

**India****RURAL REVIVAL AT A FISCAL COST****Shumita Deveshwar / Amitabh Dubey**

One of the first steps that the Bharatiya Janata Party took after assuming office in the southern state of Karnataka earlier in May was to waive farm loans up to Rs100,000 (US\$1,500) each. The state government that introduced this measure lasted only two days, but its successor is under pressure to continue with the estimated Rs530 billion write-off. All parties are wooing the rural voter in the run-up to India's 2019 general elections. Below we examine how India's troubled rural economy will shape the economics and politics of the country in the next 12 months.

- Rural wage growth has been decelerating since 2013 because of poor monsoon rains, commodity deflation, weak construction activity and the Modi government's early decision to slow down the rural employment guarantee programme.
- A recent pick-up in rural consumption is due mainly to higher government spending, including on the rural employment scheme and farm loan waivers, which will continue as the government has promised increases in the guaranteed prices for crops.
- During our visit to the eastern state of Chhattisgarh last week, we saw how government programmes are helping underpin the rural economy; indeed, the contribution of government spending to India's GDP growth has increased sharply over the past two years.
- We expect the pattern of higher government spending in an election year to continue under Modi, who may just be able to reap the electoral benefits of a pick-up in demand in the short term; it will be up to him – or his successor – to consolidate the larger fiscal deficit that will be inherited by the next government.

Decelerating rural wage growth . . .

Rural wage growth is under continued pressure in India's vast hinterlands while consumer demand has rebounded after several quarters of sluggish growth – these were the main takeaways from two contrasting reports on the state of the rural economy published earlier this month. Data collated from the Labour Bureau by the Centre for Monitoring Indian Economy (CMIE) show that rural wage growth for men slowed to its lowest level in more than three years to 3.1% yoy in January 2018; if adjusted for inflation, wage growth is, in fact, negative. This applies not only to farm incomes but to non-agricultural jobs in rural areas as well, such as electricians, carpenters and porters.

Average rural wage rates (% yoy)



Sources: Labour Bureau, CMIE, media reports.

Rural wages have been decelerating since 2013, and the fact that political parties have been announcing farm loan waivers in various states since early last year – and continue to do so – shows that rural distress is very real. Indeed, evidence from on the ground reinforces that view: there is very little change to be seen in terms of growing prosperity. According to a 28 April 2018 Reserve Bank of India (RBI) working paper, the weakening significance of the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), the slowdown in construction, lower inflation and the poor monsoon rains in 2014 and 2015 have all contributed to the drop in wage growth.

Farm waivers announced by states

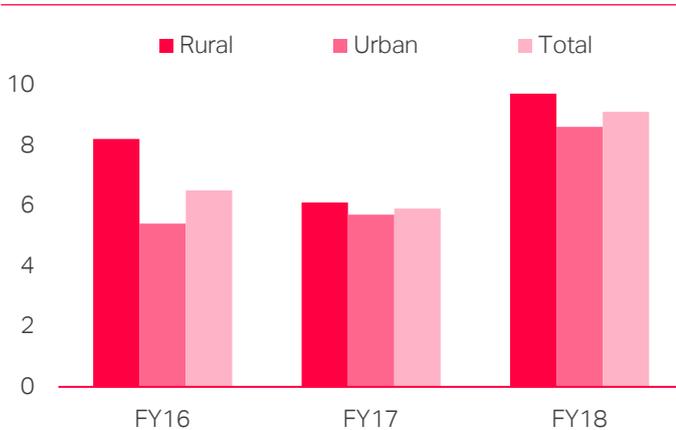
State	Ruling party	Date	Amount (in Rs bn)
Uttar Pradesh	BJP	April 2017	364
Punjab	INC	June 2017	100
Maharashtra	BJP	June 2017	340
Karnataka	INC	June 2017	82
	BJP/INC+JDS	May 2018	awaiting announcement
Rajasthan	BJP	February 2018	80

Source: Media reports.

