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WITHDRAWAL OF CURRENCY NOTES FROM CIRCULATION AND THE IMPACT ON 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 this paper is to assess the impact of withdrawal of currency notes from circulation on GDP growth in India.*

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 impacts on Indian economy. Demonetisation will have impact 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 ₹1000 and ₹500) 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 our view, 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 (Q3) of 2016-17 (with an estimated contraction in informal economic activity in trade, road transport and construction sectors by 5%), Q3 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, Q3 growth may dip as low as 1.5%. For the current fiscal year that ends March 2017, growth is expected at 6.5 per cent due to the short term impacts of India's cash crunch. The growth is expected to get momentum at 7.1 per cent during 2017-18.

How these 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 Q3 and Q4. If so, we have to take it with a pinch of salt.

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). 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.

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 this year 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 (data due in January 2017) will also not reflect the full impact of disruption.

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. IMPACT OF DEMONETISATION IN INDIA:

7.1. **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.

7.2. **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.

7.3. **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.

7.4. **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.

7.5. **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.

7.6. **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.

8. CONCLUSION:

Growth is expected to recover gradually in the fourth quarter (Q4) of 2016-17 but slipped to 6.1 per cent and the financial year ended with the growth rate of 7.1 per cent. The first quarter (Q1) of 2017-18 is now expected to returning to its normal trajectory and 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, respectively, its overall impact on GDP growth assessed may not be significant. The impact of easy availability of credit arises 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.

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