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Demonetisation and GDP Growth in India

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Abstract

Cash is the preferred mode of transaction globally, accounting on an average for 85% of them. In some of the developed countries, transactions carried out through cash are less than 50% of total transactions. In India, this ratio is at around 95%. Easy accessibility, its certainty of acceptance and efficiency as the settlement is not dependent on any additional infrastructure, and no additional charges make it universally the most preferred mode. The only problem of cash transactions is the anonymity and difficulty of establishing expenditure trail which make it an ideal mode for unreported transactions as well. The main objective of the study is to analyse the effects of demonetisation on the components of GDP growth in India.

Key words: efficiency**,** consumption, demonetisation

1 INTRODUCTION:

The ratio of currency to GDP (Gross Domestic Product) in India, which averaged 8.4% during 1975-2000, crossed 10% for the first time in 2002-03 and has remained above this level since then. This ratio has averaged 10.8% in the last decade. There has not only been a relatively sharp increase in the ratio of currency to GDP during 2015-16 but a reversal of the negative trend witnessed in the previous three years. The increase in this ratio could have persisted through the current year as well before the demonetisation of higher denomination notes announced on 8 November, 2016. Demonetisation is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.

2. CURRENCY SHOCK: After demonetisation put over 85 per cent of cash out of circulation, re-injection of liquidity into the system has been slow, hurting both formal and informal sectors. Demonetisation technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce short/ long term, consumption/investment, and welfare/ growth impacts on Indian economy. Demonetisation will have little impact on agricultural growth, hit farmers hardly and service sector slips to contraction.

The following Table-1 has explained the ratio of key monetary variables relative to GDP at current prices. It is evident from the table that the ratio of Currency to GDP is almost stagnant between 10 to11 per cent over the last 5 years. But the ratio of M3 to GDP has increased to 81.98 per cent in 2015-16 from 79.77 per cent in 2011-12 which indicates that there is steady increase in money supply. The money multiplier has increased from 5.05 in 2011-12 to 5.66 in 2015-16.

Table-1: The ratio of key monetary variables relative to GDP at current prices

Year	Currency /GDP	M3/ GDP	Money multiplier
2011-12	11.09	79.77	5.05
2012-13	10.91	79.48	5.4
2013-14	10.6	79.68	5.64
2014-15	10.56	80.49	5.73
2015-16	10.86	81.98	5.66

Source: Economic Survey, Figures in Percentages

The existence of a large informal sector has been one of the most important factors in this dominance of a cash-based economy. Nearly 45% of Gross Value Added (GVA) in the economy (average of 2011-15) was generated in the informal sector. The informal sector's growth has been mostly cash-centric and its sustenance has been dependent on prevalence of cash transactions so far. Notwithstanding an overall lower rate of growth of savings and capital formation, this sector nonetheless contributed to around 40% of capital formation and two-thirds of investible. Demonetisation of high denomination notes (of Rs1000 and Rs500) has put over 85% of currency out of circulation. This has resulted in short-term disruptions in transactions in agriculture and related sectors, small establishments, households and among professionals. Since injection of liquidity is slow, incomes in both formal and informal sectors have been affected with the intensity of adverse impact being greater for the informal sector. Since self-employed and casual workers dominate in the overall economy, their incomes may suffer a setback. While some may view it as deferring expenditure and income, a part of it may actually be revenue and income forgone forever.

3. DEMONETISATION FALLOUT:

ADB reduces India's GDP growth forecast to 7 per cent. Some rating agencies have estimated a decline of around 40 basis points in GDP growth for 2016-17 and of a smaller magnitude in 2017-18. These estimates are based on quicker liquidity injection and a sharp shift to cashless transactions. However, there is a section of the population which will still like to deal in cash because of religious beliefs. The estimation of a 40 basis point decline in GDP, given the casual nature of employment for nearly 80% of workforce, may not materialise, at least in the time frame envisaged. In another opnion, the dent in GDP growth may be larger than anticipated and recovery to the normal growth trajectory may take three to four quarters.