... contrasts with rural sales growth

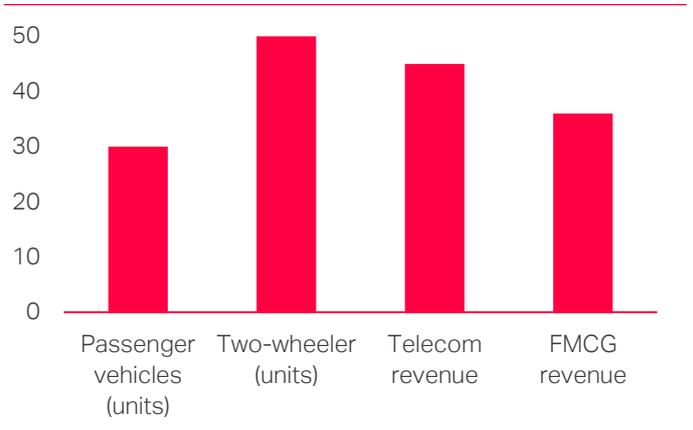
Yet, consumer goods firms have been reporting that their sales growth in rural areas is growing and now exceeds growth in urban areas. Market research firm Nielsen said that FMCG firms' sales rose by 9.7% by volume in FY18 compared with an 8.6% rise in urban areas. The growth in FMCG rural sales is higher than the growth in the past two financial years, and the gap between rural and urban sales growth has widened, as the chart on the left below shows. The rural economy contributes 50% to India's GDP and the chart on the right-hand side below shows why rural sales are important to corporates as well.

FMCG sales growth by volume (%)



Source: Nielsen data published in the Mint newspaper

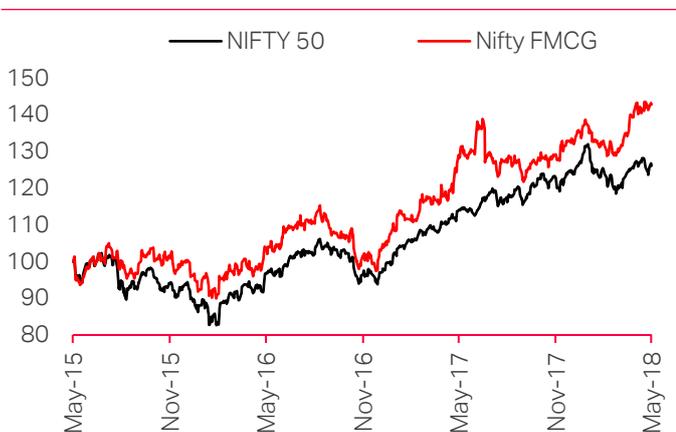
Rural contribution to sales (%)



Sources: Nielsen, India Brand Equity Foundation, media reports.

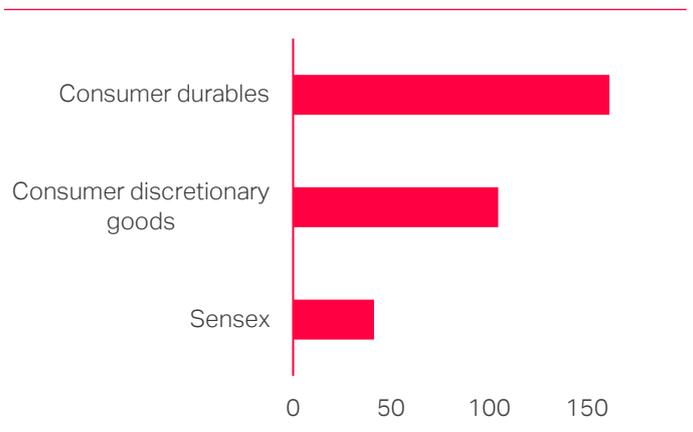
In India's consumption-driven economy, stocks of consumer goods firms have always been an investor favourite. Amid recent reports of green shoots of recovery in rural sales, the Nifty FMCG stocks have outperformed the benchmark Nifty 50 index. And since Prime Minister Modi came to power in May 2014, consumer-related stocks have far outperformed the Sensex as well.

