Auronova

Micro Economics

A Shift from the Theory of Scarcities to Excesses & How it may affect BFSI Risk Frameworks

Does modern micro economics still function on the scarcity theory, despite the paradigm shift in the constant Factors of Production ?

The base of Micro-economics is a Quadrant of Market & its Entrants

Land

Labor

Capital

Enterprise

As the traditional theory of micro economics goes, **LAND**, **LABOR** & **CAPITAL** are combined together advantageously by **ENTERPRISE** to produce the desired output i.e., the Product which constitutes of Goods & Services.

When India witnessed the industrial revolution in 1957, the economic theory in play was that of **Scarcities.** Because the market players had limited entrants & the sector was being newly built, the market produce was scarce & therefore the demand escalated.

Over time, the increasing factors of production in play neutralized the scarcity theory, aligning it with the pace of development & newer policies.

Today, the primary relevance of land has measurably diminished. It has given way to **Technology.** Modern technology has evolved from **Knowledge & Information.** Knowledge as a component is ever growing, multiplies output & increases the solution deriving capability of its users exponentially.

Knowledge is the key that unlocked the potential of technology in the 1950s and as it swiftly transformed over decades, it solely enabled the integration of labor & capital in a far more sustainable and effective manner by drastically reducing the manual Labor component through technological replacement and has ensured excess Capital since money printing by Central Banks became a reality.

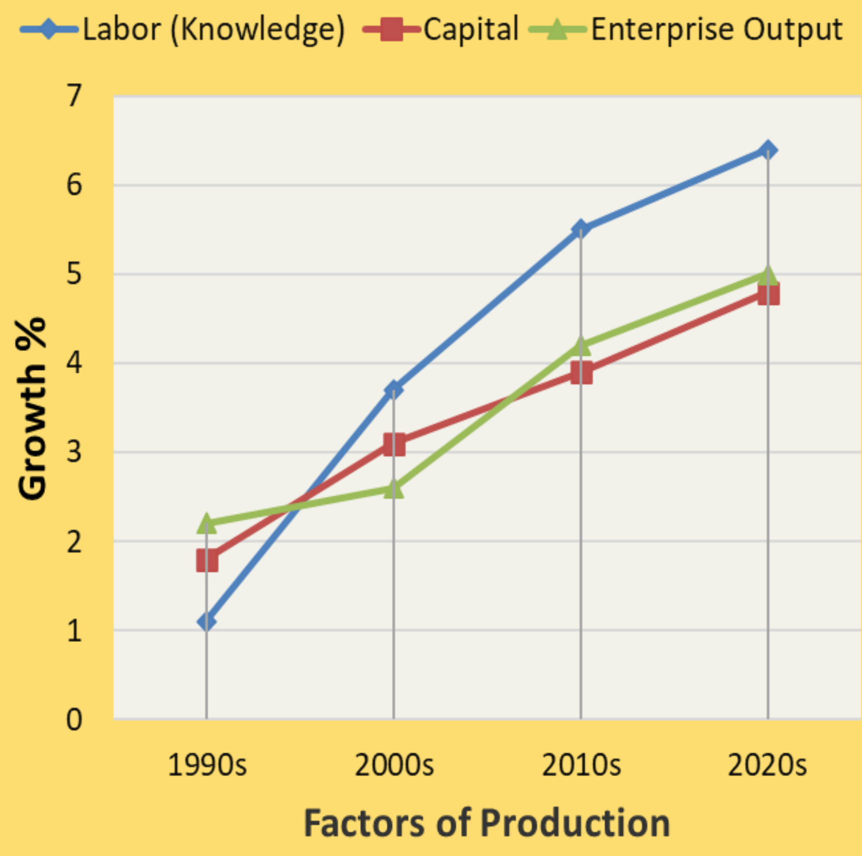
Time, as a significant factor, has radically developed within the sphere of market competition. It is not only limited to achieving near impossible work deliverables but also translating complex operating & financial frameworks within scheduled timelines. Technological innovation has set the stop watch at a faster rate, enabling all organizations to compete on the basis of time & speed.

The 2020 Divergence

Today, the explosion of Data at the epicenter of technology has propelled the industry towards creating compound, variant outputs within a fraction of time, with minimal manual labor as compared to 10 years ago. For most data centric industries, labor has undergone a transition from being manual to intellectual. Today, the quantum of manual labor employed is inversely proportional to the learning & practical knowledge capacity of workers. The millennium has witnessed a boom in the population of knowledge centric employees.

