Drought: Dealing With The New Crisis

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Never a dull moment in the corridors of economic management as the economy lurches from one crisis to the next. A year ago the inflationary conditions were quite grim. A sharp rise in world food prices had sparked off food riots in several countries in the first half of the year. This was followed by a sudden spike in world oil prices, with crude selling at over $147 per barrel. These two global factors had driven up the headline WPI inflation rate to around 13%. Barely had the economic managers come to grips with this crisis, when the world economy went into a tail spin following the collapse of Lehman brothers in Sept 2008. The crisis was transmitted to India via a sharp drop in demand for exports, the sudden withdrawal of portfolio investments, and the drying up of both rupee and dollar liquidity, all of which together led to a sharp deceleration of growth from around 9% to 6.7% in 2008-2009. The RBI and central government took several quick measures to restore liquidity, revive the flow of credit and pump prime the economy back to high growth through stimulus packages, including the huge expenditure program and deficit in the current budget (see Mail Today 30 July 2009). Now the tide has turned again. Policy must be re-set to address the emerging new challenge of a major drought.

So far there is a rainfall deficit of around 20% and 141 districts out of around 600 have been declared drought affected. Many farmers delayed and reduced their planting of the Kharif crop. Those who planted early watched helplessly as their saplings withered in the scorching dry heat. The supply of fresh vegetables and fruits in the *mandis* has declined significantly and area sown under Kharif foodgrains has also declined. How will all this effect the economy? There is some complacency that since agriculture now accounts for only 18% of GDP, a set back in this sector will have only a marginal effect on the rest of the economy. Nothing could be further from the truth. Though accounting for less than a fifth of our GDP, the sector still employs 55% of our workforce. Moreover, food is a strategic product, a basic necessity for every household in the country. Unlike, say, the production of textiles or even steel a set back in the supply of food will have an all pervasive effect on the economy. In addition to increased distress in agriculture, it will lead to higher inflation as well as lower growth, thus compounding the problems with which we started the year.

The prices of vegetables, fruits, pulses and foodgrains are already rising sharply. Though the WPI inflation rate remains low, the consumer price index for agricultural and rural workers, the largest, poorest and most vulnerable consumer group is already inflating at over 11%. That rate will accelerate further unless effective steps can be taken to curb inflation. Meeting the domestic shortfall through imports is not an easy option since India is a large country. It's entry in the market immediately raises international prices. The price of sugar and pulses have already started firming up on expectations that India will be buying these commodities. The upward pressure on food prices will exert pressure on real wages of workers in the non-agricultural sector. They will be compelled to cut back on other consumption to maintain their food consumption. They will also demand higher wages that in turn could cut profit margins, and hence dampen the producers incentive to invest. The decline in demand for both non-food consumer goods and investment goods will reduce growth in the non- agricultural sector, offsetting some of the effort made during the past few months to stimulate demand and revive growth. This will be in addition to the direct impact of reduced agricultural production,e.g., a 5% reduction in agricultural output could lead to a 1% drop in GDP growth. In short we are facing a possible situation of further reduction in growth along with high inflation or ‘stagflation’.

What can the economic managers do to mitigate these risks? With multiple challenges facing the economy at the same time, different policy tools will have to be carefully assigned to different policy goals and these will have to be carefully calibrated. Given the likely decline in private demand for consumer goods as well as investment goods in the non-agricultural sector, it is all the more imperative to maintain the fiscal stimulus introduced in the last budget. So far the RBI has backed up such stimulus efforts by policies to increase liquidity and lower interest rates. It now needs to adjust these policies to fight inflation, a primary responsibility of all central banks. Indeed, the RBI is already making these adjustments. In its latest quarterly review of monetary policy on 28 July the RBI indicated that there would be no further reduction in policy interest rates. Also, Open Market Operations will be limited to about Rs.80,000 crores, leading to a much smaller increase in liquidity than earlier envisaged.

However, restraint on liquidity growth alone will not be enough to contain the rise in food prices. That will require more direct government intervention in managing food supplies. Adequate and timely releases from around 55 million tons of foodgrain stocks could help to stabilize food prices provided hoarding can be prevented. The RBI squeeze on credit growth would make hoarding difficult, but preventing it will require more direct government monitoring of foodgrain trade. The maintenance of food supplies can also be facilitated if the planned introduction of subsidized food delivery to poor families can be accelerated along with the planned expansion of NREGA. If that is not immediately feasible, state governments should promptly launch drought relief operations in the affected districts, including food – for - work relief employment programs, the assured supply of drinking water, and provision of fodder and drought protection for livestock. Normally, the incidence of poverty goes up in years of drought, but it had remarkably gone down during the severe drought of 1987-1988. The government had then implemented a multi-pronged strategy to mitigate the impact of drought along the lines outlined here

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