A Theoretical Model of ‘Riskless Capitalism’

Rohit and Prasenjit Bose

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1We would like to thank Sucheta Sardar, Rashika Nagar, Sushant Singh and Anurag Kakkar for their research assistance.
Section 1

Certain Stylised Facts About the Indian Economy
A Few facts and Existing Theoretical Explanations

Stylised facts: From a Social Democratic (SD) to a Neoliberal (NL) Regime

- Both income and wealth inequality has risen significantly.
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- Both income and wealth inequality has risen significantly.
- *Despite* that, the last decade saw some impressive rates of growth.

High corporate debt/equity ratios associated with high rates of growth.
Banks are less risk averse which reflects in high private debt-GDP ratio.
FRBM has restricted the intervention of the State in demand management.
It becomes a ‘facilitator’ of private investment.

Theoretical Explanations in the Heterodox Tradition

The Bhaduri Marglin Model: The Exhilarationist regime explains this contradictory development.
But assuming investment a function of profit share suffers from logical incongruities.
Otherwise no exhilarationist regime.

The PP-JG-CPC Model: Consumption of the elite overcompensates for the stagnationist tendencies. Since it is financed through credit, high but unstable growth.

Our attempt is to work in this tradition with a focus on investment.
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What Drove High Growth in the Last Decade?

![Diagram showing rate of growth, consumption, and investment vs. GDP growth percentage]
Composition of Investment during Growth and Recession

![Graph showing composition of investment during growth and recession](image-url)
A Macroeconomic Model
Basic Set-up: Capitalists’ and Banks’ Behaviour

Capitalists’ Behaviour: Investment Function

- Capitalists have a desired capacity utilisation \( u_0 \). \( g \) increases/decreases if the actual \( u \) is greater/lesser than the desired one.

\[
\dot{g} = \gamma_0 + \gamma u (u - u_0) + \gamma \delta \delta (1)
\]
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- Firms are credit constrained. A higher level of debt-capital ratio $\delta$ increases $g$.

Banks’ Behaviour

- Banks have a desired debt capital ratio $\delta_d$ positively related to $g$, negatively to $\delta$ (lender’s risk).
- There is a boundary condition given by $\delta_{max}$. Higher $\delta$ has a relatively higher degree of risk of default.
- Desired rate is given by $\delta_d = \lambda_0 + \lambda g - \lambda \delta$.
- Banks try to increase/decrease the actual $\delta$ depending on whether it is lesser/greater than the desired rate.

\[ \dot{\delta} = \Theta(\delta_d - \delta) \Theta > 0 \]
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A Graphical Representation: Two Rates of Growth
Neoliberalism: Banks’ credit constraint is relaxed $\delta_{max} \uparrow$

- State’s demand management capacity is severely hampered. Also for various reasons, this regime witnesses a rise in profit share. Both should have led to a stagnationist tendency in the economy ($A$ falls). Instead $g$ rises.
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- Process of financialisation entails a relaxation in Public Sector Banks’ constraints vis-a-vis corporate loans (say through moving away from legislated priority sector lending of the erstwhile era). Public Sector Banks, in particular (because of their scale), are also the providers for big ticket corporate loans.
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- Even the RBI governor, Mr. Rajan had to admit “Promoters have a class of super equity which retains all the upside in good times and very little of the downside in bad times, while creditors, typically public sector banks...get none of the fat returns in good times while absorbing much of the losses in bad times”.

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NL: high but unstable growth with high leverage ratio

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NL: high but unstable growth with high leverage ratio

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- On the higher side, it increases till it hits the credit constraint \( (\delta_{max}) \) beyond which it can’t increase. In case defaults start rising and the ex post realisation of capitalists’ collateral is lesser than its ex ante value, banks find their balance sheets becoming vulnerable (reflected in rising NPAs).
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- The average of this regime will be somewhere between A and B. So, while the booms might be spectacular, the overall rate of growth in this regime might not be any higher or even lower than the SD regime.
- Having tied its hand by FRBM, the State can do precious little of moving the economy away from A except attempting an expansionary monetary policy. And even that might be limited given the central bank’s ill formulated inflation targetting.
Highly Leveraged Corporate Sector and PSB’s exposure
Interest Coverage Ratios for the Indian Corporate Sector

Source: IMF Corporate Vulnerability Report, April 2014
Gross NPA ratios for Banks

- Public Sector banks
- Private Sector Banks
- All SCBs (RHS)

% of Gross Advances

2005 2006 2007 2008 2009 2010 2011 2012 2013