



## Of Investment and Jobs

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Despite showing very healthy headline growth, there are continuing concerns about Indian economy's attractiveness for investment and its potential to provide jobs. The solutions for these fundamental issues are not simple, but many simplistic recommendations abound. Which are the false hopes that one must not harbor?

### Interest Rates and Investment

In principle, a fall in corporate investment can be attributed to two factors, viz. (i) an increase in interest rates and (ii) changes in expectations about the future, as shown in Figure 1. A reduction in the expected future growth, e.g. from 8% to 5% per year would mean that the corporate sector would invest less, since they expect to cater to a lower demand. This is illustrated by a downward shift in the demand curve from  $E_{High}$  to  $E_{Low}$ . So, even at a low interest rate of OL, the investment falls from OD to OB. In addition, if

there is rise in interest rates from OL to OH, driven in part by higher government borrowings, it falls even further to OA, assuming low interest elasticity. In this context, the RBI Business Expectation Index, shown in Figure 2, has improved since the lows of 2016, but not by much. To put it bluntly, business sentiment has been tepid. In Figure 1, an improvement in sentiment, i.e. a move of the investment demand curve from  $E_{Low}$  to  $E_{High}$ , even if interest remains relatively high at OH, would increase investment from OA to OC, much more than that achieved by a reduction in rates from OH to OL. To grow investment, improvement in business confidence is needed. Business will always look for a lower interest rate, since it reduces their cost, but a low interest rate alone is unlikely to lead to a jump in private investment.

The critical policy question is thus: what will improve business confidence?

Figure 1: Expectations and Investment

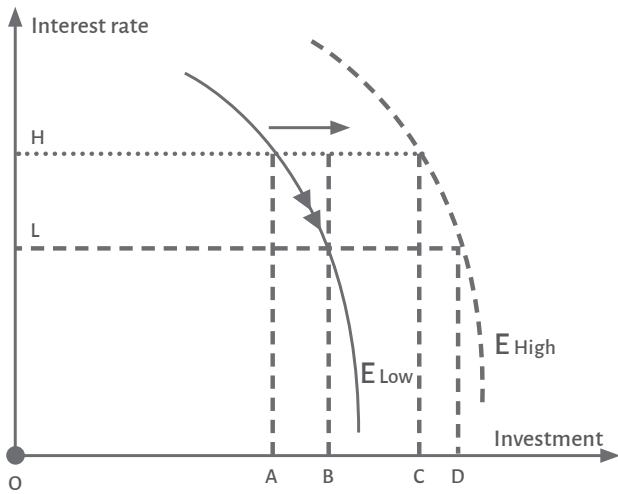
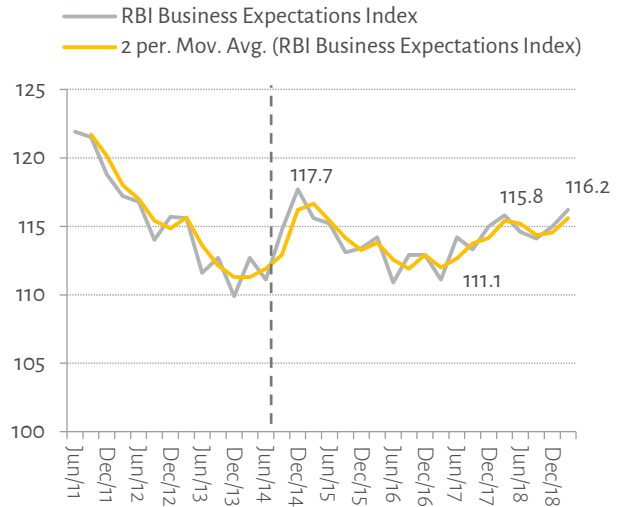


