CHALLENGES AND IMPACT ON INDIAN ECONOMY POST DEMONETIZATION

Background

The Indian economy is growing at the rate of 7.5% with a stable control in all its vital economic parameters. The inflation rate is stable at 5% since past one and half years and has projected good health in the economy.

Demonetization

Historical data displays introduction of demonetization in highly distressed economies where in vital economic parameters had gone for a toss. Hence in case of the Indian economy it is very clear that demonetization is introduced not as a tool for dealing with economic distress as in case of economies which did so in the past on account of economic depression . It is true that India has 70% cash transaction and in this circulation there is a rampant presence of counterfeit notes which is eating up value creation.

Demonetization will surely curb this issue of counterfeit notes but only if India becomes more digital in its payments and the currency issued is of smaller denomination which is up to Rs. 500. Introduction of Rs. 2000 rupee note has put the economy in a perplexed state as demonetization in real sense means decreasing the value on paper currency in circulation. The Rs. 1000 note has been deleted from the circulation and a Rs. 2000 note has been introduced which has questions to the underlying principle of demonetization. However, the Indian government is being vocal about using this tool to cleanse black money from the system and is being supported by legends both in economic and business.

It is very noteworthy to learn from statistical data that there are two very peculiar issues in India which are acting as stunning counterparts to each other and they are - India has a rich poor divide of 41% and that India has 20% share of world's billionaires.

This observation indicates that if black money does exist in India it does not do so among the 60% of the population which comprises of the middle income group and the population residing in the rural India which is more or less living below the poverty line. It is very true that the present banking system is holding about 60% NPAs on its balance sheet and a sudden cash deposit drive such as this would prove instrumental in wiping out these NPAs to a certain extent. It is very much true that only 11% of the Indian Population contributes to tax revenue and remaining 30% still evades tax. However better strategies than demonetization would have worked wonders instead of putting to task already economically stressed population.

Lack of digital infrastructure

India desperately lacks digital infrastructure and has number of bottlenecks in promotion of use of cashless payments. A bank debit card does not come free on an account and there is a transaction tax on credit card amounting to 2% on master and visa credit cards. Additionally, the internet penetration is yet to reach rural India. It may take up to at least 5 years to reach last-mile connectivity. Against this backdrop, to enable digitization, the government must appoint an effective agency to monitor implementation. The agency must be accountable for a time-bound implementation.

China UnionPay

China UnionPay also known as UnionPay or by its abbreviation - CUP, is a Chinese financial services corporation headquartered in Shanghai, China. It provides bank card services and a major card scheme in mainland China. Founded on March 26, 2002, CUP is an association for China's banking card industry, operating under the approval of the People's Bank of China (PBOC, central bank of China). It is also the only interbank network in China that links all the ATMs of all banks throughout the country. It is also an EFTPOS (Electronic Funds Transfer at Point of Sale) network. This service also has been instrumental in saving billion dollar revenue exit from China which happened in case of master and visa cards. India introduced the Rupay card on the lines of UnionPay but it still has yet to take grip of the situation.

Cash prominent Indian economy

Nearly 86% of money is held in cash in India in Rs. 500 and Rs. 1000 currency showing the dominance of cash in Indian economy. This 86% currency cannot be termed as black because nearly 90% transactions are cash based due to inadequate information and infrastructure for cashless transactions to materialize. The rural banking connect is at present only 20% of the total bank branch network in urban and semi urban areas. In fact even today 60% of the MNREGA deliveries are made in cash due to inadequate rural banking infrastructure.

It has been observed that cash is distributed among electorate at the time of elections by political parties. This is nothing but the black money as the source of income is unknown and untraceable. An exercise such as this, coupled with the introduction of Rs. 2000 currency note is nothing but a whip on the politicians rather than any economic distress signal which has been triggered to have this event of demonetization in the first place. The other reason given for having this event was the issue of counterfeit notes. However, one can ascertain the efficacy of this exercise only upon learning the exact amount of counterfeit notes recovered from this exercise, which at present is unknown.

Strengthening of infrastructure such as provision of internet to the last penetrable rural division, enough supply of printed Rs. 500 notes, incentivisation on digital payments, withdrawal of charges on electronic cards, facilitation of AADHAR enabled POS and normal POS machines at subsidized rate to retail traders would have curtailed the negative impact on the common man who was affected the most by this kind of surprise attack.

Though these measures are seeping through, the pace is too slow for aggressive consumption based Indian economy. The Indian economy that had recovered to 7.5% from a 3 year lull of 5.55% with a higher rate of inflation, after lot of hard work was subjected to such a steep fall of 1-1.5% and in a place like India where recovery of economic parameters need long time.

Some of the effects of demonetization are,

North/East/central India were more impacted than South/South-western parts of the country post the demonetization move. Further, rural regions were more affected than urban areas. Similarly, the unorganised sector was hit more than the organized segment and the discretionary sector suffered more than staples. Also, traders, retailers and wholesalers were affected more than the manufacturers due to the existing trade credit system.

Nevertheless, despite hardships, we have observed massive acceptance of the move from the 'bottom of the pyramid' population. Many felt that this move would help check corruption and black money. Moreover, we have also observed wide acceptability/movement of transactions to formal banking channels. If properly directed, this will definitely boost the Indian economy both structurally and on the fiscal front in the long term. While the sudden liquidity crunch did lead to disarray, the situation is expected to mend as currency gets replenished.

However, undoubtedly, few days into demonetization, the business activity has been hit significantly. Pre-dated sales (in the first week of Nov), acceptance of old currency notes by some traders and credit extension might initially offset the demonetization impact somewhat, but it would be reflected December 2016 onwards.

