CARE Ratings
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Four months after demonetization: Where do we stand?

Contact:
Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-022-67543489

Dr Rucha Ranadive
Associate Economist
rucha.ranadive@careratings.com
91-022-67543531

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-22-67543515

Demonetization is probably one of the largest exercises undertaken by any country to address the issue of black money, which has been high on the government's agenda. Invoked on 8th November 2016, the scheme ran till the end of December when there was a window provided for exchanging (for a limited time) and depositing old currency notes of denomination of Rs 500 and Rs 1000. These notes have been subsequently replaced with Rs 500 and Rs 2000 denominations. The situation has now reverted to normal with all restrictions on withdrawal of currency being removed.

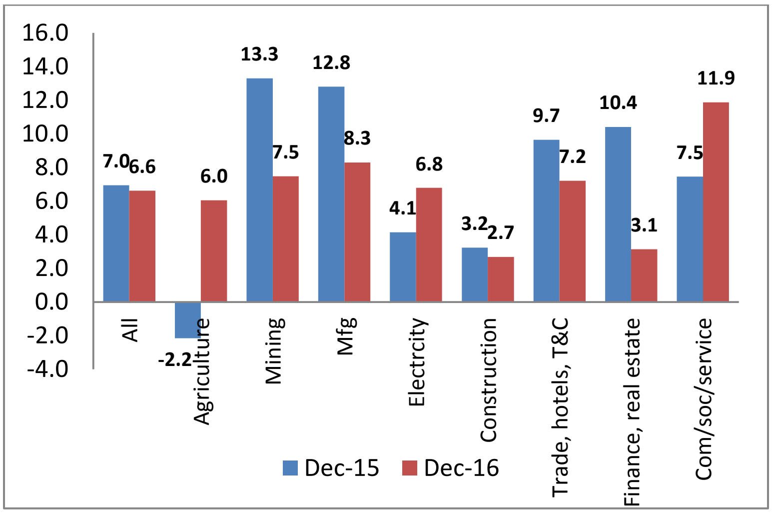
The issue of demonetization has been debated for the last 4 months. The first approach to gauge the success is to take a look at the amount of old currency which was returned to the system in the form of deposits or exchange. This information will be made available by the RBI once the data is compiled. The other way to look at the success would be to ascertain the amount of deposits that would not be accounted for satisfactorily by the holders when questioned by the IT department. This information too would be available in FY18 as account holders have a window for disclosing unaccounted money till end-March.

On the other side, there has been some discussion on how the economy would be impacted on this score, as there was a view that certain industries were affected for want of currency and as demand fell and production slowed down, there was a drop in employment. CARE Ratings had earlier in its report titled : Impact of demonetization on GDP growth in FY17, dated 18th November had estimated that growth would be impacted in two different ways: one where output would be affected negatively and irrevocably as in services, while demand would only get deferred for in case of manufacturing.

The foregoing analysis traces patterns in various economic variables over the period of 4 months with a backdrop of the situation as of September 2016 which was a high-point in the economy when revival in demand pointed to a turnaround. These are:

- Growth profile of GVA
- Trends in industrial growth across sectors
- Growth in corporate sales across segments
- Movement in currency in circulation
- Trends in movement in bank deposits and credit
- Interest rate movements
- Stock market activity

A. GDP growth profile



Source: MOSPI

Overall growth in GVA at constant prices did slow down to 6.6% in Q3-FY17 compared with 7% in Q3-FY16. This can largely be attributed to the negative effects of demonetization which was evident in case of: manufacturing, construction, trade, transport & communications, and finance, real estate & professional services. The sectors that continued to do well and prop up GVA growth were social, community services (i.e. government) and agriculture which helped to counter the negative effects of lower spending in the other segments. If the GDP growth numbers are not revised going ahead for 9M, then GDP growth would cross the 7% mark this year.