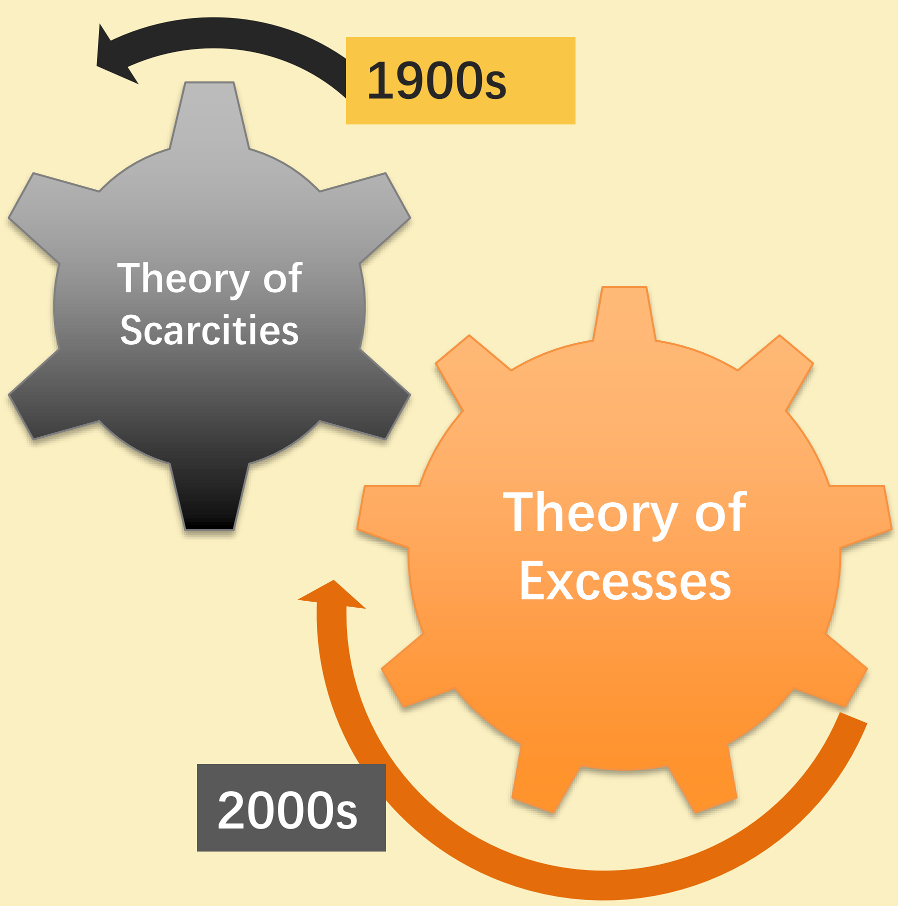
This has led to an exponential growth in revenues since the output has seen vast leaps too. Subsequently, the quantity of capital in the economy has excessively increased as circulation of money has risen considerably due to a surge in Purchasing Power of the populace. Coupled with currency printing, capital is largely in excess & the cost of borrowing has consequently reduced to very low levels.

Factors of Production in Excess



Source: Asian Development Bank

How does Economics explain Excess Supply in Markets when the traditional yet current model is based on the Theory of Scarcities?



Economics has overlooked the concept of a future, imminent interaction between knowledge based labor, capital and product markets that are in excess supply today. This is attributed solely to the lack of assured and sustained data forecasts.

Alongside Factors of Production, economics is also theorized based on **Human Behavioral Tendencies** towards market movements. Since every decade sees a paradigm shift in technology resulting in differential changes in information-based labor, land prices and capital adjustments, past human interactions with microeconomic market forces cannot be a precedent for accurate futuristic data. Today, the Theory of Scarcities can only be treated as an illusion within the markets to retain Consumer Demand and control Price fluctuations & Inflation.

Why is the Theory of Scarcities Not Working Today?

Knowledge & Information have become the cornerstone qualification for the present working population. With knowledge being branched out into niche fields, a number of Freelancers & Independent Contractors, with subject specific familiarity have seen a significant growth in the last decade.

This form of **Gig Economy** has been throwing the previously existing labor market dynamics into a disarray. Statistically, within gig economics, job tenures, annual incomes, employment status and liabilities in form of debt are ambiguous & misrepresent the actual forces at work for the labor markets. A concise, clear & a comprehensive picture is elusive due to the translucent framework revolving this economy's' statistics.

Banks today are able to provide credit at lower interest rates to borrowers thanks to Government stimulus programs for encouraging economic growth and lower financing costs encourages borrowing & investing. However, when interest rates are too low, they can spur excessive growth & subsequent inflation, reduce purchasing power & undermine the sustainability of the economic expansion.

Over-leveraged borrowers get entrapped within multiple debt-credit repayment cycles as pandemic waves cripple working population, creating a credit turmoil & increasing their level of cash conservatism as also delinquencies due to income losses.

Risk Assessment for Borrowers & Lenders

Since the functionality of current labor markets is also resultant on the anomalous combination of skewed statistics of Gig economy & excessively lowered interest rates on capital, risks emerge in form of increased borrower delinquencies & uncharted financial data sets of Gig workers, for the banks. The risk frameworks in most banks & Financial Institutions (FIs) are not structured nor have risk contingencies to resolve or mitigate these newer age risks spun by the pandemic.

A prolonged period of relatively low interest rates can induce financial imbalances by reducing risk aversion of banks and other investors.

In the short term, lower interest rates lessen the probability of default on existing loans, leading to a reduction in the banks' risk-portfolio. Thus, in long term, banks start to undertake more risky operations & projects with a higher probability of default.

Such portfolio risk assessment frameworks are paramount for banks & FIs to establish & monitor to be essentially aware of the excess capital & lowered interest impacts on borrowers repayment capabilities.

Parting Thoughts

To insulate lenders & borrowers from the negative effects of current credit financing costs & repayment disruptions, regulators must focus on macroprudential policies focusing on possible excesses in finance and the economy namely Capital & Labor excesses.

Banks & FIs require tailor made, capital stringency policies integrated within their risk frameworks to analyze & precisely decipher the risk capabilities of their borrowers in both short & long term, accounting for statistical inaccuracies arising from incomplete & inaccurate Gig economy data, thus neutralizing the domino effects of lower interest rates on both borrowers & lenders capital.