Nifty 50 vs Nifty FMCG*



Source: Bloomberg. *Note: Base 29 May 2018 = 100

Index growth since May 2014 (%)



Source: Bloomberg.

Drivers of rural spending

But if the rural economy has been in distress, what is driving this growth? One of the drivers is reduced taxes – and therefore prices – for consumer products following the July 2017 rollout of the Goods and Services Tax; rates on shampoos, detergents and home care products fell from 28% to 18%. As companies prepared for the switchover to the new tax, they offered promotions to offload their inventories, which resulted in higher sales volume growth. This has raised concerns about the strength of the sustainability of rural demand.

However, there are clear signs of a demand revival. In his 4Q/FY18 earnings call on 15 May, Hindustan Unilever CEO Sanjiv Mehta said that the company's double-digit domestic consumer growth was possible only because of a pick-up in rural sales since these account for 35-40% of the sales value and even more in terms of volume. At the same time, he pointed out that rural demand is not expanding at 1.5-1.7 times that of urban areas, as it was during the "boom days of FMCG", adding that he would still wait for a couple of quarters before arguing that the bounce-back in rural growth is a trend. The pick-up in rural demand is not consistent across the country, but it has definitely recovered, he said. Pent-up demand after years of distress is likely resulting in a spurt in sales, and HUL's Mehta said he hoped the government's promised increase in minimum support prices (MSPs or guaranteed prices for crops) would translate into higher wage rates, as would the June-to-September monsoon rains, which are forecast to be good this year.

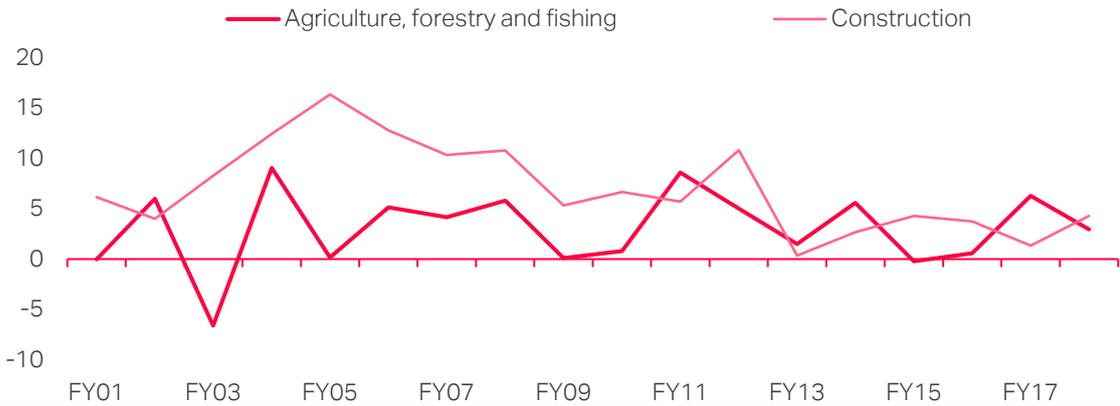
Meanwhile, sales of tractors and two-wheelers are up sharply. India's largest tractor maker, Mahindra & Mahindra, recorded a 22% increase in tractor sales in FY18 while the second-largest tractor manufacturer, Escorts, said its sales grew 25% last year. Tractor sales in FY17 had also posted a double-digit growth after shrinking in the preceding two years. Similarly, two-wheeler sales rose almost 15% in FY18 to exceed the 10% mark for the first time in six years owing to improved demand from rural and semi-urban markets.

The rise in tractor sales may be a result of farm loan waivers, which have benefited the rural rich and those with access to institutional credit, according to Himanshu (single name), an economics professor at the Jawaharlal Nehru University who looks at agriculture. In a 21 May 2018 column for the *Mint* newspaper, he wrote that "it is difficult to conclude that it [higher sales] suggests a sign of an overall revival in the rural economy". In fact, he believes that the contradictory trends between rising sales and declining wages signal "worsening inequality in rural areas and increasing vulnerability of most rural poor".

