks if the government can make a move from relationship capitalism to one where the markets compete freely across sectors

The second half of the twentieth century saw remarkable swings of the pendulum in the perceptions about the process of economic development in independent India. During the 1950s India somewhat became a path setter, if not a role model. For some, India's mixed economic system under Nehru became an answer to the challenge posed by communism in China and the Soviet Union. For others, India's journey was a unique non-capitalist path to development. While India may have been on the road then to caricature itself as an ideal social democracy and a welfare state, twenty-five years later, ie. by mid 1970s, such perceptions turned upside down. Slow growth and high level of poverty represented failure on part of the state.

Another twenty-five years down the road, ie. from early 2000s, we witnessed another dramatic change in India's politico-economic story where the strengthening of political, economic and social institutions from the adoption of pro-market policies (starting since the late 1980s), secured impressive economic growth performance for India.

Under the leadership of Narendra Modi, India in the last two years has attempted to achieve a persistent rate of higher economic growth in a process to achieve a more equitable, sustainable economic development. In this piece I analyze the operational style of the current government's economic governance and examine some evidence on its level of integration with the rest of the world (evident from an analysis on trends in FDI-foreign direct investment and OFDI-outward foreign direct investment).

In a book written in 2004, Raghuram Rajan and Luigi Zingales explained how free markets—perhaps the most beneficial economic institution known to humankind—rest often on fragile political foundations. The book, *Saving Capitalism from the Capitalists*, argues how bureaucrats and politicians who make decisions guide the invisible hand of the market. In the first few decades after World War II, state managed competition, which Rajan and Zingales referred to as 'relationship capitalism', seemed to work quite well in continental Europe and Japan.

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In a politically stable environment, both continental Europe and Japan experienced high rates of growth under a state-managed competitive system. However, as explained by Rajan and Zingales in their book, growth in these economies during the postwar decades concealed three serious problems:

i) the relationship system failed to encourage innovation across major sectors driving production;
ii) with the market suppressed, there was no allocative mechanism for monopoly profits to be adequately distributed;
and iii) the system failed to acknowledge constructive destruction where the sick, government-controlled/owned units could die out to give way to new/sunrise industries.

In India, during the last two years Modi's government seems to have taken similar steps to 'manage' capitalistic forces through a number of reforms and policy initiatives—to mixed results (under the stated expectation of launch-

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One of the key challenges for the government will be to ensure that real wages... remain sustainably at a higher level across both urban and rural areas, while the Indian economy seeks to become the next factory of the world ing measures such as the Clean India campaign, the Smart Cities proposal, the Skill India initiative etc.-highlighted below). Though most policy initiatives have relevance, the journey from policy proposal to implementation seems misplaced due to the limited (cap)abilities of Indian states; lacking both the political will and financial resources to implement some of these policy initiatives to fruition.

There is a degree of over-centralization associated with the Prime Minister's Office (PMO), which appears more presidential (as in the American political machinery) than federalist, which is germane to the Indian political economy framework. The fate of the Goods & Services Tax (GST) Bill, Bankruptcy Reform Bill, and the Companies Amendment Bill echo the Modi government's political failure in passing key reform bills. In a recent article, I've discussed how this political limitation has arisen due to institutional challenges (present at the legislative, executive, and judicial level). These have made progressive economic governance a challenge.

Let's now examine the evidence on the Indian economy's integration with the rest of world that is usually measured by the performance in trade (via exports) and investment (via FDI and OFDI). While the performance in trade levels has been quite weak due to the fall in global commodity prices and overall aggregate demand, we can look at the current foreign investment situation in India.

The Foreign Direct Investment push

To strengthen India's position in the global economic landscape, the current government's focus in the last two years has been skewed towards attracting foreign direct investment across a number of sectors. Launched in September 2014, the Make in India program has resulted in a number of foreign enterprises investing in sectors such as defence manufacturing, automobiles, aviation, media and entertainment, electronic systems, bio-technology, food processing, and mining.