Figure 2: Trends in Business Expectations



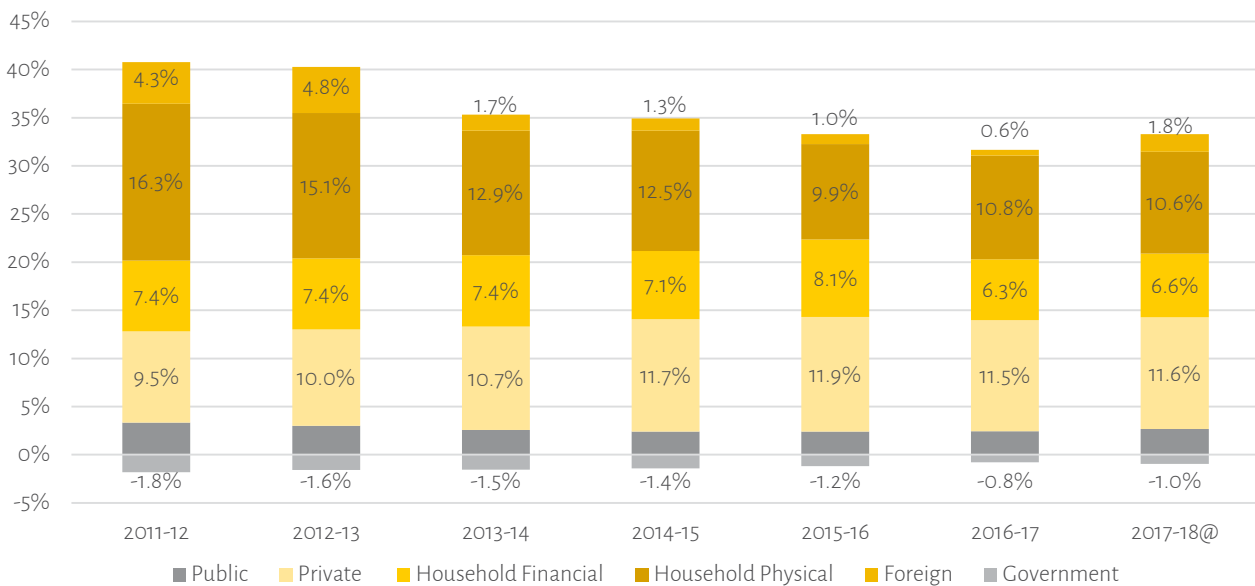
Source: Reserve Bank of India Quarterly Industrial Outlook Survey

However, the core issue in the fall of the investment rate is not that of corporate investment, but that of household savings and investment, as seen in Figure 3 and 4. Investment in physical assets, mainly dwellings, took a hit in 2013-14 and has yet to recover. Post 2016, there has been some understandable reallocation away from financial assets to physical assets, but the aggregate has continued to be low, compared to historical highs of 2011-12. While the voter has

entrusted his confidence in the current government, the household does not seem to have as optimistic a view about the future.<sup>1</sup>

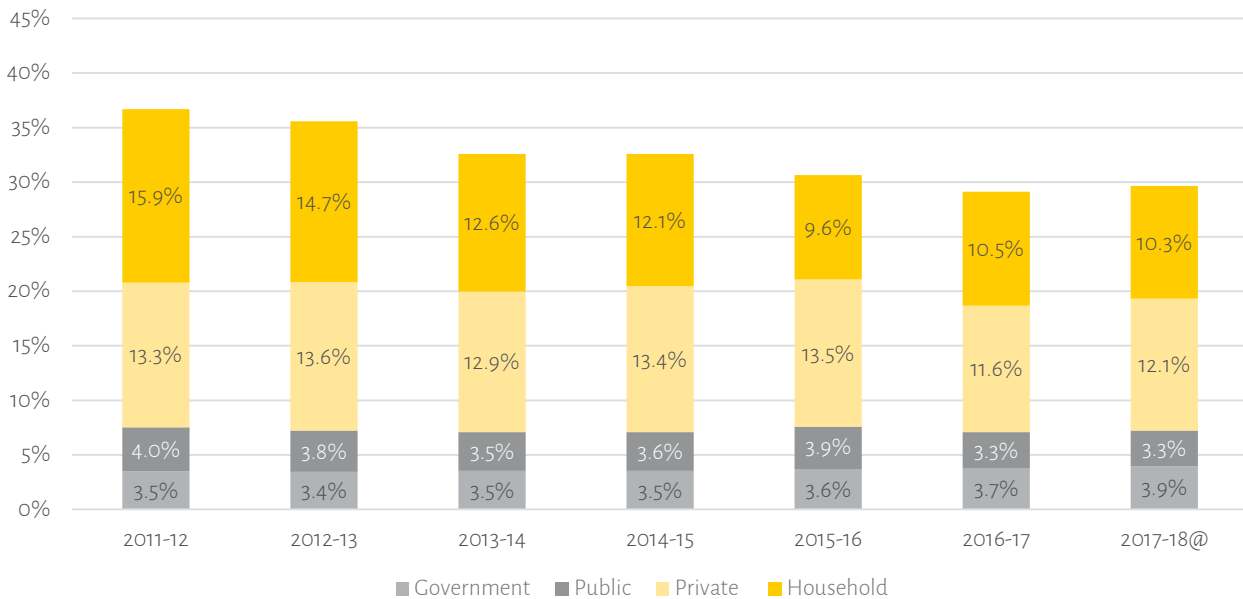
Thus, as with business, the policy question is: how to improve household expectations? The growth of good jobs will certainly help and improved agricultural income (beyond income support schemes) are major areas of action, if the household is to feel more confident.