B. Industrial growth

	IIP	Basic goods	Capital goods	Inter goods	Consumer goods	Durable	Non-durable
Sep-16	0.7	4.0	-21.6	2.2	6.1	13.9	0.3
Oct-16	-1.9	4.2	-27.0	2.6	-1.4	0.6	-3.0
Nov-16	5.7	4.7	15.0	2.6	5.2	9.4	2.5
Dec-16	-0.1	5.5	-3.9	-1.3	-6.0	-8.9	-4.4
Jan-17	2.7	5.3	10.7	-2.3	-1.0	2.9	-3.2

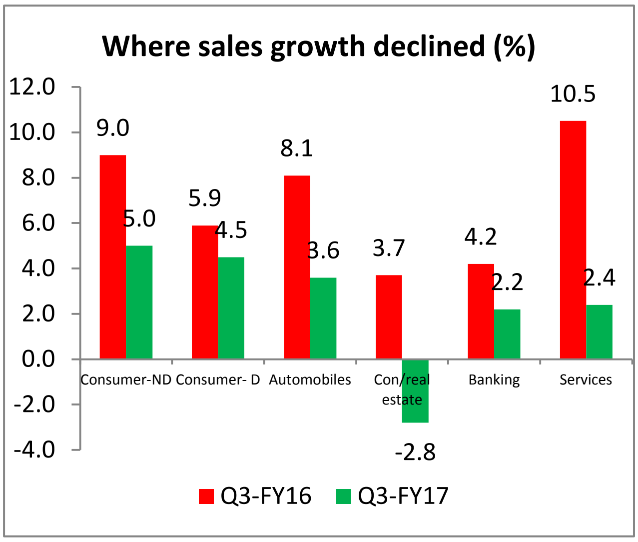
Source: MOSPI

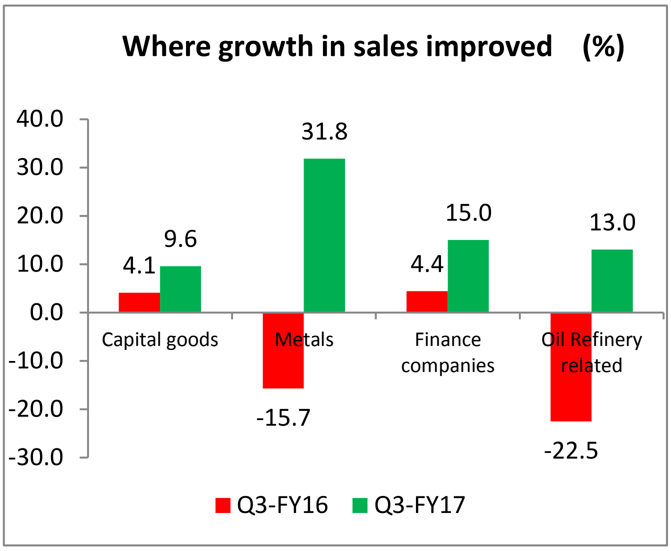
Consumer goods growth in September were extremely high with durable goods leading with double digit growth, which was expected to accelerate in October and November on the back of the festival and post-harvest demand.

Industrial growth numbers present a mixed picture. It has been jagged over the 5-month period. The impact on consumer goods has been distinct in December and January while November has been relatively buoyant which is contrary to what would have been expected post demonetization. Basic goods have grown consistently which can be attributed to government spending aggressively in infra. Capital goods progress has been spiked by single month positive noise elements in the machinery segment which has come over negative growth rates last year.

C. Corporate performance

Overall performance of the corporate sector was satisfactory. CARE Ratings study on corporate results of 2126 companies for this quarter showed growth of 6.6% in sales compared with -4.8% last year. Net profit on the other hand grew by 39.7% over -11.3% last year. While the aggregate performance was stable, there was variation in growth in sales across various sectors, which were affected differentially by demonetization which is presented in the two graphs below.



