Higher seasonal output will not sustain sales of agricultural machinery

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No industry will escape the economic pain of the Covid-19 pandemic. The high-frequency economic data for industries that are classified as non-essential during the lockdown period already shows the negative effect. However, for essential industries such as agriculture and its value chains, the data points to a relatively better performance thus far, though the outlook remains uncertain.

This is specifically the case for the agricultural machinery industry. The latest data shows that SA's tractor and combine harvester sales were down by a mild 4% and 13%, respectively, year on year in April, with 416 units and 20 units sold. By comparison, the automobile industry, which was already in full lockdown, saw new vehicle sales plummet 98.4% year on year. But I doubt the agricultural machinery performance can be sustained.

The main factor behind April's tractor sales was that SA's winter crop planting season began, specifically in the wheat, barley, canola and oat producing regions, namely the Western Cape, Northern Cape, Free State and Limpopo. In the case of combine harvester sales, a supporting factor is that SA is expecting its second-largest grain and oilseeds harvest on record in the 2019/2020 production season. The harvesting process for this crop recently started and it is set to gain momentum towards the end of the month.

The trend for agricultural machinery sales, particularly tractors, has actually been subdued since last year, when farmers' finances were constrained because of drought-induced poor harvests.

Another point to highlight is that the lower tractor sales of the past 16 months were preceded by robust sales in 2018. That year SA's total tractor and combine harvester sales amounted to 6,687 and 200 units, respectively, up 4% and 2% year on year. As a result, the rate of replacement in 2019 was expected to be lower, and 2020 sales were suppressed by the financial constraints many farmers are experiencing.

But agricultural machinery sales are likely to remain subdued in future, irrespective of the robust agricultural output expected for the 2019/2020 production year. The drag on the industry will emanate from weak exogenous macroeconomic fundamentals. First, the weaker domestic currency will lead to higher prices for imported agricultural machinery, which will reduce farmers' ability to acquire tractors and combine harvesters. Second, the recent further downgrade of SA's sovereign credit rating to subinvestment grade could negatively influence the financing of agricultural equipment.

As I have argued in this column before, in ordinary times the Reserve Bank would have responded to the downgrade by raising interest rates in anticipation of possible exchange rate depreciation and associated inflation risks, which would have increased the cost of capital. However, now the situation is different. The pandemic has disrupted global supply chains, which has led to deteriorating economic conditions. Several central banks, including SA's, have responded by reducing interest rates to ease financial conditions.

Whereas the implied prime rate after the recent policy rate cuts would suggest easier financing conditions, commercial banks are likely to be more risk averse in the current unprecedented environment. We have already seen US banks tighten lending standards despite unheard of liquidity provision by the US Fed. Therefore, risk-adjusted lending rates to SA farmers may not be as accommodative as suggested by the 225-basis point cut in the repo policy rate so far in 2020.

The classification of agriculture and its value chain as essential services during the lockdown period has enabled the agricultural machinery industry to operate and record better-than-expected sales compared with other sectors of the economy. However, the weak macroeconomic conditions could weigh on the industry's performance in the coming months. One silver lining to this cloud is that of higher rand commodity prices as a result of a weaker currency.

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