Figure 3: Savings Supply



Source: National Account Statistics, percent of GDP (current prices)

Figure 4: Gross Capital Formation



Source: National Account Statistics, percent of GDP (current prices)

### Which is better for job growth - Manufacturing or Services?

There is much handwringing about India's premature deindustrialisation and the need to revive manufacturing, in order to generate jobs. It is often posited as a choice between manufacturing and services. This is a false dichotomy.

It is important to recognise that in 1996, there was a 10 percentage point gap between India and China with respect to percentage of total employment in industry. In 2018, the gap had reduced to 4 percentage points. In urban areas, manufacturing is almost a fourth, 23%, of our workforce. Could our manufacturing sector be larger? Certainly, but that is not the whole story.

The nature of work more generally in both manufacturing and services sectors is undergoing significant transformation. The advent of the "gig economy" and technologies such as additive manufacturing (mass customisation vis-à-vis mass production) foreshadows a future of work that is likely to be very different from what is seen today in both manufacturing and services. The consequence of these changes is likely to play out over an extended period of

time but it is important for us to recognise the kind of action that is needed now, as such changes occur in the future. Three issues, on the characteristic of services, the role of education and nature of social security, are important to point out.

**Services embedded in manufacturing:** First, as the World Economic Outlook from the IMF points out, manufactured goods now have an increasing share of services. Across all countries, such service inputs in the total production value of manufactures rose by about 6 percentage points on average between 1995 and 2011. This occurred due to both compositional effects as well as changes in manufacturing practices such as a more dispersed value chain. However, such service inputs in manufactured goods account for only about 12% of overall value added in the service sector. Over the same period, the share of services in aggregate value added increased by 7 percentage points; of this 6 points corresponded to a rise in final expenditure on services rather than spending on service as intermediate input. So, while manufacturing is becoming more service-intensive, services by itself is growing as a final consumption good. As seen in Figure 5, the share of basic necessities in total consumption is declining rapidly, while that of transport, miscellaneous items,

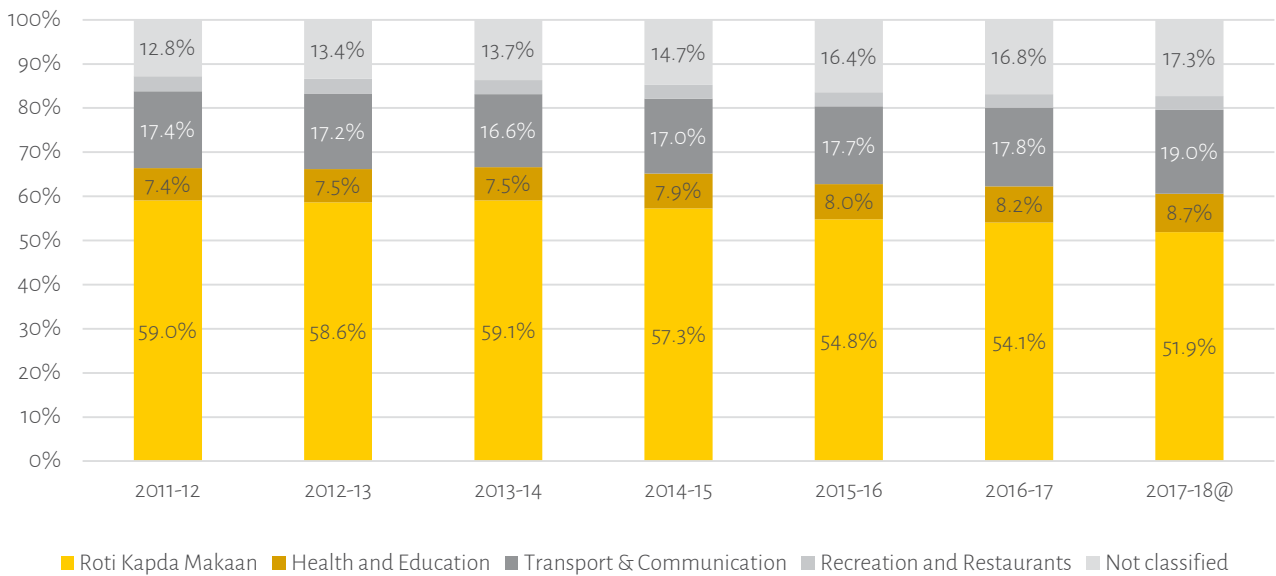
health and education is growing. Thus, as non-durable consumption (mostly basic goods and food) share is declining, the share of services is rising (Figure 6).

of global value chains. For this, attention to reliable and competitively electricity supply and logistics efficiency is key to delivering goods on schedule.