Political pressure grows...

Meanwhile, farmers appear to be unhappy with the Modi government and more than 110 farmer groups are planning a nationwide strike from 1-10 June to demand more loan waivers, higher returns on their produce and an increase in MSPs to which the government had committed itself in its February 2018 budget. Part of the frustration against Modi's government could be that rural wage growth was far higher – in low double digits – during the preceding government's term, from 2007 to 2013. A driver of that growth was the implementation of the rural employment guarantee programme, which coincided with high growth in the construction sector and elevated inflation. The April 2018 RBI working paper attributed the deceleration in rural wage growth from 2014 onwards to the global growth slowdown and the collapse of international primary commodity prices, which led to a major contraction in food prices. On the domestic front, two consecutive droughts and the construction slowdown dealt additional blows to rural incomes.

Growth in agriculture vs construction (%)



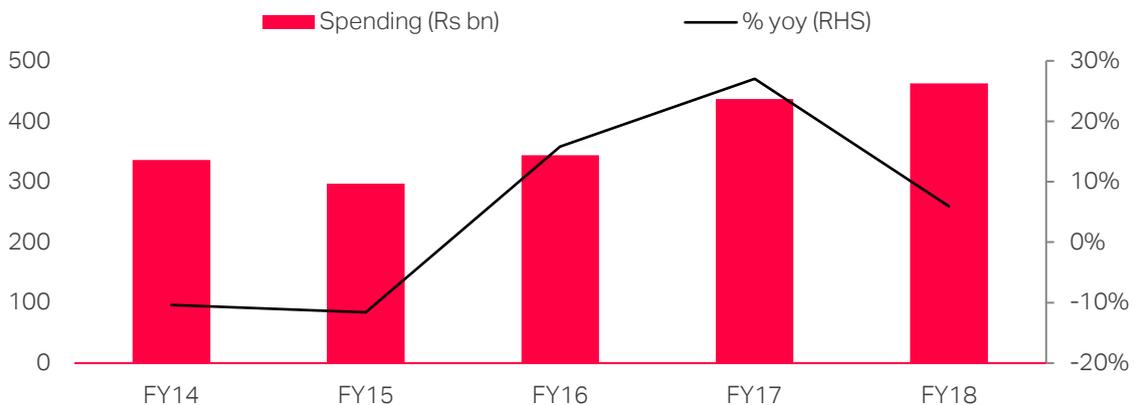
Source: Central Statistics Office (CSO).

... for more government handouts

Amid the continued pressure on farm incomes, the local economy is reliant on non-farm incomes and government handouts. On our trip last week to some northern rural areas in the state of Chhattisgarh, where state elections are due in some six months, we listened to farmers complain about low prices for paddy and maize – the two main crops grown in the region. Since construction is in the doldrums, government programmes like the MGNREGS and Prime Minister Modi’s Swachh Bharat [Clean India] Mission (SBM) are crucial.

We saw that villages around Ambikapur, a small town with a population of 145,000 in Chhattisgarh state’s northern tribal belt, where the SBM has been implemented in an exemplary fashion, were dotted with newly-built private toilets adjacent to houses, for which each household receives a payment of Rs12,000 – a not inconsiderable sum for India’s rural population. In FY18, the central government released some Rs160bn in SBM funds.

Real spending on MGNREGS (base=FY12)



Sources: Ministry of Rural Development, TS Lombard.

