WEEKLY ECONOMIC COMMENTARY

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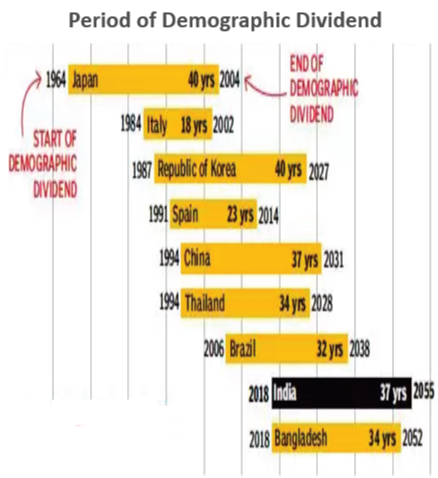
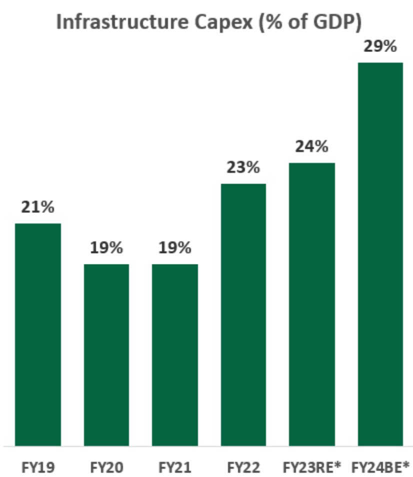
Having played sports my whole life, there is hardly an outdoor activity which I haven't tried. I have been known to skip irksome social gatherings just to get out on to the fields. The only sport I despise is running; I cannot imagine why anyone would willingly run a marathon. But I do enjoy watching these endurance contests.

The long-distance race I like following the most occurs once every five years. India's marathon national elections kicked off with the first round of polling last Friday, and will stretch over 44 days in seven phases.

The outcome of this lengthy exercise is not much in doubt, with most surveys predicting Narendra Modi to return as prime minister with a clear parliamentary majority. But there is a lot at stake for the Indian economy as it tries to realize its full potential and play a more defining role in the world.

Despite global headwinds, India has remained the fastest growing major economy, with real gross domestic product (GDP) expanding by 8.4% year over year in 2023. India's population of over 1.4 billion is the largest in the world, a title that it is poised to hold for some time to come.





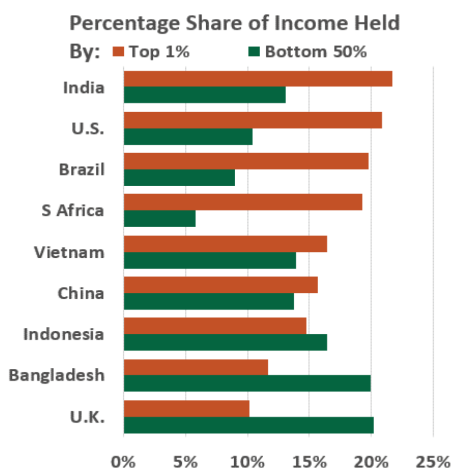
*Sources: Economic Times, FinMin, BofA; *Revised Estimate and Budget Estimate*

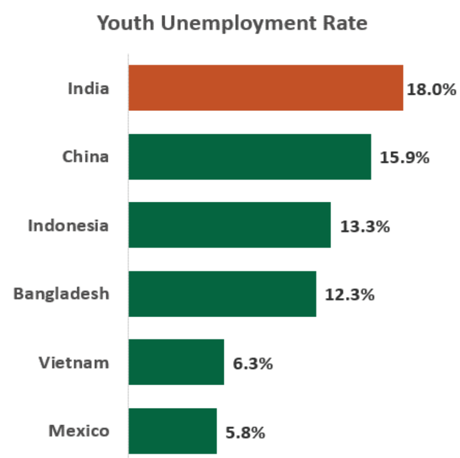
The nation's growing middle class and a young demographic skew are driving consumption. In 2018, India entered a 37-year period of demographic dividend, an interval in which the working-age population grows faster than the dependent population. Higher capital expenditures by the government over the last few years have been another pillar of growth. Cheap data and an exponential increase in mobile subscriptions are driving rapid digitization, accelerating the formalization of the economy.

External account vulnerabilities to global shocks have faded, with foreign exchange reserves climbing to an all-time high of $646 billion, equivalent to over 10 months of import cover. The rupee was one of the best performing currencies and the least volatile among global peers in 2023. India has fared better than several of its emerging and developed counterparts in keeping price pressures contained, despite heavy reliance on commodity imports. Equity markets scaled new highs, delivering 20% returns last year. Fiscal concerns have been fading, thanks to higher tax revenues and the government's commitment to reining in public deficits.

The optimism extends beyond the country's strong domestic performance. Amid tense U.S.-China relations, India is increasingly seen as an alternative to China for diversification of supply chains. The government has been actively courting multinationals to set up shop by offering incentives and spending billions on improving infrastructure. Annual foreign direct investment inflow has almost doubled from $45 billion in 2014-15 to about $85 billion in 2021-22.