It is indeed difficult to predict the likely growth trajectory post demonetisation. But assuming that the formal sectors maintain the observed growth (average of last 10 quarters) and the informal sectors have a flat growth in the third quarter (Q_3) of 2016-17 (with an estimated contraction in informal economic activity in trade, road transport and construction sectors by 5%), Q_3 growth may decline to 4.1% in a best case scenario. In case the contraction extends to industrial and professional services sector and is a little sharper in construction and trade, Q_3 growth may dip as low as 1.5%. But for the fiscal year 2016-17, growth is recorded at 7.1 per cent even the short term impact of India's cash crunch. There is marginal increase in the growth of GDP to 7.2 per cent in 2017-18 despite slow growth in earlier quarters.

How the informal sector issues will get incorporated into the quarterly GDP numbers of the ministry of statistics and programme implementation is important as the quarterly estimates of GVA are compiled by the benchmark-indicator method. The previous year's annual estimates are extrapolated with the growth rates observed in indicators such as quarterly estimates of forecast crops and livestock, index of industrial production, steel and cement dispatches, sales tax returns, sale of commercial vehicles, deposit and credit growth of banks, service tax, revenue expenditure of government, all of which are for the formal sectors. The inherent assumption in this tracking approach is the assumption of uniformity of growth for the formal and informal sector. This assumption has little relevance under the current circumstances, and we may still be surprised with a better official rate of GDP growth for Q_3 and Q_4 in 2018-19 as Q_1 ended at 8 per cent and Q_2 ended at 7 per cent.

4. IMPACT ON AGRICULTURE SECTOR:

Reports of stress in agriculture have begun to appear because of demonetisation. Cash is the primary mode of transaction in agriculture sector which contributes 15% to India's total output. Formal financing in many parts, especially Punjab, Uttar Pradesh, Odisha, Maharashtra, Gujarat and Kerala is significantly from cooperative banks, which are barred from exchange-deposit of demonetised currency. Notably, this is a time of kharif harvest and start of rabi sowing, partly explaining why this period is dubbed the 'busy season' from a standpoint of credit demand, the other being bunching of festivals and weddings.

Agriculture is impacted through the input-output channels as well as price and output feedback effects. Sale, transport, marketing and distribution of ready produce to wholesale centers or mandis, is dominantly cash-dependent. Currently, many of these networks are operating sub-optimally or altogether at a standstill, depending upon location, market links and other item-specific factors. The input side is equally affected as many payments/purchases, such as seeds, fertilisers, implements and tools, are outright in cash. Borrowing-financing operations of larger farmers and organised producers are also cut off or severely clipped.

The impact is visible in different sub-segments. Winter crops such as wheat, mustard, chickpeas are due for sowing in a fortnight. Wheat prices were already up due to low stocks and anticipated shortfall in 2015-16 output and have firmed up further as demonetisation fallout pushes traders to build more inventories. Production in 2016-17 could drop if sowed acreage (rabi) reduces for want of enough seeds on time to exploit the adequate soil moisture. Yields could fall from late sowing and subsequent exposure to rough spring weather, the lack of sufficient or timely application of fertilisers, pesticides, etc. Farm labour, vital for this period, is reported to be unpaid as farmers have no cash. Many of them are reported to be returning from some northern parts to homes in UP and Bihar. Labour shortages and wage-spikes may follow with a lag.

Plantation crops such as rubber, tea, jute, cardamom are seeing no wages paid to workers. Small-medium tea growers have few buyers now (a third of the tea was unsold in recent auction in the south). Raw jute trade is halted as paucity of funds affects procurement-delivery by traders. Projections of scarcity have appeared with appeals for official procurement support. Cotton is witnessing havoc: daily arrivals have plunged to 30,000-40,000 bales against the usual 1.5-2 lakh bales at this time (harvest) as per reports and prices have soared 9% in a week, pushing up global prices in turn. Vegetables and fruits that along with crops added 61% of agriculture's gross value added in 2015-16, depends critically upon a cash-strapped transport sector for daily supply network. Sales have dropped sharply (25-50%) across markets with occurrences of dumping. At present, demand is repressed for want of currency, so prices are subdued, but eventually, supply shortages could cause prices to rise.