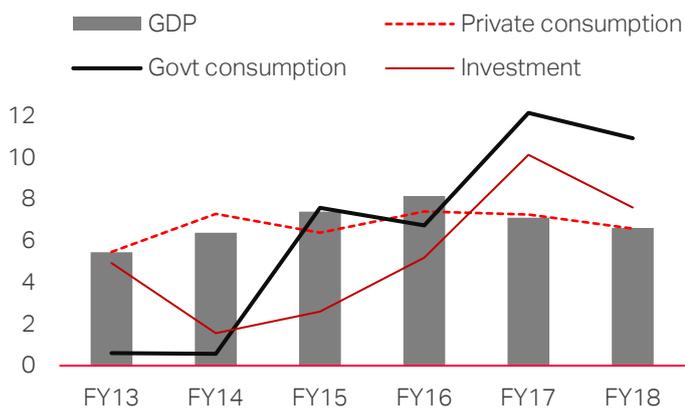
Prime Minister Modi’s approach to MGNREGS has changed since 2015, when he mocked the programme as proof of his predecessors’ shortcomings. Consecutive droughts in 2014 and 2015 elevated the programme’s importance as a backstop for the rural economy. The number of jobs offered quickly returned to historical levels, and real spending on the programme rose some 50% between FY15 and FY18 (see chart above). Some of the increase has gone to cover delayed wage payments that were as high as 73% in FY15 but have reduced to 15% by FY18.

Back in Chhattisgarh, we found other ways in which the government is supporting villagers. In one village we encountered a group of some 20 women and young men digging a large pond under the MGNREGS. Forest products – such as tendu leaves, which are used in the manufacture of bidis or Indian cigarettes – are sold to traders via cooperatives at prices fixed by the state government. We saw groups of villagers balancing large loads of tendu leaves on their heads as they made their way to collection points, where they will receive Rs2,500 per “standard bag” of 50,000 leaves. Tendu leaf production in Chhattisgarh in 2018 is projected at 1.7 million standard bags.

Rural self-help groups, too, generate income through government loans under the Chhattisgarh Mahila Kosh scheme. Self-help groups, which consist mainly of low-income women, receive loans starting from Rs50,000 at an annual interest rate of 3%, which they frequently lend onwards at an interest rate of 24% – usually, but not always, to group members. This provides cash-poor women with a pool of capital, and peer pressure ensures low default rates. We encountered such self-help groups in several Chhattisgarh villages.

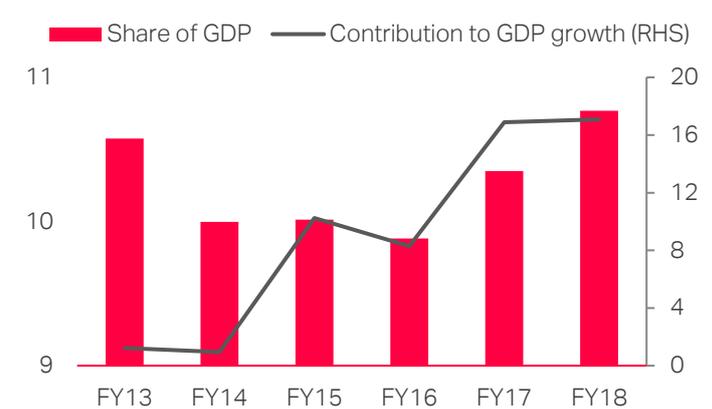
Government spending has evidently risen: growth in government consumption expenditure has outstripped that of both private consumption and investment spending, as the chart on the left below shows. The contribution of government spending to total GDP growth has risen sharply, too (see chart on the left).

Growth of GDP components (%)



Source: CSO.

Government spending (%)



Source: CSO.

