

Risk-Adjusted Profitability and India's FDI Slowdown

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Abstract

India has been growing at a rate close to seven to seven and a half percent, a number that should make any investor salivate. Yet manufacturing growth has slowed, exports have lost ground to competitors, and net FDI has turned negative. Abhishek Anand, managing director of Insignia Policy Research, argues that the puzzle resolves once you stop looking at expected profitability and start looking at risk-adjusted profitability. A policy environment that keeps changing the rules, that applies different standards to different firms, and that creates uncertainty around implementation can turn an 8 percent return on paper into something far less attractive once risk is priced in.

In this conversation, Abhishek walks through two domains where this dynamic has played out: trade and finance. On trade, he explains why India's "big domestic market" is something of a myth for manufacturers seeking scale, why electricity pricing has become a quiet tax on industry, and how past free trade agreements, particularly with ASEAN, were undermined from within through anti-dumping duties and opaque quality control orders. He also discusses the recent, if slow and reluctant, reversal of these quality control orders under pressure from the United States. On the financial side, he connects declining FDI to the growing market and political power of a small number of dominant domestic firms, and explains why that concentration raises the perceived risk for any outside investor weighing whether they can compete fairly.

The conversation closes with a discussion of what can realistically be done. Abhishek is clear that there is no quick fix for a reputation built over years of inconsistent policy, but he points to small, concrete actions, like extending infrastructure relaxations already given to a few large or prominent firms to all investors, as steps that could begin rebuilding trust over time.

Supplementary Resources

- **To help India's economy, unleash the power sector** by Abhishek Anand, Praveen Ravi, Navneeraj Sharma and Arvind Subramanian (Podcast) [1]

- **Free Trade on Paper, Protection in Practice: How India's Policy Interventions Hollow Out Trade Liberalisation** by Abhishek Anand and Naveen Joseph Thomas (Working paper) [2]
- **Why Modinomics has failed to attract foreign investment** by Arvind Subramanian and Josh Felman (Article) [3]
- **How Quality Control Orders Are Crippling India's Trade Competitiveness** by Abhishek Anand, Shoumitro Chatterjee, Josh Felman, Arvind Subramanian, and Naveen Thomas (Article) [4]
- **Rolling Back QCOs Fixes the Damage, but It Is Not the Same as Reform** by Abhishek Anand (Article) [5]

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Introduction

[00:00:09] **Abhishek Anand:** We're here today with Abhishek Anand, managing director of Insignia Policy Research. His work largely focuses on macroeconomics, trade, and public finance. Hi Abhishek, good to have you with us today.

[00:00:19] **Abhishek Anand:** Hi, thanks a lot for having me here.

Risk-adjusted profitability as the core problem

[00:00:21] **Sanjuktha Athreya:** Can you tell us about what your big idea for us today is?

[00:00:24] **Abhishek Anand:** So, what I would want to speak about is a lot of things that have been happening in recent time. Whether it comes to the goods side, trade, or what is happening on the financial side, we haven't really done well. And people often wonder what could be the reason if India is growing at a gangbusters rate of say seven, seven and a half percent.

[00:00:48] **Abhishek Anand:** And what I personally feel is that we often tend to look at what is the extent of profitability that one can make if you invest in India. But we often tend to overlook the fact that it is not what the expected profitability matters, but it's the risk-adjusted profit. There could be uncertainty in policy making that leads to, even if you're on paper making 8%, risk-adjusted profitability could be low.

[00:01:14] **Abhishek Anand:** So, that would be my big idea that I would want to speak about, that how risk-adjusted profitability maybe has worsened things in recent few years for India, which maybe has led to declining manufacturing growth, as well as our ability to attract FDI.

[00:01:32] **Sanjuktha Athreya:** So let's start with the trade side. What do you think uncertainty has looked like there?

Trade barriers hindering manufacturing exports

[00:01:37] Abhishek Anand: See, on paper, of course, we have done a lot of reforms. A lot of reforms happened in 1991. Then when the government came to power, we had this Make in India campaign that really wanted to boost manufacturing.

