Economics

DBS Focus

India: Easing inflation – macro positive, micro concern

DBS Group Research

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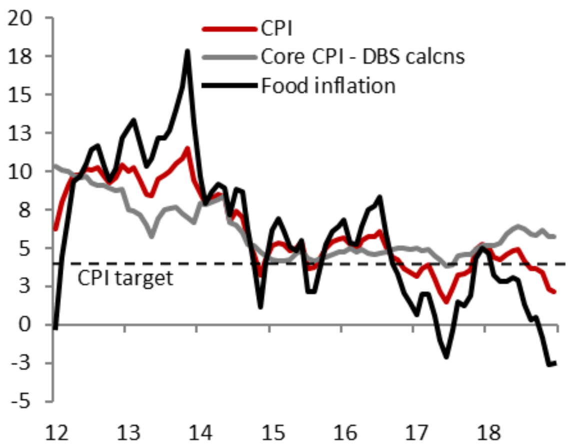
- *India's inflation has eased to the lower end of the RBI's target range of 2-6%*
- *From a macro perspective, soft inflation bodes well for the economy and consumption*
- *Yet, much of this disinflation is led by declining food prices, which is a worry at the micro level*
- *Host of factors, structural and cyclical, have caused farm and rural incomes as well as demand to moderate*
- *This underscores the pressure on policies to shift from a consumer bias (pro-inflation) to producer bias (protecting incomes)*
- *Pro-rural measures, particularly a less-distortionary income support scheme, are under discussion*
- *Latest speculation is that a proposed farm plan might absorb existing programs and subsidies.*
- *This or any proposed plans along these lines will provide relief, while also setting the stage for durable and long-term support*
- *In the meantime, India's monetary policy is likely to remain in neutral-to-dovish gear this year*

India's FY19 CPI inflation slowed sharply into the December 2018 quarter. Headline CPI inflation slipped to 2.2% YoY from near 5% in May-June, falling to the lower end of the central bank's 2-6% inflation target range (4% marking the mid-point). This was against the backdrop of a rise in imported price pressures, due to a surge in global (and local) oil prices and an 8.5% fall in the Indian rupee in 2018.

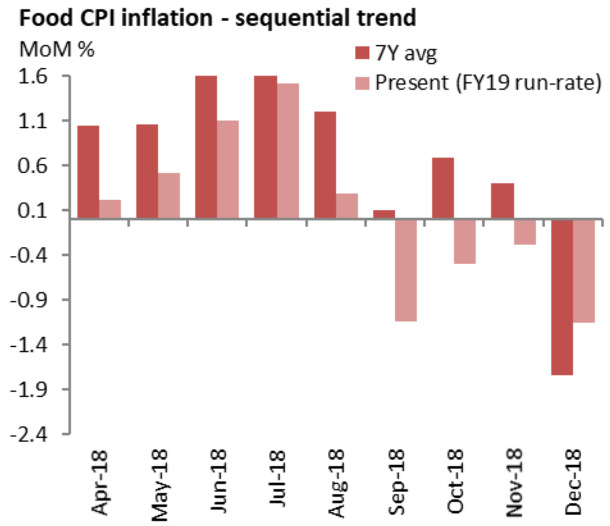
Lower food inflation drags headline CPI lower



Source: CEIC, DBS Group Research

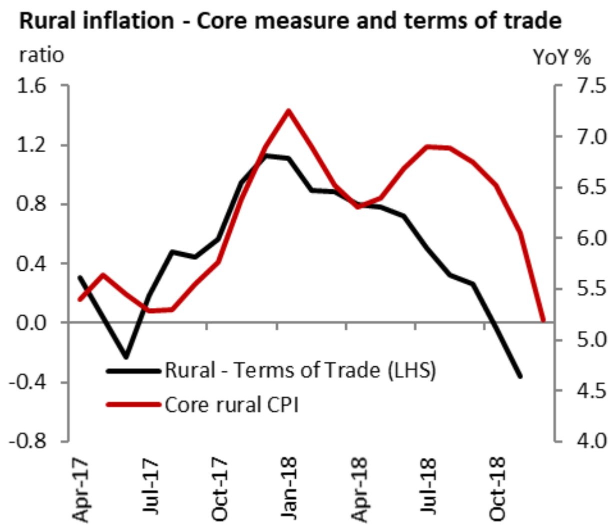
From a macroeconomic perspective, ongoing deceleration in inflation is a positive development, particularly as stubbornly high inflation in the past resulted in high real rates, impinged on consumption spending and hurt investment interests. Hence, a correction from 6% in FY15 to a second consecutive year of sub-4% is a welcome improvement. This favourable inflation backdrop provided the central bank with the headroom to prioritise its price stability mandate and keep benchmark rates on hold in 2H18, while others in the region raised rates.

