

Impact of Demonetization on Indian Economy

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Abstract

This paper analyses the short term costs and medium term benefits of demonetization and its Impact on the growth of various sectors of an economy where significant cash transactions are involved. It is evident from observed data that the impact of demonetization on Gross Value Added growth was modest. Although the Gross Value Added contracted marginally, it is projected to be positive in coming years. In the beginning it negatively impacted the segments of manufacturing and service sector showing the downward movement in various markets such as automobiles, consumer, real estate etc. Later with the remonetization and lower lending rates the growth of an economy has been recovering fast through increase in private consumption, disposable income and affordable loan. With digitization economy is moving towards cashless society and will bring more transparency in the system reducing tax evasion thereby curbing the use of black money for illegal activities and terror funding.

Keywords: Demonetization, Remonetization and Gross Value Added

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1. Introduction

Demonetisation was an unanticipated step by PM Narendra Modi when he announced on 8th Nov 2016 the demonetization of India's two largest denomination Rs 500 and Rs 1000 that were replaced with new 500 and 2000 ones. The aim for such a drastic action was to abdicate fake currency, terror funding, corruption and most importantly to curb accumulation of black money, which is generated by income that is not declared to tax authorities.

India is cash based economy in which major volume based transactions are made in cash. Since cash is difficult to handle and carry, it's become difficult for the government to keep the track of the same.

As per data total Notes in circulation as of 4th Nov 2016- Rs 17, 742 billion accounted 13% of GDP whereas value of Rs500 and Rs 1000 consisted of 86.5 per cent of notes in circulation accounts 11 per cent of notes in circulation. Therefore, almost 86% of cash in the economy was rendered invalid overnight, leading public haphazard.

Such demonetization steps were taken in the past also, first in 1946 and later in 1978. Then also the RBI demonetized 1000 and 10000 banknotes, with the same aim to tackle issue of black money. The main difference now and then was that currency of higher denomination was barely in circulation unlike 500

and 1000 notes. It did not have much impact on the GDP as it accounted only 1percent of GDP.

2. Data Source

The study is based on the annual report of Reserve Bank of India in which data is collected from Central Statistical Organization, Society of Indian Automobile Manufactures, Insurance Regulatory and Development Authority, Centre for Monitoring Indian Economy.

3. Impact on Growth

Indian economy largely consists of three broad sectors namely agriculture sector, manufacturing sector and service sector. Service sector is the largest sector of Indian economy that shares 53.66 per cent in gross value added, manufacturing contributes 29.02 percent and agriculture and allied sector shares 17.32 per cent.

According to the latest CSO estimates, the Gross Value Added on 28 Feb'17 was 6.7 percent lower than 7 percent estimated on 6 Jan '2016. GVA in Q3 at 6.6 percent declined marginally relative to gross value added growth in Q2 at 6.7 per cent. According to CSO estimate, the impact of demonetization on GVA growth was modest. However, acc to disaggregated component wise GVA

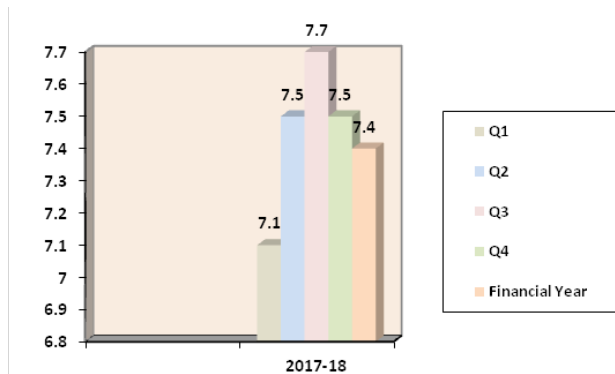
estimates, demonetization impact was felt to a large extent in real estate and construction activity in Q3 FY'16-17.

Table 1. CSO Estimated GVA Growth (Y-O-Y) in per cent

| Period | May 31, | Aug 31, | Nov 30, | Jan 6, | Jan 31, | Feb 28, | |
|--------|---------|---------|---------|--------|---------|---------|------|
| | 2016 | 2016 | 2016 | 2017 | 2017 | 2017 | |
| 15-16 | Q1 | 7.2 | 7.2 | 7.2 | 7.2 | - | 7.8 |
| | Q2 | 7.3 | 7.3 | 7.3 | 7.3 | - | 8.4 |
| | Q3 | 6.9 | 6.9 | 6.9 | 6.9 | - | 7.0 |
| | Q4 | 7.4 | 7.4 | 7.4 | 7.4 | - | 8.2 |
| Annual | | 7.2 | 7.2 | 7.2 | 7.2 | 7.8 | 7.8 |
| 16-17 | Q1 | - | 7.3 | 7.3 | - | - | 6.9 |
| | Q2 | - | - | 7.1 | - | - | 6.7 |
| | Q3 | - | - | - | - | - | 6.6 |
| | Q4 | - | - | - | - | - | 6.5* |
| Annual | | - | - | - | 7.0 | 7.0 | 6.7 |

Source: RBI Report

With the boomerang of money in the market the demand and supply has started expanding therefore resulting in offsetting the negative effects of demonetization which can be observed in the data below. Growth is projected to be higher at 7.4 per cent in 2017-18.