[00:01:51] Abhishek Anand: However, of course, there are a lot of policies that we have designed to incentivize manufacturing, but your manufacturing cannot grow unless you are able to export. Because people often think that India is a big country, but what really matters is what percent of population in India has enough purchasing power to absorb your goods.

[00:02:15] Abhishek Anand: And Apple will not be manufacturing in India if it only has to supply in India because there would be very few people with enough purchasing power to buy Apple products. So they are basically coming here so that they can export.

[00:02:30] Abhishek Anand: So for firms to grow bigger, this myth that India is a big economy, a big booming domestic market, is not true. You have to be able to export more. So you have to ensure that it is easier for firms to be able to compete globally. And I think on that part there are a lot of restrictions in recent years, and I'll give you maybe two examples.

[00:02:53] Abhishek Anand: One of the big parts of your manufacturing cost is power. You consume a lot of power, for example, textile is very energy intensive. And what has been our policy over time is that, of course, because of political reasons, you tend to provide free power on the domestic side.

[00:03:14] Abhishek Anand: So if you're a household, every government will announce, you know, 300 units of electricity free, 200 units of electricity free. And finally you have to recoup the cost from somewhere. And then we end up charging manufacturing and commercial entities much more than what they should be charged.

[00:03:35] Abhishek Anand: And this is a recent tendency. In the last few years, what industrial entities have to pay has grown up quite a bit, which raises their cost of production and also raises uncertainty because this is not a fixed thing. Every year it's getting worse and worse.

[00:03:53] Abhishek Anand: Second, again, we often talk about how we are signing a lot of FTAs and that should boost our access to global markets. We have passed a few FTAs in the past as well. And one should draw lessons from what happened in the past, because that is going to determine, if we continue business as usual, we may sign an FTA with the EU and it's not really going to help us much.

[00:04:20] Abhishek Anand: I'll give you just one example. We signed an FTA with ASEAN countries. That should have actually benefited our apparel, which is very labor intensive, high job creation.

[00:04:34] Abhishek Anand: Because countries like Indonesia are the largest exporter of some of the key inputs that go into manufacturing apparel.

[00:04:50] Abhishek Anand: So India should have been able to import all these critical inputs at zero duty. But, on paper, yes, that's what was done, but what really happened is that we raised a lot of non-trade barriers. First, even before the deal came into effect, we added anti-dumping duty on anything that comes from Indonesia. So basically we nullified the effect of the FTA.

[00:05:12] Abhishek Anand: To make matters worse, we had a broad instrument called Quality Control Order where, again, you could not import from some of these key countries unless they fulfilled certain conditions. A labor inspector would visit the production facility and they would have to get a certificate. And that never happened, of course — we did not have the capacity to visit each and every country.

[00:05:38] Abhishek Anand: That's charitable, maybe, maybe that's what happened, but more likely what happened is that you picked out countries — these are the countries which really matter for our domestic people who produce the same stuff.

[00:05:55] Abhishek Anand: And you would see that most of the countries got the certification, but specifically two, three countries that matter did not get the certification. And of course, our apparel, if you look at the data, really collapsed. Our market share — we have been losing it.

[00:06:10] Abhishek Anand: So these are just two examples that highlight how, on paper, a lot of things were done which sound great, but in practice all these barriers were there, which led to heightened risk, heightened uncertainty in the mind of people who would want to invest and do business in India. And because of that, the sector suffered. And we need to look at it, otherwise all these FTAs that we have recently concluded with either the UK or the European Union will not help us much.

Quality control orders and their reversal

[00:06:41] Sanjuktha Athreya: So, you mentioned QCOs, or quality control orders. Now you have written a lot about this topic recently, and we know we've been seeing some reversals from the government on this. So could you tell us a little more about this and how that's contributed to the uncertainty?