Data breakdown, however, reveals few micro concerns. Food, which accounts for half the basket, is behind the sharp pullback in the headline, while service pressures prove to be relatively sticky (reflected in the core readings). To be sure, inflation has whipsawed in the past (case in point, the mid-2017 swoon to sub-2%), but what is different at this juncture is that the slump in the seasonally weak periods of the winter months is sharper than the 7Y average for the series (see next chart). Most food categories are showing low inflation, with vegetables, fruits, pulses and sugar on a decline.



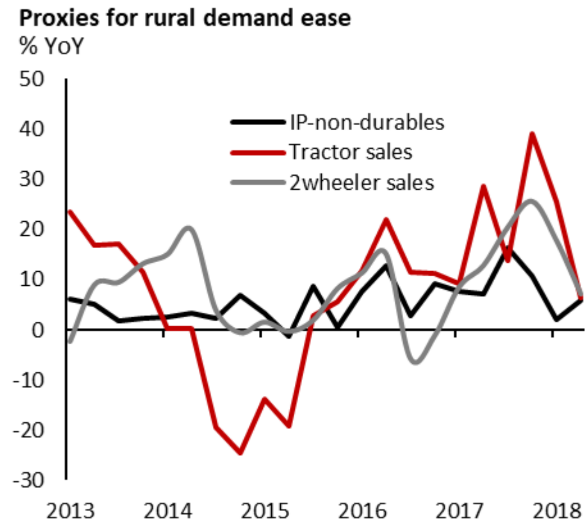
Source: CEIC, data transformations by DBS Group Research

A sustained bout of food disinflation point to falling returns on farm output. Other data also corroborate this observation. Rural inflation has declined at a faster than urban. Secondly, the rural terms of trade i.e. food vs non-inflation changes have also weakened, boding poorly for demand conditions.



Source: CEIC, data transformations by DBS Group Research

Add to this, rural (agri and non-farm) wage growth have slowed, with the recent pick-up being still at modest levels than in the past. Demand, as a result, has been subdued. The next chart shows most of the proxy indicators, including two-wheeler sales, non-durables output and tractor sales retreating from recent highs.