That said, India's strong headline GDP growth masks a host of economic challenges. The benefits of strong economic performance have not trickled down to the bottom of the pyramid. Extreme poverty is falling from a high level, but a high proportion of the population still struggles to make ends meet. 800 million residents qualify for the government's free food program. Inequality has worsened to a 100-year high. The top 1% of Indians account for over one-fifth of the national income, compared to less than 15% earned by the bottom half of the population. That is higher than countries like the U.S. and South Africa.





Source: World Inequality Database, World Bank

India's youth can provide a demographic dividend, but only if employment prospects improve.

India has the world's largest workforce, but not enough jobs. This situation is a major issue surrounding this year's election. India's youth unemployment problem is one of the most acute among its emerging market (EM) peers, and more dire than reported in the official surveys. The labor force participation rate among women is still quite low, relative to other EMs. Millions of young people are becoming a drag on the economy. According to HSBC, India needs to create 10-12 million jobs a year to prevent the demographic dividend from turning into a disaster. That is about twice as many as are being created annually at present.

India seeks to become more of an industrial hub. Our "Make in India" campaign seeks to increase manufacturing's share of national output from 17% to 25% of gross value added (GVA) by 2025. Though more and more companies are seeking to shift or diversify their supply chains to India, the share of manufacturing in GVA has remained unchanged over the past decade. Infrastructure, along with an improved ease of doing business, will be needed if goals are to be met.

Growth in the agriculture sector, which contributes 16% to India's GDP and employs nearly half of the population, has been slowing and faces frequent disruptions from climate change. With some very sensitive borders, the country also needs to invest in shoring up its defenses. Public debt has been rising fast, but a significant chunk is in domestic currency, thereby reducing vulnerability to external shocks. Despite tax cuts and incentives, private investment as a fraction of GDP has been shrinking for more than a decade. It isn't ideal for the government to do the heavy lifting on both capital and welfare spending.

India has immense opportunities, but also immense challenges.

The two biggest national parties are making big economic promises. The Congress aims to double GDP in the next decade, while the ruling BJP aims to quintuple per capita income by the centenary of independence in 2047. On average, GDP will have to grow by more than 7% annually to hit those ambitious targets. By comparison, India's GDP grew 7.7% last year and averaged 7.2% in the decade before COVID.

The Indian economy needs to maintain its tempo if it wants to finish this marathon task of becoming a developed economy by 2047. More investments in physical and human capital will go a long way toward improving performance. The last miles of a marathon are the hardest, but they are the interval over which successful competitors stand apart from the pack.

Going Separate Ways

The International Monetary Fund (IMF) publishes a wealth of information during its spring meetings, which took place earlier this month in Washington. The lion's share of attention goes to the World Economic Outlook, the release of which is marketed heavily.

By contrast, the IMF's Fiscal Monitor is low-key. But the most recent edition was worth reading. It focused, in part, on the increasing application of industrial policy around the world. This trend will have important consequences for growth, inflation and debt.

In classical economics, an "invisible hand" steers resources to their best use. Capital and labor migrate naturally to industries and occupations where opportunities are the best. Any attempt to interfere in the process creates "wedges," areas of inefficiency which are costly to societies. Nonetheless, all governments engage in some steering of their economies.

The degree of government intervention in markets has escalated substantially since the pandemic. Centrally-directed efforts were critical to dealing with COVID-19: subsidies for medical research, testing and vaccination were essential to corralling the virus. Developments in this space might certainly have progressed naturally without Federal direction, but coordination proved much better than competition in speeding response.

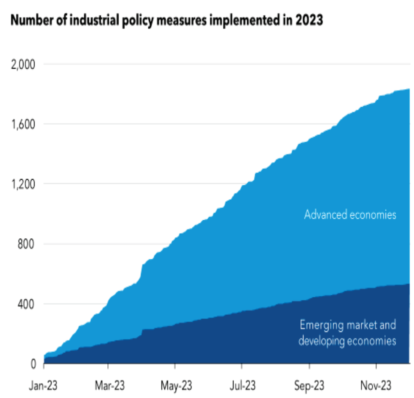
The post-pandemic era has provided new openings for the broader application of industrial policy. Problems with far-away supply chains prompted a desire for more proximate options. Increasing stress between Beijing and the West has prompted the latter to reduce reliance on China. Governments have become heavily involved in "re-shoring" efforts.

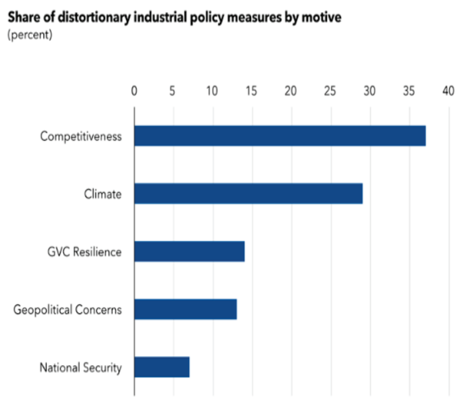
Security has become more tenuous in the wake of wars in Ukraine and the Middle East. This has always been an area where government involvement is common, even desired. Policy support for the defense sector is increasing, and advancing investment in microchip fabrication has strategic as well as civilian foundations.