Source: RBI Report

Figure 1. Projected Gross Value Added Growth (Y-o-Y) in percent.

4. Impact on the growth of various sectors

Demonetization significantly impacted the growth of all the three sectors mainly manufacturing and service initially due to restraint on both demand and supply side.

Demand Side: Shortage of cash reduced the disposable income to make payments which resulted in the fall of private consumption

Supply Side: Contraction of production mainly in the unorganized sector where the wages are paid in cash. Lower wages resulted in lower demand and thereby fall in the production.

Table 2. Lead Indicators of Economic Activity (y-o-y growth in per cent)

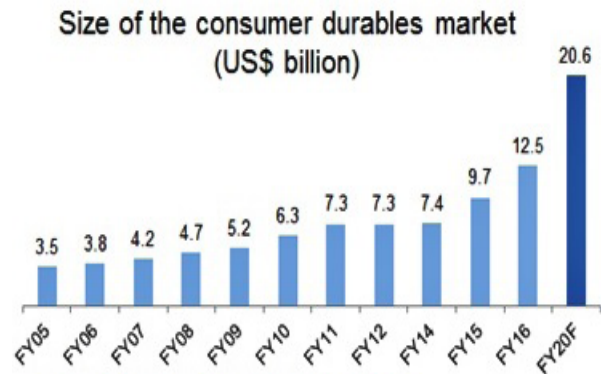
| Sectoral indicators | Apr-Oct | Oct-16 | Nov-16 | Dec-16 | Jan-17 | Feb-17 |
|---------------------|---------|--------|--------|--------|--------|--------|
| PMI manufacturing | 52 | 54.4 | 52.3 | 49.6 | 50.4 | 50.7 |
| PMI services | 52.6 | 54.5 | 46.7 | 46.8 | 48.7 | 50.3 |

Source: RBI Report

From the above table, it is noticeable that manufacturing purchasing managers' Index (PMI) contracted in December '16 to 49.6 per cent thereafter rebounded in January'17 and February'17 to 50.4 and 50.7 respectively. The service PMI declined from 54.5 in Oct'16 to 46.7 in Nov'16 and 46.8 in Dec'16. However, it has increased to 50.3 per cent in Feb'17.

4.1 Consumer Sector

This sector comprises of rural and urban market and demand across world. It has grown at an annual rate of 5.7 per cent between 2005 -2015 and is estimated to be 6.7 per cent during 2015-2020 and 7.1 percent between 2021 -2025. The size of the consumer durables market has expanded over the time to \$3.5 US billion in the year 2005 and estimated to be \$20.6 US billion in 2020.



Source: Electronic Industries Association of India, CAGR – Compound Annual Growth Rate, F: Forecasted

Figure 2. Size of the Customer durables market.

Demonetization resulted in liquidity crunch causing the decline in the sales of fast moving consumer goods and impacted the sales of consumer durables industry.

Table 3. Growth in Consumer Durable Segments (in per cent)

| Category | Volume Growth | | Value Growth | |
|-----------------|---------------|-----------|--------------|-----------|
| | Oct. 2016 | Nov. 2016 | Oct. 2016 | Nov. 2016 |
| Microwave | 90.6 | -53.0 | 90.7 | -51.5 |
| Refrigerator | 74.0 | -41.2 | 73.4 | -40.3 |
| Air Conditioner | 1.8 | -34.0 | 4.0 | -33.8 |
| Washing machine | 116.7 | -31.7 | 113.1 | -34.4 |
| Flat Panel TV | 94.7 | -30.4 | 99.4 | -26.6 |

Source: RBI Report

However, it is likely that this move will benefit organized retail market and restrict counterfeit goods. The sales of FMGC and consumer durables will bounce back and expand through online retail and increase in demand by remonetization.

4.2 Automobile Sector

The automobile industry account for 7.1 per cent of the country's GDP and is one of the largest in the world with an annual production of 23.37 million vehicles in the year 2014-15.

Demonetization adversely impacted the sales of the automobiles shrinking its sales by 5.5 per cent in Nov'16, 18.7 per cent in Dec'16 and 4.7 per cent in Jan 2017, among the vehicles two-wheeler segment felt highest impact since large proportion of two wheeler transaction in rural areas are in cash than loans. However, automobile sales recovery has already begun showing growth of 0.9 per cent in Feb'17.