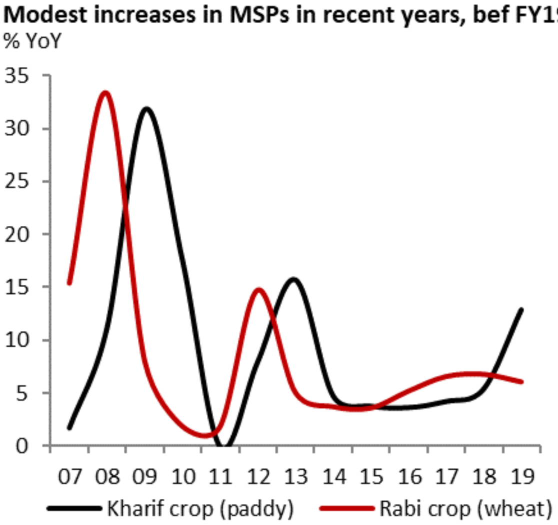


Source: CEIC, DBS Group Research

Drivers of soft food prices and slowing rural incomes

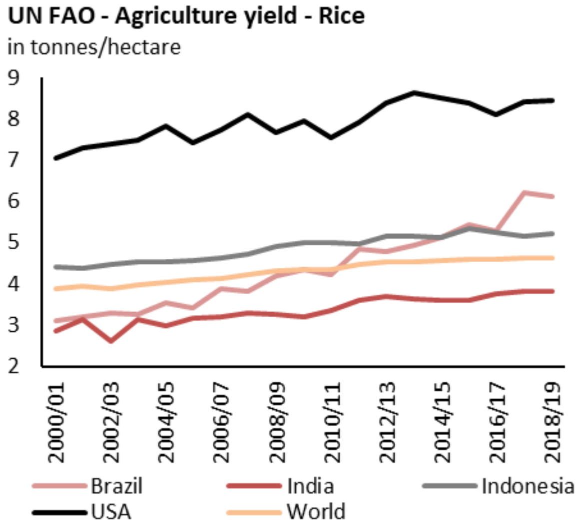
Contribution of agriculture to India's growth has fallen to 17% today from nearly a third in the 1990, but farm jobs still provide 43% of the employment (2017; World Bank). **Despite being one of the key breadwinners for the economy, food prices have declined in the past two years,** mainly due to cyclical factors, while the farm sector faces larger structural constraints, leaving food vulnerable to swings.

Cyclical factors include weaker cues from global farm commodities, along with domestic over-supply due to higher production/ imports whilst export restrictions are in place. Demonetisation was a temporary initiative but dealt an enduring impact on the cash-based rural/farm sector. Increases in the minimum support prices were modest for the past three years, keeping a lid on inflation, with a sharp increase only undertaken in the latest kharif crop (see chart). The latter is, however, yet to translate into material gains for the farming community. Procurement has been on track, but domestic over-supply coupled with imports, have left actual prices way below MSPs [1]. In the two years to June 2018, key agencies i.e. National Agricultural Cooperative Marketing Federation of India, Small Farmers' Agribusiness Consortium and Food Corporation of India (FCI), cumulatively, stepped up procurement not only of foodgrains, but also pulses and oilseeds. But surplus availability and continuous imports, resulted in massive build-up of stocks, which in turn makes it a challenge to step up further market intervention, with high associated costs as well. Many issues related to agriculture are state subjects, thus making it crucial, yet a challenge, to arrive at a cohesive policy in a federal set-up.



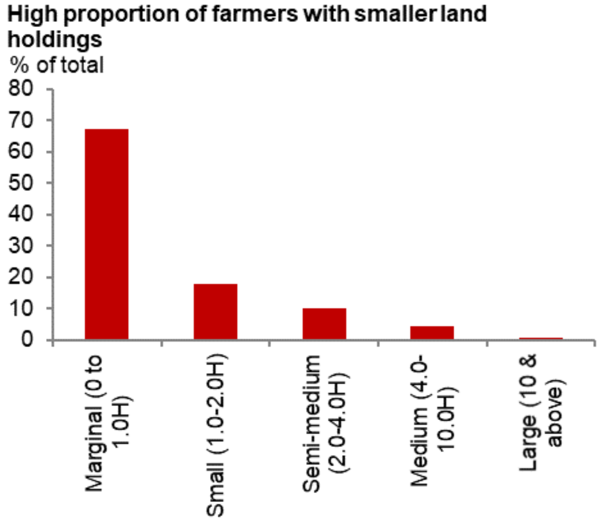
Source: CEIC, DBS Group Research

On the structural end, the agricultural sector continues to face headwinds. Labour productivity in India has lagged other Asian economies, including China, Vietnam, Indonesia and Thailand [2]. While land productivity has improved, yield potential across crops is still low.



Source: UN FAO, DBS Group Research

Add to this, there is substantial fragmentation in holdings and land use. A disproportionately large set of landowners have small land holdings which render their incomes vulnerable to swings in farm produce (see chart).



Source: Agriculture Census 2010-11, DBS Group Research

Next, production trends have diversified as a bigger area has been allocated to commercial crops, whilst some other decisions are dictated by incentives and ecosystem availability (e.g. support prices, marketing, inputs etc.). Outside of this, farmers face substantial swings in the price of their produce, including for horticulture crops. Here the lack of adequate physical infrastructure and warehousing capabilities are a constraint. State-specific have also crept up, impacting the supply-demand dynamics for crops [3]. Rain-fed parts of southern and central Maharashtra as well as in parts of Karnataka and Telangana, have exposed farmers to an uncertain cropping pattern and pressured earnings. In Uttar Pradesh, production has alternated between cereals and sugar cane, with the farmer confined to a low-income margin output from cereals, and volatility in returns from sugar cane (especially in midst of the current price slump).