5. IMPACT ON INDUSTRIAL SECTOR:

Industrial production data for October 2016, the last point before demonetisation showed that overall industrial output contracted by 1.9%. The fall over September was steeper at 6.3%. The index (IIP) has grown by -0.3% in 206-17 so far (April-October), compared to a corresponding 4.8% growth last year. This shows how weak industrial activity was even without demonetisation, a home-grown shock. The two major components, consumer and capital goods, shed some light on trends in consumption and investment or aggregate demand. Growth in consumer goods, although positive at 1.2% in the year so far, was weaker than the last year. And capital goods output growth was -22% in the period (-26% in October) relative to a decent 9% growth in April-October 2015. So, industry was not in a good situation to start with. Production actually dropped in April-October across mining (-0.2% against 2.2% last year) and manufacturing (-1.0% against 5% growth in April-October 2015) with only electricity segment showing positive, 4.6% growth.

November's manufacturing PMI already showed moderation at 52.2 against 54.4 in October, 2016. Demonetisation will hurt demand with consumer goods being the worst affected. Cement sale volumes halved in November. This is unlikely to improve considering the darkened outlook for real estate, property prices are anticipated to fall by 20-40% and developers are pruning overall costs, including staff, to economise on cash and sustain bottom lines. Ripple effects will be felt in steel and other inputs as well. Automobile sales in November were 5.48% lower, the slide is expected to accelerate in coming months as sagging retail sales feedback to manufacturers who may even cut output in next round. Consumer goods' firms whose sales volumes either fell or grew feebly in September quarter will also get impacted. Industrial performance for November, as captured by the IIP will also not reflect the full impact of disruption. The first full impact of demonetisation on industry will thus be known only from December data, which will arrive only in February 2017.

Since the cash crunch impact is widely expected to persist for two quarters, there is little chance that industrial growth will improve in the second half of 2016-17. Therefore, the year as a whole may see industry contracting. This would be for the first in three years. In 2013-14, total industrial output grew by -0.17% as the "taper" shock struck the economy. This time, the shock is home-grown and will impact both demand and supply sides. Whether the repercussions for industry will endure beyond the near-term is still debatable, though falling property prices and related chain effects can be long lasting.

6. IMPACT ON SERVICES SECTOR:

Hit hard by demonetisation, the services sector slipped into contraction in November 2016, worst slump in nearly three years, as new orders dried up and customers cut spending due to cash shortages, putting pressure on RBI to keep rates low. Perhaps the worst hit by Modi's demonetisation move has been India's services sector. The sector comprises areas such as trade, hotels and restaurants, transport, communication, finance, insurance, and real estate, among others, and accounts for 60 per cent of India's $2 trillion GDP. The Nikkei/Markit Services Purchasing Managers' Index—which measures sales, employment, inventories, and prices at service sector companies, sank to 46.7 in November from 54.5 in October, 2016. This is the first time since June 2015 that the index has slipped below the 50 mark. "New business declined for the first time since June 2015, leading to a solid reduction in activity," IHS Markit, the compiler of the index, said. "Correspondingly, backlogs of work rose, while employment increased only marginally." The decline of 7.8 points was also the biggest one-month drop since November 2008. Yet, IHS believes that the sector will rebound quickly.

7. EFFECTS OF DEMONETISATION ON INDIAN ECONOMY:

Demonetisation is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetisation affects the economy through the liquidity side. Its effect will be a telling one because nearly 86 per cent of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs.500 and Rs.1000 notes, there occurred huge gap in the currency composition as after Rs.100; Rs.2000 is the only denomination. Absence of intermediate denominations like Rs.500 and Rs.1000 will reduce the utility of Rs.2000. Effectively; this will make Rs.2000 less useful as a transaction currency though it can be a store value denomination. The intensity of demonetisation effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts.

7.1. **Liquidity crunch (short term effect):** Liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs.500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49 per cent of the previous currency supply in terms of value. Higher the time required to resupply Rs.500 notes, higher will be the duration of the liquidity crunch. At that time, reports indicated that all security printing presses can print only 2000 million units of Rs.500 notes by the end of that year. Nearly 16000 million units Rs.500 notes were in circulation as on end March 2016. Some portion of this was filled by the new Rs.2000 notes and approximately 10000 million units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next few months.