Table 4. Indicators of Economic Activity (Y-Growth) in percent

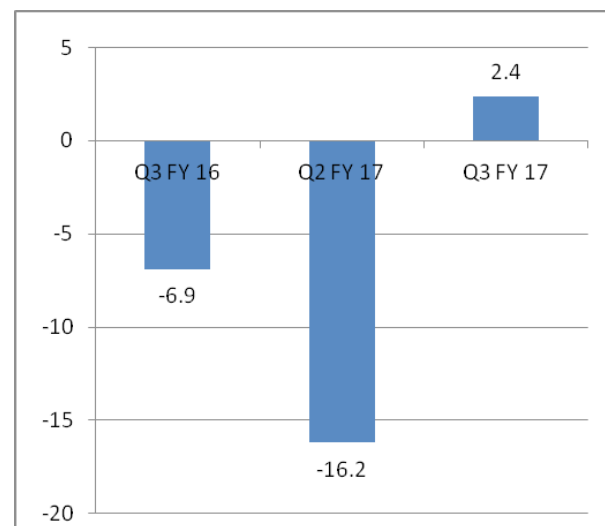
| | Apr-Oct | Oct-16 | Nov-16 | Dec-16 | Jan-17 | Feb-17 |
|---------------------------|---------|--------|--------|--------|--------|--------|
| Automobile sales | 15.0 | 8.1 | -5.5 | -18.7 | -4.7 | 0.9 |
| Commercial vehicles sales | 6.9 | 11.9 | -11.6 | -5.1 | -0.7 | 7.3 |
| Passenger vehicles sales | 11.0 | 4.5 | 1.8 | -1.4 | 14.4 | 9.0 |
| Three wheelers sales | 11.8 | 4.4 | -25.9 | -36.2 | -28.2 | -21.4 |
| Two wheelers sales | 16.0 | 8.7 | -5.9 | -22.0 | -7.4 | 0 |

Source: RBI Report

Large deposits lower lending rates and increasing circulation of money has already uplifted sales growth and further expected to boost demand for automobiles by making loans affordable

4.3 Real Estate Sector

Real estate is the second largest sector which comes after the agriculture. It consists of housing, retail, commercial and hospitality. It is expected to touch US\$ 180 billion by 2020 from which the housing sector alone contributes 5-6 percent to GDP. Demonetization severely impacted the growth performance of the real estate sector initially but in contrast to previous quarters, companies in the real estate sector recorded positive sales growth in Q3 FY'17.



Source: RBI Report

Figure 3. Sales growth (year on year) in percent.

Furthermore, demonetization along with real estate regulation Act will increase transparency, higher FDI and boost investor confidence. In addition to this it will slow down inflation due to fall in the price of housing where the large percentage of transaction is in cash.

5. Digital Modes of Payments

The catalytic drive from demonetization shifted towards digital payments with the aim to move nation to cashless economy. Till now only few banks offered app based services for transactions, however this step led to the introduction of Bharat Interface for Money (BHIM), which enables fast secure and reliable cashless payments through mobile phones.

The growth rates surged in both volume and value of major modes of electronic Payments in Feb'17 relative to Nov'16 as can be noticed below. In addition, a sharp increase is noticed in UPI transactions- A flagship product of the NPCI from 0.3 million in Nov'16 to 4.2 million in Jan-Feb'17.

Table 5. Growth in Select Electronic Modes of Payments (Yo-Y) in per cent

| | Category | Oct-16 | Nov-16 | Dec-16 | Jan-17 | Feb-17 |
|------|----------|--------|--------|--------|--------|--------|
| NEFT | Volume | 16.2 | 23.3 | 39.0 | 38.0 | 34.5 |
| | Value | 37.6 | 38.3 | 40.8 | 60.2 | 49.5 |
| CTS | Volume | -1.1 | 23.0 | 58.4 | 52.7 | 20.2 |
| | Value | 2.9 | 8.6 | 13.0 | 19.3 | 0.8 |
| IMPS | Volume | 116.7 | 89.6 | 157.2 | 177.7 | 150.4 |
| | Value | 150.7 | 135.9 | 186.6 | 196.7 | 184.2 |
| NACH | Volume | 53.0 | 30.8 | 58.3 | 19.8 | -0.9 |
| | Value | 89.8 | 76.3 | 116.7 | 22.8 | 54.2 |

Source: RBI Report

Such drive will improve Direct Benefit Transfers, bring transparency, curbs corruption and black money where each person contributing towards the development of the country.

6. Summing up

The study shows the significant impact of the demonetization on various sectors of the Indian economy where the most adversely

hit sectors were manufacturing and service mainly unorganized market where the significant percentage of transactions are based on cash. Demonetization resulted to the fall in disposable income caused by liquidity crunch thereby affecting the overall demand and supply. With the passage of time increasing circulation of money and lower lending rates helping to revive the economy from the consequences of demonetization. This drive has reforming nation towards cashless economy. As based on observed data, the impact of demonetization on GVA growth was modest, mostly all the sectors have shown positive growth over the period. Hence, negative changes are temporary and short lived and will further benefit economy in the medium and long run.

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