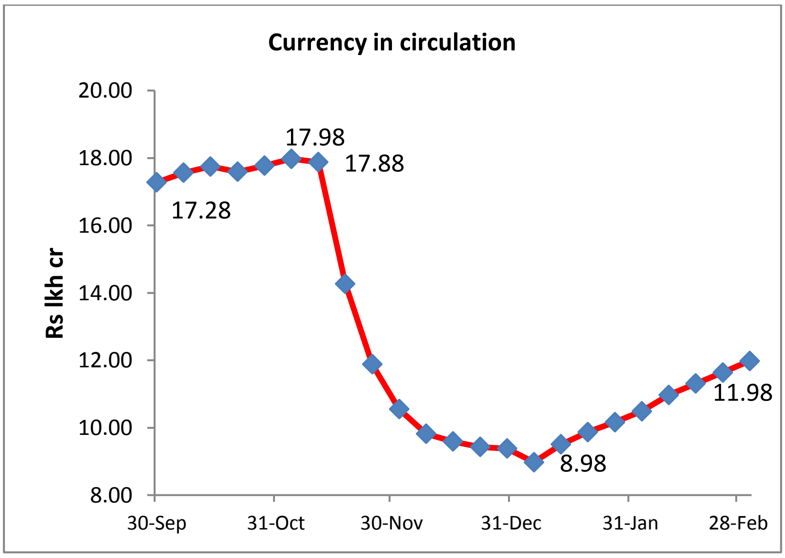


Consumer-D: Discretionary segments like durable
Consumer-ND: FMCG goods

Quite clearly the sectors related to household spending have been impacted in Q3 due to the limited availability of cash. Here there would tend to be a revival of pent up demand as the situation normalizes. But for services, which include transport, hotels, trade, telecom there could be permanent erosion in output. This is probably why the CSO has also put out a growth number of 7.1% in GDP this year as against 7.9% last year with the difference being attributable to demonetization as there has been no other negative development in the economy during the course of the year.

The improvement in growth in sales in this quarter can be attributed to the government proactive stance on infra. Other factors such as revival of steel industry also contributed to the higher growth rate in in the metals sector. In general those industries that were not directly linked with household spending behaviour tended to do better in this quarter with an added advantage of negative base effect. The oil related sector did better on the back of an increase in the price of crude oil gradually over time.

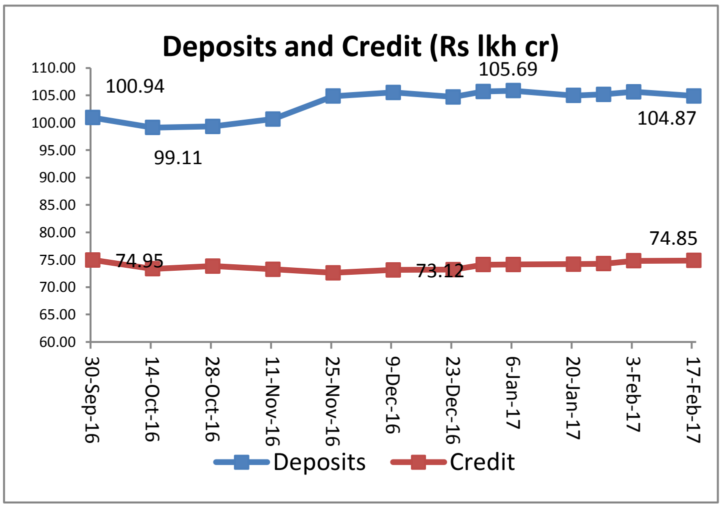
D. Currency in circulation



Source: RBI

The RBI has been remonetizing the economy over time and the currency chart has followed a U shaped trajectory. It had peaked just at the time the demonetization scheme was announced at 17.98 lkh crore and then declined as people rushed to deposit the currency held by them. The currency in circulation reached a low on January 6th, just after the scheme of deposit of old currency notes came to an end at Rs 8.98 lkh crore. Subsequently, there has been an increase in the cash available in the system which has reached Rs 12 lkh crore by March 3. It does need to be seen whether or not the final tally would be close to the Rs 18 lkh crore mark or not. As the RBI would be providing adequate currency any lower quantum could finally be attributed to the progressive preference for digital modes of payment.