But, this is just the domestic consumption scenario. The emphasis on manufacturing must be associated with an export oriented strategy. India's share of the world market is small enough for there to be substantial room for expansion – especially if one can become part

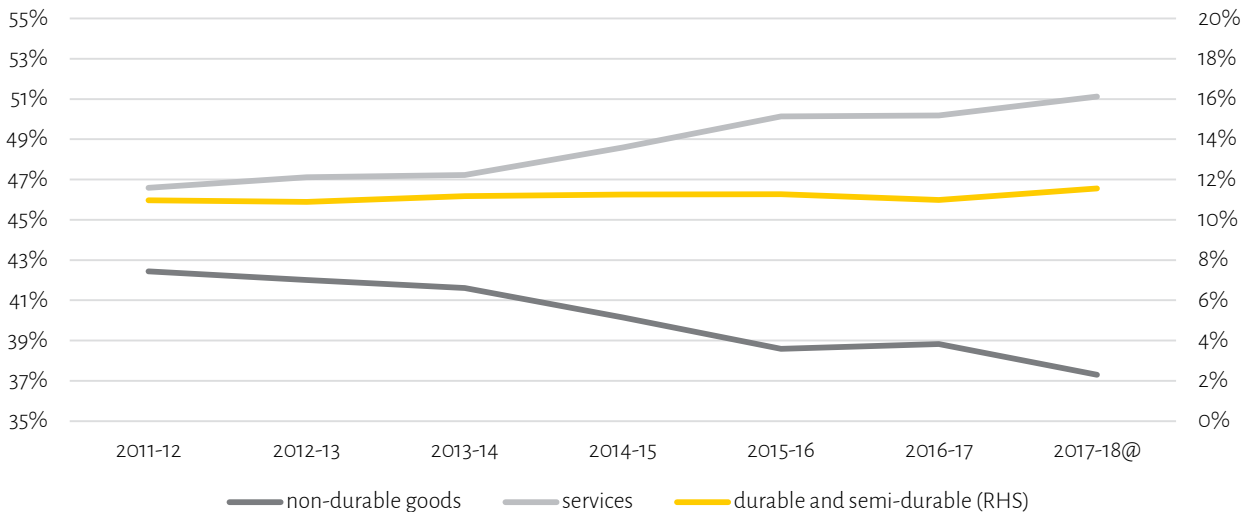
A broad-based job creation strategy will build upon domestically oriented services (externally oriented high-end services will continue to generate high value but limited employment opportunities) and externally oriented manufacturing.

Figure 5: Consumption Basket



Source: National Account Statistics, percent of GDP (current prices)

Figure 6: Growing Share of Services



Source: National Account Statistics, percent of GDP (current prices)

**Lessons for Education:** Second, the fast changing nature of technology means that specific skills are likely to be less valuable, because they will become obsolescent over the lifetime of a worker. It is therefore important that education be seen as much more than training for the workplace, because the training that one will receive a given point in time will last a worker only for relatively short period. Education has to evolve to a system where the core knowledge that is transferred is learning how to learn. In addition, it is also important to recognise that persons could need to acquire new skills and knowledge multiple times during their working life. As such, it is important to provide for an educational and training architecture that would permit workers to acquire new knowledge and skills at a relatively low cost, as and when the needed. Learning how to learn and lifelong learning are thus two characteristics of the education system that is needed to respond to the working environment of the future.

**Social Protection:** Third, the current architecture of most social security systems globally, including that of India assumes that a worker will be employed in a single job for extended periods of time. During this time the person is expected to make contributions into the social security system. These funds, including matching contributions from the employer are invested in a regulated manner and eventually upon the worker's retirement, the return on these funds (and pension, if any) will meet the worker's expenses during retirement. Additional elements of social security like

health Insurance are often provided by the employer with the worker contributing a part, the whole, or none of the premium. These old assumptions about social protection are now increasingly invalid. A worker can change jobs multiple times. A person is occasionally in a formal job and occasionally self-employed or in informal employment. In such a situation it is imperative that the social security system including pensions, retirement benefits and health insurance be delinked from employment and made portable.

## Conclusion

In conclusion, one critical takeaway is the importance of expectations. Price signals are an important component of this but there are many other factors involved in how business and households look to the future – and both are important, if India is to be on a sustainable high growth path.

The second takeaway is that we cannot afford to choose between manufacturing and services. Services have served us well and continue to be a larger part of the global economy and consumption basket. Even manufacturing now has substantial embedded services. We must recognise this, even as we pay more attention to generating more manufacturing jobs.

Finally, as the Fourth Industrial Revolution begins to affect our economies, we will need to pay more attention to the structure of education and the architecture of social security systems.

## END NOTE

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1. Of course, fear about the future may increase precautionary savings, but these are likely to be invested in physical assets.