India: significant, yet temporary, impact of currency demonetisation

In a surprising move to counter the importance of undisclosed 'black' money, the Prime Minister of India has decided to withdraw large value banknotes and replace them progressively with new banknotes. The laudable objective is however riddled with short term negative implications on business and personal activities, which should translate in a significant reduction of the GDP growth in the current and next quarters with year-on-year performance below 3% in the current quarter. Business transactions should resume rapidly, depending on the availability of new banknotes, while the boost in cash-less economy will reduce weight of informal sector and corruption, hence likely strengthening the potential for a high economic growth in the medium term.

PM Modi: demonetisation announcement on Nov. 8

On November 8, 2016, the Indian Prime Minister has announced the end of the legal tender for the largest banknotes (500 and 1000 Rupees, i.e. USD 7.5 and 15), with immediate effect. The main reasons for this surprise move are to eliminate the unaccounted "black money" and counterfeit currency, to fight corruption and terror financing, and to encourage cashless transactions. New banknotes of 500 and 2000 Rupees are introduced very gradually, and old banknotes can be deposited in bank accounts until Dec. 2016.

The importance of these two banknotes in the economy is substantial as they represent almost 86% of the currency in circulation, while the overall cash is equivalent to about 12% of GDP. This is high by international standards (Russia: 10%; Mexico: 7%; Brazil: 4%), and reveals the massive size of the cash-based informal sector (around 50% of GDP and nearly 80% of employment). Unfortunately as regard to the initial motive of the demonetization decision, the cash comprises only a minor share of black wealth (5-6%), as large tax evaders would reinvest their undisclosed income in real estate, gold or financial assets abroad.

Serious disruptions with fatal consequences

The sudden announcement has led to a rush at bank branches as almost 22 bn defunct notes needed to be exchanged or deposited, entailing long hours of wait and tragically some 80 deaths. The short supply of new banknotes has created severe bottlenecks in the banking system. Though deposits have rapidly surged, the low availability of formal banking services in India has affected rural workers and farmers while credit distribution has slowed down in urban areas.

Considering the size of Indian cash-economy and the (unknown) time needed to fully replace the old banknotes with new ones, the short-term impact will be a substantial disruption in transaction capabilities, concentrated on consumers (85% of total consumption spending is paid in cash) and informal sector producers.

In parallel, the agricultural sector will suffer due to the combination of the lower selling of the recent crop's outputs and the falling cash liquidity to complete the winter sowing season (purchase of new seeds, fertilizers). Considering the large share of working population in the agricultural sector (almost 50%), the demonetisation will restrain the consumption pattern of the country.

Significant impact on the economy: sharp slowdown and accelerating inflation

Estimates of the impact of the demonetisation on the overall economy are highly heterogenous, because it is very complex to measure the potential effect on transactions of the time-delay in re-building cash holdings, the "destruction of wealth" for unrecorded or illegal cash holdings and the consequences on other asset classes (notably high-end real estate), and the potential implication on aggregate confidence.

Negative short-term implications are likely to be amplified by the simultaneous occurrence of other headwinds, from the expected US monetary tightening to poorer-than-expected monsoon rains.

Our rough assessment is a sharp reduction in aggregate year-on-year GDP growth for 2016Q4[1] as consumer will massively shrink their expenses, possibly to below +3% y/y; the consumption constraints would progressively ease over the subsequent two following quarters. Overall the annual impact on GDP growth performance for FY2017 could be a reduction of 1.5 percentage point, to around +6.5%.

In parallel, inflationary pressures may rise as agriculture, trade and transportation are likely to be among the hardest hit sectors. In a context of acute organisational and logistic issues for the banking system, the central bank is likely to pause and keep its interest rates unchanged, unless a dramatic decline in the exchange rate following a stronger-than-expected US monetary tightening imposes a more restrictive stance. Construction activity (as well as jewellery / gold) are also likely to be severely hit in the very short-term.

The negative impact is however expected to subside rapidly. In parallel, the move should have positive medium-term implications: it could modestly increase fiscal revenue collection as previously unrecorded transactions get into formal mechanisms; and it should support stronger banking intermediation mechanisms, as larger bank deposits will substitute to previous cash holdings and translate into lower lending rates while reinforcing modern payment mechanisms.

[1] Indian fiscal year starts on April 1st. Calendar 2016Q4 is equivalent to Fiscal Year 2016/17 Q3 (noted FY17Q3)