Finally, industrial policy may be justified on the basis of competitiveness. If trading partners are supporting key industries, then nations feel more justified in responding. China's state-sponsorship of key sectors is the most substantial example of this, but not the only one. Creating national champions as opposed to trusting external channels seems to be the order of the day.

However sensible all of these initiatives may seem, they have increased fragmentation between countries. Battles over subsidies and sponsorship have become common; reversing anti-competitive behavior is difficult, given the challenges facing the World Trade Organization. The result is an industrial arms race that will almost certainly result in global overcapacity. Smaller economies are at a disadvantage to larger ones in promoting their industries, narrowing their paths to development and making it more difficult for them to handle their debts.

Government direction of economies should be viewed with apprehension.





Sources: IMF, Global Trade Alert

Further, the execution of industrial policy invites a host of potential hazards. Governments may not be the ideal agents to determine which sectors are worthy of special emphasis; dulling the influence of markets in directing capital risks inefficient allocations. Even if sector selection is prescient, identifying the "winning" providers is not easy. Government involvement invites politics into the process, which may not be aligned with maximizing efficiency. This can be an especially powerful distortion during election years.

Governments rarely get the full returns on their investment in industrial policy. The public provides capital through the national budgeting process, but the rewards for success (if achieved) accrue primarily to the private sector. Tax regimes rarely return sufficient revenue to defray costs, leaving budget deficits enlarged.

Debate over industrial policy is active in both academic and political circles. Some studies hail its benefits, while others illustrate substantial downsides. Only one thing is clear: countries are looking out for themselves more than they used to, which weakens the global order. And that has both economic and diplomatic costs.

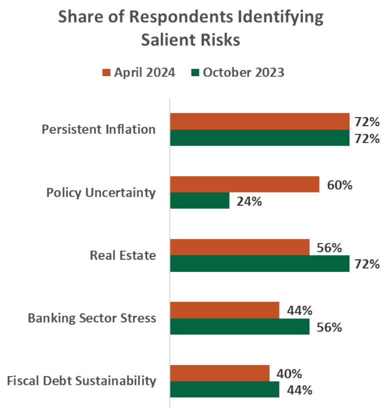
Financial Stability, Rapport

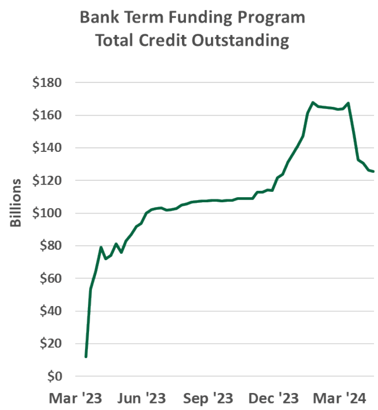
My first professional turn as an economist came when I worked in consulting. And I do mean *worked*: Late nights and weekend deadlines were routine. In contrast, the work-life balance of bank employment has been a tremendous relief. With rare exceptions, weekend time is our own.

One memorable exception came last March, as the failure of Silicon Valley Bank (SVB) carried the risk of contagion to the entire financial sector—as I learned while on an emergency Sunday conference call. High stress endured through the closure of First Republic Bank on May 1, 2023.

A year later, we can see that weekends across the financial sector are more relaxed. Last week, the Federal Reserve published its semiannual Financial Stability Report. The report was broadly encouraging, noting that banks maintain capital ratios well above statutory minimums, with ample liquidity. Bank profits have been stable in spite of a volatile rate environment, as interest income has nearly kept pace with rising interest expense. Deposit outflows were a point of great concern in the wake of SVB, but they stabilized and returned to net inflows in the fourth quarter of 2023.

Still, the report noted a bevy of risks: Banks carry unrealized market value losses on their fixed-income portfolios. Office commercial real estate is an albatross for many lenders. Subprime consumer credit delinquencies are on the rise, as are some small business loans. Financial sector participants reported inflation and its corresponding impact on monetary policy as the top risk.





Sources: Federal Reserve, Haver Analytics

Pressure on the banking system has diminished over the past year.

The report also spotlighted the Bank Term Funding Program (BTFP), the Fed's special facility launched to ameliorate last year's distress. After injecting $168 billion of liquidity into the system, BTFP was closed on schedule this past March; its loans will wind down to zero by March 2025. We have now learned that BTFP extended advances to 1,804 depository institutions, 95% of which were institutions with total assets below $10 billion.

This suggests that the liquidity challenges facing the system last year were fairly widespread. The BTFP provided a very effective bridge to a more normal environment, and will likely be resurrected in the event of future financial instability.

In sum, risks facing the U.S. banking system are still present, but they are well-understood and not nearly as pressing as they were a year ago. That should keep our weekends clear.

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