[00:06:56] Abhishek Anand: So yes, that's a good thing that the government is thinking about reversal. And I just want to highlight one thing — it was celebrated by many that, oh wow, the government is taking the right measure. And we should congratulate the government for at least owning up to the mistake and then trying to do all this reversal.

[00:07:16] Abhishek Anand: And I say that because these are not something new — we are not only learning in the last few years that, okay, all this quality control, import substitution is something we need to experiment with and then learn, oh, maybe these are bad. Of course those were bad, we learned it, and that's why in 1991 we opened up the economy.

[00:07:38] Abhishek Anand: And we already have that experience that certain things did not work and we shouldn't do it. And in a way we are going back to the pre-1991 era. So basically, despite knowing that these things are bad, that they will not work, the government initially did it. And then, of course, there was a lot of pressure from industry, and from within the policymakers as well — not everyone, but at least some of the well-intentioned people.

[00:08:04] Abhishek Anand: And certainly what really helped is that Trump coming to power and all the things that Trump was saying. And in a way we were forced to reverse some of these decisions. So it is good — I think it happened under pressure, but good that it has happened.

[00:08:23] Abhishek Anand: But the thing is, it is still taking time, and ideally they should have, in one stroke, reversed all the quality control orders. It is happening in steps. Certain sectors where it has been reversed. Now what they are trying to do is, for other sectors where it hasn't been reversed, they have a temporary measure called transitional control order, where they have diluted the strictness of the implementation.

[00:08:49] Abhishek Anand: So I think we're going slow. It's good that the government recognizes that this is something that hasn't worked, and also that the pressure coming from the U.S. is making it course correct, but I guess they need to act faster. Otherwise, we always talk about the China plus one opportunity — it's not going to be there forever.

[00:09:05] Abhishek Anand: And again, in the past, what happened is that because of all these issues, Vietnam and Bangladesh benefited at the expense of India, and we risk losing this opportunity if we don't act as fast as we should.

Uncertainty in financial flows and declining FDI

[00:09:17] Sanjuktha Athreya: Okay. So, now coming to the financial side, what do you think uncertainty looks like there?

[00:09:23] Abhishek Anand: Let me give maybe a slightly generic answer without getting too much into specifics — a lot of commentary about how FDI is slowing down in India. And in fact, the net FDI is now negative.

[00:09:41] Abhishek Anand: And it really matters for a country like India, where, because the current account is always in deficit, the capital account surplus used to finance the current account deficit. And we saw why it matters just now because of the West Asian crisis. And I'll tell you why — if you remember the 2013 crisis, which we often speak about as maybe one of the worst phases in recent decades.

[00:10:08] Abhishek Anand: But that happened after two continuous years of very high oil prices. Oil prices were always above 120, 130 dollars for a good two, two and a half years, plus the taper tantrum. These were two very big shocks for close to maybe two, two and a half years, and that's what was the trigger for 2013.

- [00:10:30] **Abhishek Anand:** And then here, two months of war, and we were just thinking, oh wow, are we going to face a similar situation again? And what was different earlier was that we could still attract a lot of capital flows, and this time, for the last one and a half to two years, capital flows have completely dried up.
- [00:10:50] **Abhishek Anand:** But it has consistently been coming down for over the last seven to eight years, except for maybe the COVID year. And why should that be the case if our economy is genuinely growing at say seven and a half percent? Any country would be salivating looking at the rate of growth in India and would want to invest in India, and despite that we see FDI is slowing down.
- [00:11:12] **Abhishek Anand:** And the reason, I think, is more about uncertainty and risk that foreign investors think about. If I have to invest in India, will I be able to do my business fair and square and compete with others or not?
- [00:11:27] **Abhishek Anand:** And unfortunately, what has happened is there are a few big businesses in India, and the concentration in some of the key sectors has gone up. In many of the key sectors you will just have one or two dominant firms, and the rest of the firms have a very small market share.
- [00:11:45] **Abhishek Anand:** And also these big firms have grown not just in terms of market power, but their access and influence over policymaking. So a lot of regulatory favors get done. They somehow make it happen — that is not possible for other domestic firms, and certainly not for international firms who would want to invest in India.
- [00:12:04] **Abhishek Anand:** And of course that goes into their calculation that, okay, fine, on paper maybe it's a growing economy, big population, and I can make some money. But will I be able to compete with other dominant firms? And perhaps looking at what has happened in the past, it would be unfair competition, because a lot of things will be done in favor of dominant firms, and I will lose out on my investment.
- [00:12:29] **Abhishek Anand:** And I think that's a big — I'm not saying that's the only reason, one can always talk about opening up, getting rid of all the controls and stuff — but given the level of control that we have, I think because of all these risk-related issues, firms are kind of wary of coming and investing in India now.