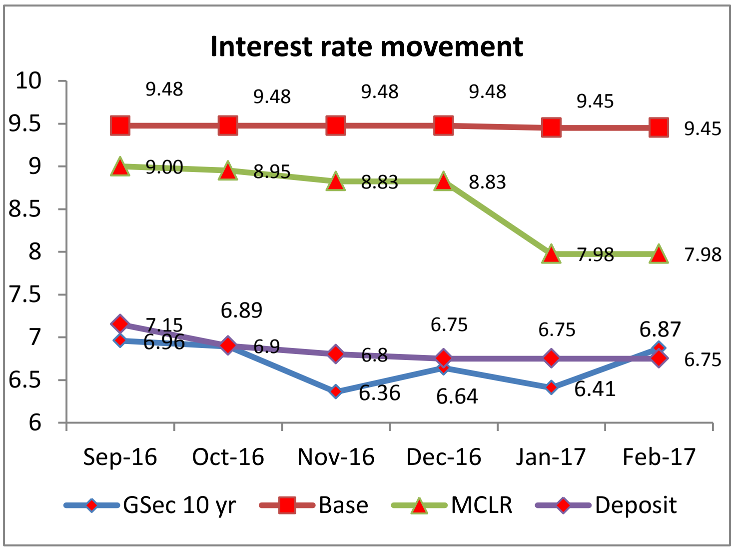
E. Bank deposits and credit



Source: RBI

Bank deposits were one of the main beneficiaries of this policy as old notes were deposited. This did create problems for banks which rushed to invest in GSecs which were depleting with the RBI prompting remedial action through issuance of MSS bonds. These deposits had peaked on January 6th. Bank credit however, continues to lag and on a point to point basis has witnessed a marginal decline from Rs 74.95 lkh crore as of end September to Rs 74.85 lkh crore as of end Feb 2017. The lower offtake is a reflection of lower activity in the industrial segment which continues to witness negative growth in industrial credit over March as well as the NPA challenge which banks are confronting.

F. Interest rates

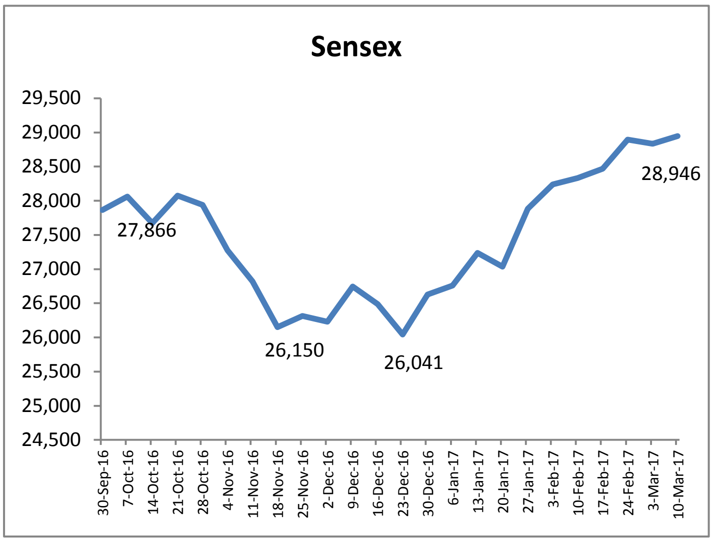


Source: RBI

The RBI has kept the repo rate unchanged in the period subsequent to November 8 2016. The 10-GSec yield had come down in November, but started ascending once the MSS bonds were issued and the rate has moved upward ending at 6.87% in February end. Banks on the other hand have lowered the deposits rate due to excess liquidity entering the system even though the repo rate was unchanged by about 15 bps on an average basis. On the lending side, things have been different with the base rate remaining almost unchanged at 9.45% (3 bps fall in the rate) though the MCLR has come down sharply from 8.95% on October to 8.83% in November and to 7.98% in February. Hence, while GSec yields have tightened due to excess supply of paper, deposit and lending rates have benefited.

G. Stock markets

The movement in the stock indices is driven by several factors with specific events or announcements leaving their impact. Further, the impact of any positive or negative news tends to last for a couple of trading sessions after which it is normally 'business as usual'.



Source: BSE

The Sensex did come down when the scheme was announced though it did also coincide with the US Presidential Elections too which impacted stock markets across the world. The next trough came about in December which may not be linked with demonetization. Subsequently it has been driven by other factors which have taken the index to a high of 28946 by March 10th. It crossed the29000 mark just after the state Elections results were announced, which were interpreted in a way as a vindication of the scheme of demonetization. Hence, on the whole the capital market has been isolated from the developments in this area, and the downward movement in November could be attributed to global factors - with demonetization providing a secondary impact.

Concluding remarks

The impact of demonetization does appear to be getting diluted over time. The effect on the real sector has been sharpest in the months of November and December and preliminary data on the auto sector does suggest revival in pent up demand. The monetary sector has gone through challenging times on the back of the NPA legacy issues and still witnesses low growth in credit. The availability of currency in the system has been normalized by the RBI but the amount in circulation is still 2/3 of that in November just before it was announced. Interest rates have shown a varying trend, with GSec yields rising just at the time when they appeared to be headed southwards. Bank deposit rates have fallen under the force of excess liquidity in the system while banks have lowered their MCLRs in a bid to make borrowing easier. However, bank credit growth is still to pick up.

CORPORATE OFFICE:
CREDIT ANALYSIS & RESEARCH LIMITED
Registered Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400 022.
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com