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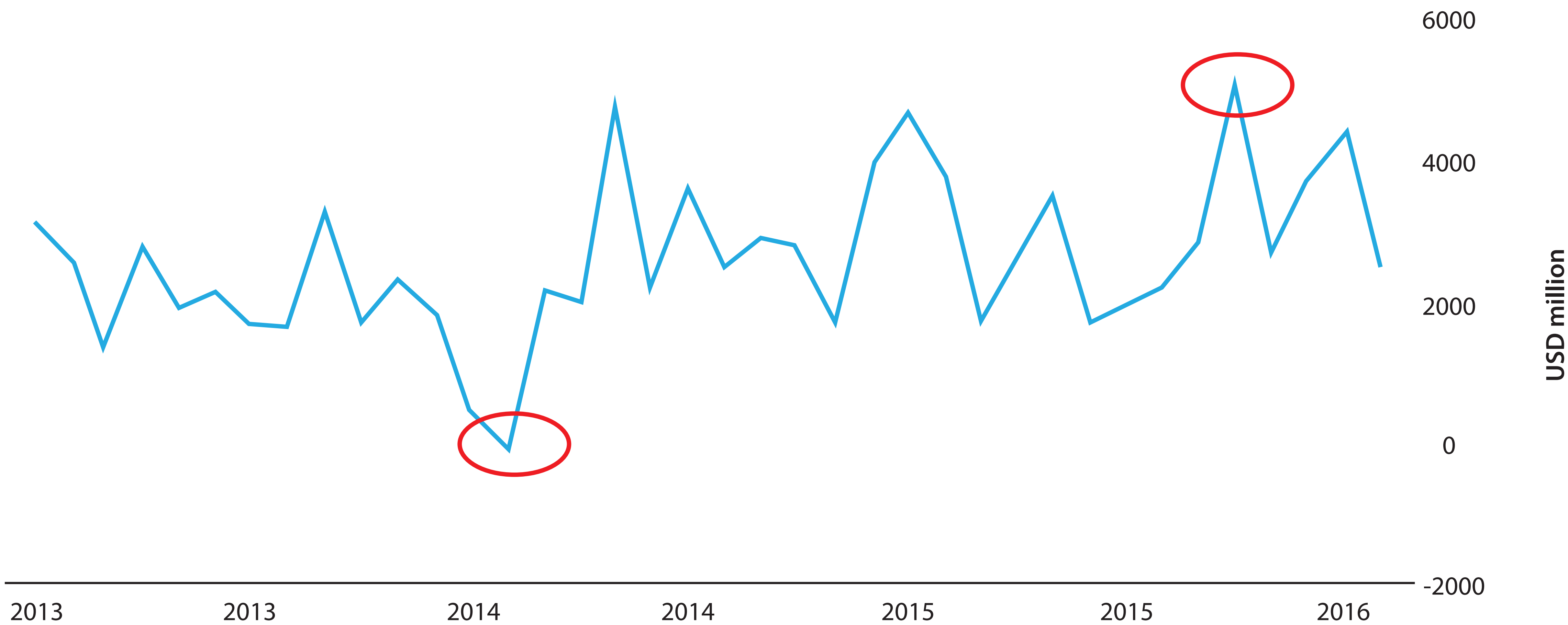
Figure 1. Foreign Direct Investment (2014-2016)



Source: Reserve Bank of India database (Trading Economics)

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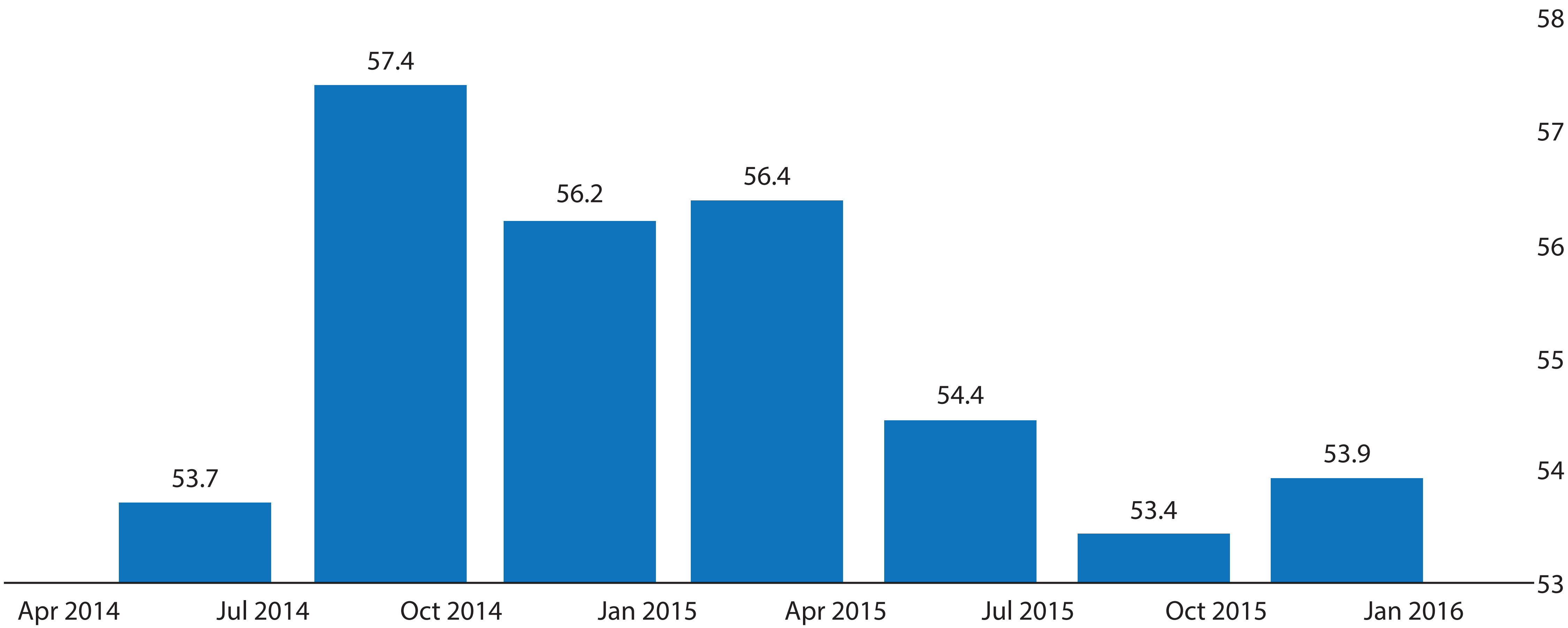
Figure 2. India's Business Confidence Index



