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Demonetisation - A New Transition in Indian Economy

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I. Introduction

India is offering relative value in a slow growth world and it's faster growth is allowing the country to emerge as the second largest emerging market after China, noted a recent report by Bank of America Merill Lynch. "India is a rare economy in today's world in that it is not in stagflation. It is poised to overtake Brazil this year after having overtaken Russia last year in nominal GDP terms to emerge as the second largest emerging market after China," the report added. The country is expected to register a GDP growth of 7.4 per cent this fiscal, according to the global brokerage firm."India still offers relative value in a slow-growth world". A shallow recovery at home, estimate growth at 5.5 per cent in FY16 and 6.5 per cent in FY17 (old GDP series).

II. Demonetization –an Overview

Demonetization is the act of stripping a currency unit of its status as legal tender.Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit.The move by the government to demonetize Rs.500 and Rs.1000 notes by replacing them with new Rs.500 and Rs.2000 notes has taken the country with surprise. The move by the government is to tackle the menace of black money, corruption, terror funding and fake currency. From a market perspective, we think that this is a very welcome move by the government and which has taken the black money hoarders with surprise. The total value of old Rs.500 and Rs.1000 notes in the circulation is to the tune of Rs.14.2 trillion, which is about 85% of the total value of currency in circulation. This means that the total cash has to now pass though the formal banking channels to get legitimacy. The World Bank in July, 2010 estimated the size of the shadow economy for India at 20.7% of the Gross Domestic Product (GDP) in 1999 and rising to 23.2% in 2007. Assuming that this figure has not risen since then (quite unlikely though) and that the cash component of the shadow economy is also proportional (it could be higher), the estimated unaccounted value of the currency could be to the tune of Rs.3.3 trillion. Now, post the announcement of demonetization by the government this money would have to either account for by paying the relevant tax and penalties or would get extinguished. There are higher chances of larger proportion of this unaccounted currency getting extinguished as the tax rate and subsequent legal issues could be prohibitively high for such money. The positive macro benefits of this move by the government this move by the government is likely to have long term benefits for the economy. The extinguishing of the major proportion of unaccounted currency would reduce from the liabilities of the government and would add to its finances. This can have very strong implication as the government would get money to spend without borrowing from the market. This would mean that while interest rates can be low, the government spending on large infrastructure (we assume that the government would use large proportion for infra spending) projects would kickstart capex cycle and push economic growth higher in the medium term. The move is also likely to have a habit changing impact in the Indian populous and there could be increased belief of keeping cash in the banks rather than stashed at home and use formal banking channels for their spending needs. With a large part of the cash moving through the banking channels, the banking sector is likely to be flush with funds in the near term and this would help them reduce cost of funds for such period. Also with more money being kept in the banking channel, some of these low cost deposits may be sticky and improve the medium to long term Current Account and Savings Account (CASA) ratio of the banks.

III. Impact of Demonetization

The currency ban move by Prime Minister Narendra Modi on November 8, 2016 has caused 35 percent job losses and 50 percent decline in revenue of micro-small scale industries, an Indian Express report quoting the All India Manufacturers' Organisation (AIMO) report.

According to a study conducted by India's largest organisation of manufacturers, micro-small industries segment in India has suffered a 35% loss in jobs and 50% dip in revenue after the first 34 days of demonetisation. All India Manufacturers' Organisation (AIMO) also projected a fall in employment of 60% and loss in revenue of 55% till March 2017. Over 3 lakh micro, small, medium and large scale industries occupied in manufacturing and export activities are represented by AIMO.As per the study, the industrial sector has been badly affected, with Small and Medium-sized Enterprises (SMEs) sector worst-hit. AIMO understands certain immediate repercussions of such a bold step (demonetisation) by the government, it did not anticipate or was prepared for such a jolt to industries even after one month.

