ECONOMY

Modi's farm price rise awaited as bond yield hovers at 3-year high

Market expects support for agri-produce to raise inflation and fiscal deficit

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India's Prime Minister Narendra Modi in February pledged to raise the minimum support price for agricultural produce to help farmers. © Reuters

MUMBAI -- Indian Prime Minister Narendra Modi is expected to announce details of an increase in the minimum support price of agricultural produce this week, stoking fears of a rise in inflation and a widening in the fiscal deficit that will deal a further blow to the Indian rupee and rising bond yields.

It is likely that the government will increase the guaranteed price it pays for commodities such as pulses and cotton by around 150% as announced in the budget in February. Last week a statement from the prime minister's office reiterated the plan following discussions with farmers from key agriculture states. The move is seen as a populist measure to win support from financially distressed farmers ahead of the general election in 2019.

Market watchers believe that concerns around inflation and increased government borrowing is already reflected in the weaker rupee, which is currently hovering at around 68-69 to the U.S. dollar -- its lowest level in 18 months.

According to Sunil Sihna, principal economist at ICRA Ratings, the impact of this increase will depend on the method that the government uses. If it uses a different practise to the current one of taking into account actual cost plus imputed value of family labor in production, the cost to government could reach between 1.5 trillion rupees ($21.85 billion) and 1.75 trillion rupees, according to some estimates.

"This kind of quantum will certainly impact the fiscal deficit or in other words government may have to resort to additional borrowings. That means there will be more supply of government paper in the market and bond yields will firm up further," Sinha told the Nikkei Asian Review. "Even now bond yields are rising in respect to the expected rise in inflation and also currency depreciation."

Care Ratings data shows yields on the benchmark 10-year Government Securities ended last week eight basis points higher at 7.9% and touched a two-week high of 7.94% in the week ended June 28, driven by the rise in crude oil prices and weakness in the rupee fueling concerns over inflation and the widening trade deficit. The supply of fresh state and central government securities also helped push the yield up, it said. Since early June, the benchmark yield has been hovering at its highest level for three years.

India reported a fiscal deficit of 3.45 trillion rupees during April-May period, or 55.3% of the target for the financial year that started in April. It is hoping to cut the deficit to 3.3% of gross domestic product.

Bond yields spiked after the Reserve Bank of India on June 6 raised its key interest rate by 25 basis points to 6.25% for the first time since January 2014, due to fears about rising crude oil prices and spiraling inflation. Retail inflation in April rose to 4.58% from 4.28% in March, against the 4% mandated by the government. The inflation target has a margin of plus or minus 2%.

"India's economic outlook is subject to several headwinds in H2 2018, which are likely to keep investors cautious," Oxford Economics wrote in a note on July 3. "Topping the list is the expected widening in the current account deficit to 2.5% of GDP in 2018 from 1.6% last year. Higher inflationary pressures, fiscal slippage risks and less emphasis on economic reforms ahead of the upcoming general elections in 2019 also encourage a 'wait and watch' stance. Lastly, valuations make a weak case for a sizeable [Indian rupee] recovery."

The economic forecaster said that year-to-date the rupee was the worst performing Asian currency, down more than 7% against the U.S. dollar. Rapidly rising oil prices in the first half and a challenging domestic environment had undermined investor confidence in India for some time. It added that, unlike China, South Korea and Taiwan, which were just beginning to experience weak investor sentiment, India had been subject to strong portfolio outflows since the start of the year.

Oxford Economics noted that the rupee could touch 70 against the dollar before settling to 68 by the end of the year.