[00:12:48] **Abhishek Anand:** And that's a big part of the reason, at least the sense that I get, which has led many firms thinking about coming and investing in India to prefer staying away and going to other places where doing business is much easier. One always talks about, oh, maybe it's a global issue.

[00:13:06] **Abhishek Anand:** There's some other issue which is affecting not just India but every other country, which is true, but even if you look at the share of whatever FDI is coming to different countries, India is losing market share. And, for example, Vietnam would be getting much more FDI. So I think it's more about not what is happening globally, but our own domestic policy and the risk that it has created, that has led to the slowdown in our FDI.

Short-term fixes vs long-term trust building

[00:13:34] **Sanjuktha Athreya:** So, we're talking about a very broad environment here, and that's kind of a more long-term change to talk about, right? To change this whole perception of what investing in India is like. But like we were talking about the reversals on QCOs, is there something smaller, more short-term, that you can think of that would be a positive for firms looking to invest in India?

[00:13:57] **Abhishek Anand:** See, unfortunately there is no quick fix to this, because you create perceptions based on your policies, and it's not easy to reverse it. The government will have to, through its action, show that it is not trying to favor a particular group of industry or one particular dominant firm.

[00:14:21] **Abhishek Anand:** It will have to take actions, and it will only happen, for example — I'll give you one example. A big firm wants to invest in India, and usually what happens is power cost is very expensive in India, and you don't want to procure power from the DISCOM, the public utility in India.

[00:14:44] **Abhishek Anand:** And they would want to have their own procurement system, set up their own captive power plant. And usually, of course, it's a source of revenue for the government because if you're buying power from DISCOM, they're very wary of giving you all those relaxations. But for some of the houses that I mentioned, it would be easy for them — they can easily set up a captive power plant or their own solar panel and everything.

[00:15:12] Abhishek Anand: So this is a very small thing, but it's very easily doable — that you give that relaxation. If you are giving relaxation to one or two firms, you should be willing to give that relaxation to any other big firm that is coming here and investing in India, like how they have done it now for Google.

[00:15:28] Abhishek Anand: Google has been allowed that relaxation. This is the first time in history that a private entity, a foreign private entity, has been given that relaxation. But you have to show it in your action, not just to one firm like Google, but to others. Google is very big, it can perhaps influence some of these decisions, but anyone willing to invest in India — something as basic as access to infrastructure, access to power.

[00:15:50] Abhishek Anand: There are small things that can be done quickly, but that doesn't mean immediate reversal. You will have to build that trust, and it may take maybe four to five years. I think there is no short-term fix, but there are small actions that you need to take, and hopefully that builds confidence, and you will start seeing results maybe in another four to five years.

[00:16:11] Sanjuktha Athreya: Got it. Yeah. Okay. Thank you so much for that.

[00:16:11] Sanjuktha Athreya: I think we've gotten a good understanding of what it looks like on the trade as well as the financial side, and maybe some options to hope for in the future as well.

[00:16:23] Sanjuktha Athreya: Thank you for speaking with us today, Abhishek.

[00:16:25] Abhishek Anand: Thanks, thanks a lot.

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