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EXECUTIVE BRIEFINGS
POLITICS & ECONOMY: DEMONETISATION

Adit Jain, IMA India
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Now you see me, now you don't

The crowds at China Kitchen, a popular eatery at The Hyatt Regency New Delhi, were curiously thin for a Friday evening. Apart from a few overseas guests, the restaurant appeared eerily quiet. The familiar chattering amongst families seated on long tables with glasses of chardonnay, was noticeably missing. The manager complained that following the government's decision to demonetise high-value currency notes, business had rather abruptly crumbled. Retails outlets selling luxury products across the hallway in the shopping arcade had similar grievances. Everything had changed overnight.

Over the past two weeks, following the dramatic demonetisation step, there have been expressions of passionate support in favour and some vociferously against. It is hard to say how things will eventually play out, but even his critics would acknowledge that Prime Minister Narendra Modi has been brave and consistent in his efforts to weed out black money from India's economic system. The demonetisation is one in a series of steps undertaken since his administration assumed office in 2014, its immediate predecessor being the Income Disclosure Scheme (IDS) announced a few months ago. This allowed the declaration of undisclosed income by paying a penal tax rate of 45%. The two questions that now present themselves are related to the impact firstly, on economic activity and growth; and secondly, on the curbing of unaccounted wealth.

As far as the first goes, it is conceivable that in the short term both consumption and investment would fall. Consumption, in particular, has taken a whack with several retail outlets reporting drops of as much as 80%. Whilst this is temporary and should eventually recover, it is nonetheless disruptive. What may take longer to recoup however is the impact of the 'wealth effect' phenomenon. The demonetisation initiative will result in a gross reduction in discretionary spending, curbing demand for automobiles, consumer durables, electronics, holidays and other luxury fritters. According to back-of-the-envelope calculations using NSSO consumption expenditure patterns, IMA estimates that private consumption, in an extreme scenario, could fall by as much as 15% in absolute terms for at least a few months. Some of this may be counter-balanced by a rise in Government spending based on a jump in tax collections. However, the net impact could still be a drop of 10% in aggregate consumption, which translates into a GDP decline of 1.5-2% in real terms. However, GDP comprises the sum of consumption and savings and the latter is likely to reflect a statistical increase on account of a bump-up in bank deposits. This will moderate the negative impact of consumption. Whilst it is hard to say for sure, we suspect the net impact on GDP could be a decline of 1-1.5% for the next two quarters. Since the first two quarters of the current financial year witnessed GDP growth of 7.5%, this means that the full year average could slip to 3-3.5%. Ultimately however, these calculations are a play on assumptions and frankly could go either way. The second worry is investment, which has remained subdued over the past 3 years and is unlikely to recover in a hurry. Markets and investors dislike uncertainty and major capex decisions will almost certainly be deferred for many months.

The demonetisation step is as yet the strongest assertion of the Modi administration's commitment to address the black economy. Arguably, idle cash represents only a fraction of unaccounted wealth and while estimates vary, the bulk is probably in the form of physical assets such as real estate and gold. Be that as it may, the message remains powerful. Going forward, it seems likely that punters will be more cautious when undertaking questionable transactions. Over time, off-balance-sheet wealth will conceivably be rebuilt but perhaps not at the same pace. In the final count, the problem of black money will only be fixed by building stronger institutions and providing better governance. That is unlikely to happen in the near term. The rot that has accumulated within governance structures over the decades is simply too intense to crack in a single stroke. In the longer term, digital money will need to replace physical cash as that gives authorities an easier trail to shadow. Demonetisation has been a bold step, but its final success will be consequent upon the economy's ability to adapt to digital finance. That may be somewhat harder.

Going forward, in the near term, the economy will remain subdued with dwindling consumer and investor confidence. Equity market assets and real-estate have taken the first knock. With an expected hike in US interest rates in December and an extraordinary hardening of bond yields in America – which jumped from 1.8% to 2.33% in a matter of weeks – foreign capital is likely to scamper out of emerging markets. This will put further pressures on the Rupee and inflation, undermining the Reserve Bank's intent to lower interest rates hurriedly. However, in the longer term, capital will be redeployed from dud assets such as gold and property into financial markets, giving a boost to productive savings and growth. The government's decision to demonetise comes with agonising consequences, but may yet on balance be a virtuous one. China Kitchen will in time regain its customers, only this time they will pay with taxed income.