Efforts to safeguard rural incomes are necessary

Amongst the immediate economic priorities for the government is to address the weak farm demand quotient. Hence, policies are likely to shift from a consumer bias (pro-inflation) to producer bias (protecting incomes). Efforts were underway in the past two-three years through various reforms including introduction of the e-NAM (National Agriculture Market), crop insurance scheme, direct benefit transfers, following up with the Model APMC Act, amongst others. While these are long-term positive, pressure has risen to introduce steps to boost incomes in the short-run.

Farm loan waivers were the first line of defence at the state level, with nearly eight having announced waivers, including by Maharashtra, UP, Punjab and Karnataka. **Official remarks belie the likelihood that the program will be adopted at a national level, but three other measures are likely under consideration** – new direct income scheme, cash handouts to bridge the gap between support and actual prices, and revised crop insurance or lending scheme. Popular discourse is split between a price deficiency scheme and direct income/investment support. While the former lifts farmers' incomes, it is seen as distortionary. Instead the income scheme is considered more equitable and transparent, though fiscal costs will be high.

As we write, the latest speculation is that a proposed farm plan might absorb existing programs and subsidies, according to Bloomberg. Plans might include transferring cash to farmers, subsuming various subsidy overheads (food, fertiliser etc.) Cost of such a program is pegged at INR700bn per year (i.e. 0.4% of GDP), with a manageable impact seen in the FY20 math, while FY19 math remains unaffected. According to the FY19 subsidy breakdown, food and fertiliser subsidies accounted for 1.3% of GDP, down from 1.6% in FY16.

While no final word was available on this as we go to print, any such plans will provide interim support, but face implementation challenges and associated fiscal costs. If an income scheme is rolled out on a national scale, the math might work like this - INR10k/hectare for total cropped area of 1978 lakh hectares, total costs will accrue to INR1.97trn [4]. Press reports peg the annual costs of such cumulative benefits in the range of 0.5-1.5% of GDP, which will require the centre to share the cost burden with the respective states. Add to this, farm-focused schemes would require updated land records, with progress on the Digital India Land Records Modernisation Programme (DILRMP) differing across states [5]. As of 3Q18, two states and three Union territories have completed computerization of land records, while four others are yet to start the process; remaining states have computerized between 80-90% of the records. Also, land ownership needs to be ascertained through various departments, making it a challenge to access them.

Despite these challenges, an income safety-net is likely on the cards. Impact of the measures will be more apparent in the FY20 fiscal math. This will require the authorities to either set the fiscal target higher than the FRBM's suggested -3.1% of GDP or factor in an optimistic 12.5-13% nominal GDP growth estimate vs FY19's budgeted 11.5%. We see the possibility of the FY20 deficit being pegged at -3.2-3.3% of GDP. On revenues, greater traction in GST revenues due to a wider tax base and improved compliance, and steady commodity prices will be factored in.

Longer-term initiatives for the sector will be necessary but drawn out in implementation. These include measures to improve labour/ land productivity, easier access to input markets (seeds, fertilisers, water etc.), strengthen institutional overreach, transport/ warehousing facilities and better access to efficient domestic and export supply chains, amongst others

Monetary policy in neutral gear

Ongoing food disinflation is likely to keep the headline CPI in the 2.0-3.0% range this quarter, guiding the Reserve Bank of India panel to shift the policy stance from 'calibrated tightening' to 'neutral' in February 2019. Remarks of new Governor Das and a commitment to keep the fiscal deficit close to its FY19 target of -3.3% of GDP (at the interim budget announcement on 1 February) will also be watched closely. Street expectations are shifting towards rate easing in April or 3Q19, with the wide real rates cushion providing enough cushion. If undertaken, the cut cycle will be shallow at best, with a neutral policy outlook looking more likely for the year. Prospects of firmer demand, owing to an expansionary fiscal stance and income support schemes, along with low base effects, is likely to lift inflation towards 3.5-4.0% by late-2019, closer to the mid-point of the RBI's 2-6% target range.

The global environment remains a wildcard. Factoring in our current expectations of a US Fed tightening cycle to continue into 2019, with an eye on the end of the 90-day waivers on oil exports from Iran, by 1Q19, the direction of oil and USD/rates will be watched closely.

Notes: [1] MSP intervention: A different surplus; Indian Express; [2] OECD-ICRIER Food and Agricultural Reviews; 2018; [3] Institute of South Asian Studies; Insights 530; [4] ICRIER Working paper No. 357; [5] PRS; Modernizing land records in India; Sep 2018

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).