The changing politics of food price inflation

Government policymaking seems to be making a volte-face from supporting consumers (by keeping food inflation low), to supporting producers (by raising food prices).

In the 2018-19 Union budget, the government "decided to keep minimum support prices (MSP) for all unannounced crops of kharif at least at one-and-a-half times of their production cost" and rabi MSPs had already been adjusted pursuant to this formula. This cost was later clarified as covering all input expenses incurred by farmers as well as the imputed value of unpaid family labour (A2+FL).

Other than MSPs, there have also been announcements on trade policies (higher import tariffs on pulses, sugar and edible oils), on ensuring that the MSP benefits are realized by farmers (via a yet-to-be-announced form of fiscal transfer) and states announcing "bonuses" above MSP.

This shift in government policy makes both economic and political sense. Economically, a balance needs to be struck between consumers and producers. There is also a wider political game afoot; not only are key states like Karnataka, Madhya Pradesh, Chhattisgarh and Rajasthan brushing the dust off their voting machines, but the looming 2019 general election is ever present in the minds of the political cognoscenti.

To be fair, the government has launched medium-term initiatives, such as the E-National Agriculture Market, to meet its objective of doubling farmers' real incomes, but the political cycle necessitates faster results.

This raises two pertinent questions: One, what are the macro implications; and two, will these policies materially change the agrarian outlook?

Both answers depend on how much MSPs will eventually increase. An MSP at least 1.5 times the production cost sounds large, but it is not. Consider this: Over the last four years, most rabi MSPs were already more than 1.5 times the production cost. When it comes to kharif, the MSPs over the last four years were lower: 1.41 times for paddy, 1.36 times for maize and more than 1.5 times the cost for only a few pulses. So this kharif MSP increase is material.

Assuming production costs grow at the past three-year average pace and that all future MSPs are fixed at a minimum of 1.5 times this cost or the latest mark-up given, whichever is higher, we estimate the weighted average kharif MSP could rise by 12.9% year-on-year in 2018-19 from 6% in 2017-18 (with a rise of 11.6% for paddy and over 40% for jowar, ragi and Niger seed). Given that rabi MSPs are already high, the weighted average rabi MSP rise should be lower at 6.6% next year. Even for kharif, the large MSP rise is a one-time event, as future increases will be a function of how input costs rise and the actual mark-up.

There will also be an inflationary impact, as the MSP increases are being announced in conjunction with complementary trade policies and efforts to make the MSP an effective floor.

Higher MSPs make a prima facie case for higher inflation, as they form a floor for food prices and rising food inflation can feed into inflation expectations and higher wages. Moreover, linking MSPs to a multiple of costs and ignoring other dynamics (such as demand and global prices) risks creating distortions and disincentivizing productivity.

We estimate that every 1 percentage point increase in MSPs leads to a 15 basis point increase in consumer price index (CPI) inflation. So our baseline estimate on the weighted average MSP rise for both crops could add 60 basis points to CPI inflation over the next four quarters, although the shock should dissipate in the second year.

The worry is that this MSP news comes during what is referred to as an agricultural “cobweb cycle”, as the sharp drop in food prices in the first half of 2017 has already resulted in a lower supply (by farmers) of crops with lower prices. It is not surprising, then, that the February monetary policy committee minutes struck a more hawkish tone and the MSP news has set the cat among the doves.

There will be a fiscal impact too, although it should be relatively benign. The food subsidy bill is set to rise. Other fiscal costs depend on how the government ensures farmers benefit from MSPs: It could be either via a price deficiency payment scheme, where the loss incurred by a farmer in selling below the MSP is compensated by the government by directly transferring cash to the farmer’s bank account, similar to Madhya Pradesh’s Mukhyamantri Bhavantar Bhugtan Yojna; or it could take the form of a market assurance scheme under which states procure crops when prices fall below MSPs, creating an effective floor for all crops, and not just rice and wheat. Both these schemes have their own drawbacks.

This brings us to the second question: Will all of this reverse the terms-of-trade deterioration in the agriculture sector? This is surely positive at the margin, but it is not clear whether it will be sufficient to lift rural incomes significantly and quickly. Rural wage growth—both nominal and real—has moderated in recent months and the construction sector—an important engine of job creation—is not yet in full force. For all its pro-farmer rhetoric, this budget’s allocations to agriculture and rural development are roughly at the same levels as a percentage of gross domestic product as previous years. Overall, whether these policies ultimately “bite” remains to be seen; meanwhile, the costs of missing the target are escalating.

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