India’s rural distress puzzle

The state of India’s rural economy is puzzling. There is enough evidence to support two opposing statements: one, that the rural economy has improved; and, two, that the rural economy is in the doldrums.

On the one hand, some indicators are positive. The unemployment rate has been falling while rural wages have been rising. On the other hand, instances of rural distress are rife and rural consumer sentiment has weakened. There has been a surge of demands for farm loan waivers. Four states have already announced waivers worth about 0.5% of national gross domestic product (GDP). Four more are threatening to do the same and, if they do, waivers could rise to 0.75% of GDP, endangering a hard-won reduction in debt and deficit ratios.

Some of this distress was likely triggered by the large fall in food prices and the resulting shift in the terms of trade (the cost of producing food versus the income derived) to the detriment of rural India. Even if some of the causes of falling food prices are one-time (for example, a bumper crop) or short lived (such as demonetization and goods and services tax related uncertainties), other factors may keep food prices low for longer (such as structural improvements in food distribution).

Which of the two opposing claims is true, and how long will the confusion in data last?

It helps to solve the puzzle if we note that the rural economy consists of two distinct parts, “landless” and “landed”. We define landless as those owning less than a hectare of land, and landed as those owning more than a hectare. The landless, by our definition, make up about 70% of rural households and the landed the rest.

This distinction illuminates three other things. One, we find that the landless rural population has a negative income-consumption gap, which basically means that its income is hardly enough to cover its consumption requirements. On the other hand, the landed have a positive income-consumption gap. Two, it is the landed who are more indebted as a group than the landless. They also use more formal sector sources of credit than the landless. Finally, we find that a majority of the income for the landless comes from wages while that of the landed from cultivation.

Putting all this together, we can build a compelling narrative. After a two-year drought, the good monsoon rains in 2016 increased the demand for labour. As a result, real wages have risen gradually and the unemployment rate has fallen in tandem. This has largely benefited the landless, given that the majority of their income is from wages.

In contrast, the landed, who pay these wages and depend more directly on income from cultivation, have borne the brunt of falling food prices, as what they have received from selling farm produce has been lower than expected.

Real indebtedness for this group has been growing at a faster clip than real incomes since FY14, which explains the growing clamour for bank farm loan waivers (*see chart*).

Eventually, however, one would imagine that the fates of the landed and landless are likely to move together (given that the landless are often indebted to the landed). For now, the fact that these two groups are not yet moving in the same direction is throwing up confusing signals about the health of the rural economy.

There are two broader points to be made here: The first is that one-off reforms cannot improve an economy. There needs to be a series of reforms, each supporting the other. In the worst case,

stray reforms may even do harm.

Let us explain. Inflation-targeting was a welcome reform with distinct economy-wide benefits. But the large fall in inflation that it helped engineer has hurt the indebted by increasing “real” indebtedness, i.e. debt relative to inflation. And that is the bitter truth. Large and desirable reforms always tend to hurt some sub-groups.

What is needed now is another spate of reforms to help those who have been hurt. Agricultural reforms, such as in irrigation and warehousing infrastructure, can help increase farm productivity and therefore incomes. They will not just help fund consumption expenditure, but will leave extra funds in the hands of rural India, which can then be used to service the higher real debt bill.

The second broader point to be made is that farm loan waivers may do more harm than good. They spoil the credit culture, making formal finance more nervous about serving rural India. They also erode macro-economic stability. In particular, a rapid rise in farm loan waiver expenses could bind India’s states in a vicious cycle, increasing their interest bill or lowering the quality of their spending, or both.

Rural distress is a recurring theme in India. Every few years, farm loan waivers or a good monsoon provide some short-lived respite. Clearly, the benefits from neither are sustainable. The panacea for rural distress can only be reforms that will help raise farm productivity and incomes.

Pranjul Bhandari is chief India economist at HSBC.

END