Below are the key gleanings from our on-the-ground interactions.

1. **The great regional divide**

The regional divide was very clear – North India is witnessing the maximum impact on business activity, given that the region's economy is more cash based. On the other hand, the demonetization impact was relatively marginal in South India.

2. **Urban-rural divide**

Urban areas have seen quicker demand recovery versus rural regions. This has been led by better cash availability, increased acceptance of plastic money and increased use of formal banking channels for transactions. Recovery has been slower in tier 2/3 cities versus metros/tier 1 cities.

3. **Essentials consumption – Recovering swiftly**

We have observed that essential consumption has been the quickest category to pick up (down only 10-15% so far). Discretionary consumption (especially big-ticket items) is expected to take 3-6 months to recover. We believe that the recovery order would be trade, manufacturing and construction in terms of economic activity. Consequently, sector-wise recovery order could be Essential Staples, Impulse Category Staples, Telecom, Petroleum Products, Consumer Durables, Automobiles, Cement, Home-improvement and Realty.

4. **Organised players to gain market share**

Given increased acceptability of plastic money, government's focus on digital cash and GST push, organised players would gain the higher market share. This was visible post-demonetization as super markets and organised electrical product stores saw a mild rise in sales, while unorganised witness decline.

5. **Keenness to accept digital payments**

We have observed that acceptance of digital payment modes by traders is improving. It varied from usage of various fintech products such as Paytm by micro retailers, multi-fold increase in application for POS terminals by shops and increased activity on the UPI front.

Impact on key economic activities

Agriculture

Vegetable prices have been hit the most given its perishable nature and bumper crop due to the normal monsoon and early onset of winter. Wholesale vegetable prices were down by 70-80% across

India, while retail prices were down only to the level of 20-30%. Grain prices have been stable so far. APMC activity in the North has been hit hard given the higher cash component in trading. Wider acceptance of formal banking channels such as cheques and RTGS have lent support to western/southern APMC markets.

Rural areas are still facing acute cash crunch along with lower number of banks (at times one bank is servicing five villages). This has led to some productivity loss in farms.

Construction

Retail construction activity has been hit very hard. While institutional construction is going on, albeit at a slower pace. Construction activity is further impacted by sand/steel availability (majorly traded in cash; hence, a bottleneck and also affected by environmental clearances).

Trading

Dealers/stockists have seen an inventory build-up of 1.5-1.8x across sectors. Few companies have extended credit (HUL, GCPL etc.) and some have not (Asian Paints, ITC etc.). New orders have been nearly muted.

Wholesalers, especially in North India, have seen an adverse impact on trade, given higher cash component of transactions. Cash retail sales have been impacted the most. Part of this demand has been postponed or cancelled and part has been fulfilled through the organised retail channel.

Manufacturing

We visited various manufacturing hubs across India and observed a sharp decline in activity in an unorganised sector. The unorganised sector is dependent more on cash (daily wage payments and supply chain transaction are majorly cash based).

Sectoral impact:

Autos

Two-wheelers, tractors and commercial vehicles have seen the most pronounced impact (~40-50% dip) compared with passenger vehicles (20-30% decline). More delivery postponements have been registered in rural/semi-urban areas given the high amount of cash used. We observed that Maruti's and Eicher's deliveries were the least impacted.

Cement

While retail cement demand has completely dried up, institutional demand is keeping it going. Overall demand is down ~20-25%, with a pronounced regional effect.

Consumption

Staples – Staples have seen a quick recovery, with sales down by ~10-15% of the original level. Essentials demand has recovered completely, while impulse purchase category is still seeing the impact.

Discretionary – Consumer durable sales in smaller towns/rural areas have been hit significantly. In metros, wedding season and financing options have lent some support to durables demand.

Home improvement - This segment has seen a sharp decline in sales ranging from 50-60% to as high as 70-80% decline across categories (paints, tiles, window panes, sanitary-ware etc.).

Realty - Price correction is expected widely, especially in regions with lower ready reckoner rates. We have also observed a spike in pre-dated sales in November 2016 (which was carried out using old currency).

Telecom - Usage of old currency notes has lent some support to pre-paid recharges, thereby negating some of the lost sales in mid-November. New activations are down 15-20%. Pre-paid recharges in rural areas have suffered more given the cash crunch.

Fleet traffic/Oil & Gas - Fleet movement has been impacted more in North/West/East/central India compared with the South given their high cash dependence. Though acceptance of old notes helped boost sales in early-November. Sales in petrol pumps are down in general and the impact would be clear only post December numbers.

Impact on GDP

Overall, we have reduced our GDP growth estimate for H2FY17 to 6.4% from 7.8% earlier. The maximum impact will be seen in Q3FY17. The sectors that are likely to be hit the most are Construction, Trade, Electricity and Manufacturing. GDP growth for FY17 is expected to be lower by nearly 60 bps at 7% (from 7.6% earlier) and for FY18 to be lower by 20 bps at 7.6% (7.8% earlier).

Transactions approach, an alternative way to assess the impact on economy

We have attempted to analyse the impact of cash transactions on overall transactions growth to arrive at an estimated impact on the economy. As per the analysis, we expect that transactions growth (22% till October-16) might fall to 16.1-19.4% for FY17.

Against this backdrop, we request you to take necessary steps to address concerns over bleak business scenario in his forthcoming budget. The Budget should provide taxation relief and further incentivize businesses in this challenging environment to avoid irritants coming in the way of tax payers and also to do away with various discretionary power in regard with taxation laws to bring in uniformity.

The businesses are looking forward to ease of doing business by having minimum laws and better governance and doing away with multiplicity of taxes and redundant regulations and laws.