- There has been a 35% drop in employment and 45% revenue loss in the medium and large scale industries that are related to infrastructure projects, mostly road construction. There is further chance that the number of jobs and revenue may dip to 40% by March.
- A loss in jobs of 30% and 40% drop in revenue was reported from the medium and large scale industries, including the foreign firms, which are engaged in export-oriented activities. This fall in job and revenue is expected to rise to 35% and 45% respectively by March.
- While the least job loss of 5% was reported in the manufacturing sector in the first 34 days, on the other hand, revenue sector dipped 20%. However, this dip is most likely to be 15% for both by March.
- AIMO study state that medium and large scale industries engaged in infrastructure projects, like as big road construction projects, reported a 35 percent job losses and 45 per cent in revenue loss.It also said that the number of jobs and revenue are expected to further dip by 40 per cent by March this year.
- The Reserve Bank is believed to have received deposits close to Rs 15 lakh crore, of estimated Rs 15.4 lakh crore worth junked Rs 500/1,000 currency notes that were in circulation, from the 50-day demonetization exercise that ended on December 30.
- Another element of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable to some extent. This may be visible more in the rural belt, where many non-farming entities purchase fertile farmland, not for farming but for money parking purpose.
- The demonetization and consequent reduction in shadow economy would bring the demand for such farm lands down. This move is likely to lead to better tax compliance, raise the Tax to GDP ratio and improved tax collection. This could lead to lower borrowing and better fiscal management. Also with lower cash transactions in the near term, inflation may see downtrend in the near term. Also with higher tax to GDP ratio, the government may also get enough headroom to reduce the income tax rates, which can lead to higher disposable income with people and can improve consumption demand in the medium to long term. However there could be near term challenges In the immediate term, the reduced ability of the unorganized sector to deal in cash would impact the demand.
- Consumption items which had large element of cash dealing involved may see lower demand. Real estate and allied sectors may see near term to medium term negative impact.
- The services sector is expected to be affected the most under both the approaches, mainly on account of losses in trade, hotel, transport etc. due to the volume of cash transactions involved in these economic activities. Importantly, these losses, due to their inherent nature, can’t be recovered in the next quarter.
- SMEs in industry will have a major problem in adjusting production schedules as both payments and receipts flow in cash given their structures. - For rest of manufacturing, demand side issues would exist till such times conditions stabilize and could get reversed in Q4. Hence, Industry is also expected to be impacted which will be more significant in the first 2-3 weeks post the announcement.
- The gains would be positive for the banking sector due to the increase in deposits which would be countered by slowing down of other sectors in the group like real estate.
- Agriculture is expected to least impacted with major shock being absorbed in the first 2-3 weeks itself as there have been issues in sales at mandis due to the cash crunch presently.
- After demonetization of Indian currency on 08 Nov. 2016, rupee has became weaker than currency of 96 countries or economies. Out of 161 countries’ currency, rupee has became stronger than 60 currencies and is at same exchange rate with 5 currencies.
- From the data for past 6 months before demonetization from 08 may 2016 to 08 Nov. 2016, rupee has became stronger than 125 currencies. But after 26 days of ban on Rs 500 and Rs 1000 notes, rupee has became stronger than only 47 currencies.
- Rupee has became weaker by 2.66% against US Dollar ($) from 66.40 to 68.17 INR per unit US Dollar. Rupee has become weaker against some popular currencies like British Pound, Canadian Dollar and Hong Kong Dollar too. But also became stronger than Euro, Australian Dollar, Swiss Franc, Singapore Dollar and Japanese Yen.
- Indian rupee (INR) became weaker than currencies of other south Asian nations Pakistani Rupee, Sri Lankan Rupee, Bangladeshi Taka and Nepalese Rupee.

Sector wise Impact summarized

Table 1: Expected Impact on GVA

Sectors	Estimated GVA for FY 16	Expected Impact sector FY17		EstimatedGVAPost Impact FY17	
Rs.Crore		**Conservative**	**Aggressive**	**Conservative**	**Aggressive**
Agriculture	16,04,044	(-)604	(-)1,271	16,51,562	16,50,894
Industry	23,71,531	(-)3,016	(-)7,826	25,76,775	25,71,965
Services (incl. construction)	64,51,616	(-)29,420	(-)45,130	69,55,195	69,39,484
Total	**104,27,191**	**(-)33,039**	**(-)54,227**	**111,83,531**	**111,62,344**

Source: www.careratings.com

- The GVA numbers for FY17 in the second column have been drawn up on the assumption of growth of 7.6% for the year which was our assumption prior to the demonetization with GDP growth projected at 7.8%.
- Under the conservative approach GVA will grow by 7.3% which is 0.3% less than what was projected.
- Under the aggressive approach GVA will slow down to 7.1% which is 0.5% lower than the initial estimate.
- Assuming that the transition from GVA to GDP would remain unchanged at 0.2% (i.e. GVA 7.6 and GDP 7.8%) as per initial estimate, overall GDP growth would be affected by 0.3-0.5%.