Source: Confederation of Indian Industry (CII) data (Trading Economics)

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Over the last two years, there has been more than 48 percent growth in FDI equity inflows and 37 percent in overall FDI inflows. This is pleasant news considering the fact that level of foreign direct investment was at its lowest in February 2014 (as shown in Figure 1).

This has largely been made possible by a string of policy measures enacted to ease regulatory and procedural formalities in setting up and running a business. The improvement in ease of doing business has been complimented by an array of policy initiatives as exemplified by Skill India, Digital India, Start-Up India, Smart Cities, Atal Mission for Rejuvenation & Urban Transformation (AMRUT), to name a few. These initiatives have aimed to lay the foundation for the next wave of investment and growth through a massive infrastructure push.

One of the key challenges for the government will be to ensure that real wages similar to growth levels in India also remain sustainably at a higher level across both urban and rural areas, while the Indian economy seeks to become the next factory of the world. Lessons from the economic history of East Asian economies like Japan and China show how a state-led development model in a relationship capitalistic set up may lead to the formation of an export-led manufacturing bubble in the long run.

The increasing Outward Foreign Direct Investment (OFDI) trend

India's big businesses as well as small- and medium-scale enterprises have received continuous support from government-controlled finance plans. However, if we observe domestic industrial performance levels and the business confidence index, performance seems to be quite weak or underutilized due to both internal and external (what I call as endogenous and exogenous) factors.

While India continues to attract foreign investment into critical sectors, its own businesses are stagnating in their domestic performance and looking for opportunities to invest abroad/off-shore. This perceptible shift in Overseas

Foreign Direct Investment (OFDI) and Overseas Investment Destination (ODI) in the last few years is an interesting trend. While most of the Indian investment went to resource-rich countries such as Australia, United Arab Emirates, and Sudan earlier, the trend over the last two years points to a big push towards countries providing higher tax benefits such as Mauritius, Singapore, the Netherlands, and the British Virgin Islands.

Most Indian firms have invested there through Mergers and Acquisitions (M&As) transactions, where the expectation is that these companies will get access to better technologies and more extensive markets, which will enable them to cater to a global consumer base. As per a recent estimate, *"M&A activity increased in 2014 with deals worth US$38.1 billion, compared to US$28.2 billion in 2013 and US$35.4 billion in 2012. There have been M&A deals worth US$28.8 billion in the first 10 months of 2015."*

The challenges ahead

In the years to come it remains to be seen if the Indian economy on a whole continues to perform better under Modi and whether the government can gradually make an effort to move away from the relationship capitalistic system in letting the markets freely compete across sectors, and if improved coordination can be established with the states on areas of policy implementation? It would be prudent for the government to focus more on promoting greater economic and financial freedom to states and local level political institutions.

Real prosperity can come from the ability of the Indian economy to grow an export-led manufacturing or via service-led sectors, through more trade and investment, ensuring that growth transforms as one of the means by itself to achieving equitable, sustainable economic development. The current government at the same time must do away with its obsession with increasing FDI as an answer to all economic/financial woes and promote economic development by focusing more on enhancing access to quality education (at a primary level) and primary healthcare

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as the foremost means for communities/societies to get the opportunity to develop. The focus on driving greater investment from/to abroad must be complimented by socially investing this capital for long term returns. ■

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