7.2. Welfare loss for the currency using population: Most active segments of the population who constitute the 'base of the pyramid' use currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class. There will be a trickle up effect of the liquidity chaos to the higher income people with time.

7.3. Consumption will be hit: When liquidity shortage strikes, it is consumption that is going to be adversely affected first. Reduction in consumption leads to reduction in production, employment, growth and tax revenue.

7.4. Loss of Growth momentum: India risks its position of being the fastest growing largest economy; reduced consumption, income, investment etc., may reduce India's GDP growth as the liquidity impact itself may last few months.

7.5. Impact on bank deposits and interest rate: Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply takes place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetisation will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

7.6. Impact on black money: Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetisation depends upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetisation has a big propaganda effect. People are now much convinced about the need to fight black income. Such a nationwide awareness and urge will encourage government to come out with even strong measures.

7.7. Impact on counterfeit currency: The real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise. Demonetisation as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

8. IMPACT OF DEMONETISATION IN INDIA:

8.1. Black Money: Black money stored in the form of Rs.500 and Rs.1000 notes will be taken out of our system. As predicted by ICICI Securities Primary Dealership the government's plan to scrap ₹500 and ₹1,000 notes will uncover up to ₹4.6 lakh crore in black money.

8.2. Terror funding: Fake Indian Currency Notes (FICN) network will be dismantled by the demonetisation measures. Taking out ₹500 and ₹1000 rupee notes out of circulation will have a lasting impact on the syndicates producing FICN's, thus affecting the funding of terror networks in Jammu and Kashmir, North-eastern states and Naxalite hit states.

8.3. Real estate may see significant course correction: The demonetisation decision is expected to have far reaching effects on real estate. Resale transactions in the real estate sector often have a significant cash component as it reduces incidence of capital gains tax. Black money was responsible for sharp appreciation of properties in metros; real estate prices may now see a sharp drop.

8.4. Political parties in crisis ahead of polls: With nearly five state elections in 2017, demonetisation has stunned political parties. Especially, in large states like Punjab and Uttar Pradesh, cash donations are a huge part of "election management". In one stroke, big parties will find themselves hamstrung as cash hoards are often undeclared money. Parties will have to completely rejig campaign strategies in light of expected cash crunch.

8.5. Moving towards digital payments: Demonetisation will likely result in people adopting virtual wallets such as Paytm, Ola Money etc. This behavioural change could be a game changer for India.

8.6. Temporary chaos and confusion: Public will face minor problem for a few days owing to the scarcity of lower denomination notes in the system., Demonetisation has often been used as a tool to cut down hyperinflation. We were running smooth on Inflation and for that matter, were the fastest growing economy in the world.

9. CONCLUSION:

Growth is expected to recover gradually in the fourth quarter (Q4) of 2016-17 and in the first quarter (Q1) of 2017-18 before returning to its normal trajectory thereafter. It is indeed true that increase in liquidity in the formal banking sector will increase GDP growth originating in this sector, but with its share of around 6% in GDP and with an increase in growth of 0.5 and 1.0 percentage points factored in, this sector's growth in Q3 and Q4 of 2016-17, respectively, its overall impact on GDP growth assessed may not be significant. The impact of easy availability of credit to the formal sector on account of this additional liquidity may take some time to materialise, and in Q3 and Q4 it may not be significant. Further, a decline in demand in general may also keep the demand for investible funds at moderate levels.

Despite the imminent slowdown across sectors and the hit to the Indian economy, experts also see an eventual recovery over the next year. With a potentially strengthened formal economy, forecasters now see India's GDP returning to the over 7 per cent growth phase by coming years. 2017-18 ended with a marginal increase in the growth of GDP of 7.2 per cent despite slow growth in earlier quarters. Agriculture sector recoded 4.5 per cent but manufacturing and construction sectors recoded a growth of 9.1 and 11.5 percent respectively during 2017-18. Much of that will be due to a significant uptick in private consumption expenditure as the RBI is likely to cut interest rates. Overall, the demonetisation step has short term impact in all most all the sectors in India, but expected to come out with good results in the coming fiscal.

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