IV. Pros on Demonetization

On Nov. 8, 86% of India's currency was nullified in a great demonetization effort that aimed to clean out the black market's cash supply and counterfeit notes which completely disrupted the social, political, and economic spheres of the world's second largest emerging market. All 500 and 1,000 rupee notes were instantaneously voided, and a 50 day period ensued where the population could (ideally) redeem their concealed cash for newly designed 500 and 2,000 rupee notes or deposit them into bank accounts. India has done this before. In 1946, all 1,000 and 10,000 rupee notes were recalled. In 1978, 1,000, 5,000, and 10,000 rupee notes were demonetized.This transition into a cashless economy though seemingly hard at the moment, may prove to be an inflection point in the long term. There is beginning of an acceptance by consumers to adopt the digital route by moving to card based usage or m-commerce. Marketers too are swiftly adapting to new and more efficient ways to gain traction in this emerging business landscape of a new India, where digitisation is the call of the hour.As across all service sectors, the retail sector too experienced an immediate impact of the move towards demonetization. However, they have shown great agility to turnaround the situation with a variety of sustainable measures enabling consumers with a wider choice to transact thus encouraging a gradual transition towards a cashless economy.

India as a nation has always been largely dependent on cash transactions owing to considerable challenges of lack of digitisation and last mile financial outreach and unaccounted income. The new ruling of demonetization has put everyone on a fast track to align with the Government's vision of Digital India. As expected, this has given an opportunity to numerous digital and financial service providers to create innovative ways to attract new consumers and build awareness on how to operate digitally.

Today, as the retail landscape adopts digitisation, both organised and unorganised retailers will benefit with a better view of consumers and their transaction behaviour enabling a more thought through approach to increase business. For retailers this can be advantageous as they can enable more personalised, real time communication and engage with consumers on an on-going basis. In addition to the regular modes of digital payment, retailers can create value added benefits like reward programs and provide consumers an opportunity to re-engage using alternate forms of currency in the forms of offers, cash backs and points.

Reward programs such as PAYBACK with multi-brand access become more relevant in such a scenario as consumers have an opportunity to utilise the rewards earned on their transactions and spend them across categories like commodities, services, holiday and travel bookings, entertainment bookings, luxury items, automotive, and general household goods. Loyalty points are a benefit, as they enable consumers to use them for doubling their benefits and rewards. Rewards programs today no longer solely focus on transactional loyalty; they are a destination through data-centric marketing communications that is catering to a sustainable and measurable change in the consumer behaviour.

With mobile phone penetration on the rise and access to financial services and increased awareness due to regulatory and policy push accelerating the process, digitisation is finding more acceptability. Digital transaction modes are easy to use and widely accepted by most service providers and e-commerce portals. Urban centres are the first to lead the way; however, consumers across rest of India are also gradually making the move.

It is quite clear from the benefits of digitisation that the payment landscape will provide consumers and companies alike with many opportunities. The need of the hour is for the retail sector to build more awareness around adoption and convenience of the new-age technologies and means available for consumers to continue to transact seamlessly. Apart from cashless transactions, changes in the regulatory guidelines with FDI, GST and other ease of doing business initiatives from the Government should also prove to be beneficial for the retail sector in the long run.

V. Conclusion

India is certainly going to experience "Acche Din" in Modi's regime. The decision of this surgical strike on black money was not taken in a day or two. Rome was not built in a day and similarly, this plan is the result of Prime Minister's meticulous planning and never ending fight against corruption. One of the biggest benefits of this move is that it is going to drastically affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalised and prosecuted by the authorities. Enemies of the country which are involved in counterfeit currency and terrorism will not be able to continue it further for quite some time at least. The banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial inclusion. It will also reduce tax avoidance. Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this period. As a result, he has successfully made the right stroke at the right time. Further, the penal provisions are hefty enough to ensure that corrupt practices will find it hard to take roots again. Despite certain short term troubles, demonetization is certainly going to give a boost to the Indian economy in the long run.

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