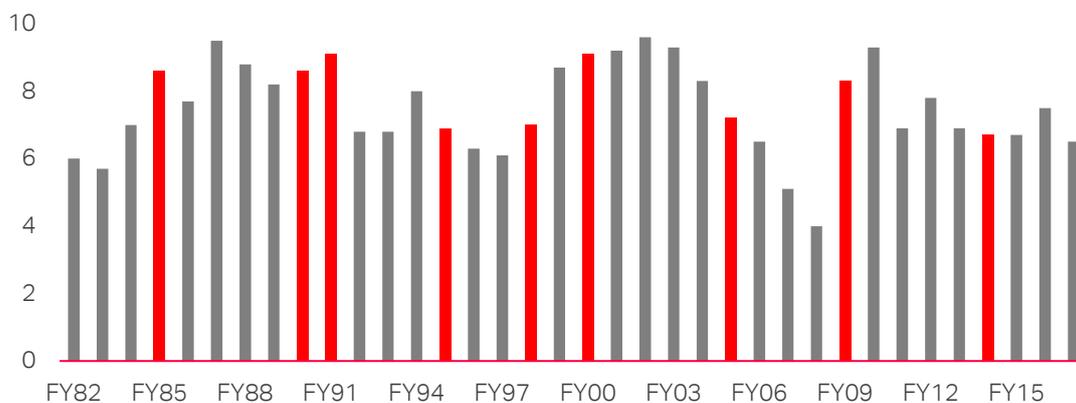
Spending to rise in this election year

Government spending will likely rise again in the current fiscal year (which began in April) and ahead of key state polls in late 2018 and the spring 2019 national elections. The BJP's manifesto for the Karnataka elections, which were held earlier this month, had promised waivers on farm loans of up to Rs100,000 from nationalized and cooperative banks, incentives of Rs10,000 each for 2 million small and marginal dry-land farmers and a Rs50bn revolving fund to facilitate market intervention during price volatility. Although the BJP won the maximum number of seats in the Karnataka polls, it was unable to form a government that lasted more than two days as it was short of a majority in the assembly; but the new government in the state has said that loans of all farmers will be written off – a move that will likely cost the state exchequer Rs530bn.

As we highlighted in our 25 January 2018 note [Growth recovery at the expense of macroeconomic stability](#), historical precedence shows that government spending rises ahead of elections. The chart below illustrates the combined fiscal deficit as a percentage of GDP and the years marked in red are those immediately preceding a national election or the year in which a national election was held. The states' fiscal deficit data for FY18 has not yet been published, but the effects of the farm loan waivers will be spread over FY18 and FY19. For its part, the central government slipped on its deficit target for FY18, recording a shortfall of 3.5% of GDP compared with its budget goal of 3.2% of GDP. At the same time, it revised its FY19 goal to 3.3% of GDP, up from 3%. Several members of the RBI's Monetary Policy Committee have warned of further fiscal slippage in this election year and the consequent impact on already rising inflation.

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Consolidated fiscal deficit (% of GDP)



Sources: Budget documents, RBI, TS Lombard.

Prime Minister Modi is pursuing populist policies – such as the farm loan waivers in various BJP-ruled states, which were introduced following a campaign promise he made ahead of polls in India's largest state of Uttar Pradesh in early 2017. And as the government promised in its February 2018 budget, more rural handouts are forthcoming. Most notably, these include an increase in MSPs – the details of which have yet to be announced.

Conclusion

Prime Minister Modi is facing intense political pressure to pursue populist policies that will help boost rural incomes. Earlier, he promised to increase the living standards of villagers and double farmers' income by 2022; but in the absence of serious agricultural reform and amid continued rural distress, he and his party have resorted to waiving farm loans and granting higher subsidies to farmers. This may be good news for consumer-related companies in the short term but it bodes ill for broader macroeconomic stability. And with parties across the political spectrum advocating loan waivers and higher crop prices, populism could become a race to the bottom in economic terms with no obvious winners.

The Modi government has already scaled back its fiscal consolidation efforts for FY19, missing its previously set targets and promising more rural handouts in the coming year. It is difficult to estimate the extent of the possible fiscal slippage at this juncture, but it should be kept in mind that it is not just the central government's fiscal deficit that matters but also the consolidated fiscal deficit, which is currently at around 7% of GDP owing to deteriorating state finances and thus is cause for concern. The added risk of higher oil prices impacting government finances if excise duties on fuel need to be cut is raising further worries about growing fiscal and inflationary pressures.

The RBI has consistently cautioned against the macroeconomic fallout of a large fiscal deficit over the past year and appears set to start tightening interest rates as early as next week, when it meets for its next policy review. Such a move would further dampen economic sentiment. So, while Modi may just be able to reap the electoral benefits of a pick-up in demand in the short term, it will be up to him – or his successor – to consolidate the larger fiscal deficit that will be inherited by the next government.

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