

Impact of demonetization on GDP growth in FY17

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The government recently withdrew Rs. 500 and Rs. 1000 notes as legal tender and introduced the new Rs.500 and Rs. 2000 notes. This move, in an attempt to remove the black money and counterfeit currency from the system, is also expected to have a significant effect on the economy, particularly on the GDP growth prospects as various sectors would tend to get affected differentially on this score.

Here in this report, we are presenting the expected effect of the demonetization on the GDP growth for the current financial year.

Methodology

We have estimated the effect of the demonetization and the resulting cash crunch on various sectors, which are included for GVA estimation. The impact period considered is 7 weeks (from the of demonetization announcement on 8th November'16 till end of December'16). Certain projections have been made for the losses or gains in each sector week wise, which have been accounted for in final expected GVA for FY17 which will get reflected In the GDP growth number.

A point to note is that some of the losses in GDP incurred in these 7 weeks (under Q3) will be recovered in the next quarter, particularly for consumer goods where there would be only deferment of purchase. However the same doesn't stand for losses in services sector. Nonetheless, the expected recoveries in Q4 have been netted off while considering the overall impact in these 7 weeks.

Approach

For individual sectors the proportion of output likely to be affected has been used as the basis for extrapolating the potential loss of output on a weekly basis till December end when it is assumed conditions normalizes. The impact hence varies across these 7 weeks with the intensity being highest in the first two weeks which keeps tapering downwards towards the end of the terminal period. As the judgments made on these effects is critical to assess potential loss of GVA, the methodology works on the basis of two alternative approaches which will help to formulate a range for the same.

- *Conservative Approach:* Here the premise is that the expected impact is moderate as the assumption is that there would be minimal level of distortions on growth in output.

- *Aggressive Approach:* In this model the assumption is that there would be extreme distortions to begin with which will subsequently taper down proportionately over time. This becomes significant especially in the services sector.

Impact

- The services sector is expected to be affected the most under both the approaches, mainly on account of losses in trade, hotel, transport etc. due to the volume of cash transactions involved in these economic activities. Importantly, these losses, due to their inherent nature, can't be recovered in the next quarter.
- SMEs in industry will have a major problem in adjusting production schedules as both payments and receipts flow in cash given their structures.
- For rest of manufacturing, demand side issues would exist till such times conditions stabilize and could get reversed in Q4. Hence, Industry is also expected to be impacted which will be more significant in the first 2-3 weeks post the announcement.
- The gains would be positive for the banking sector due to the increase in deposits which would be countered by slowing down of other sectors in the group like real estate.
- Agriculture is expected to least impacted with major shock being absorbed in the first 2-3 weeks itself as there have been issues in sales at mandis due to the cash crunch presently.

Sector wise Impact summarized

Table 1: Expected impact on GVA

Sectors	GVA for FY16	Expected Impact on each Sector (FY17) (+/-)		Estimated GVA post impact (FY17)	
		Conservative Approach	Aggressive Approach	Conservative Approach	Aggressive Approach
<i>Rs. Crore</i>					
Agriculture	16,04,044	(-)604	(-)1,271	16,51,562	16,50,894
Industry	23,71,531	(-)3,016	(-)7,826	25,76,775	25,71,965
Services (incl. construction)	64,51,616	(-)29,420	(-)45,130	69,55,195	69,39,484
Total	104,27,191	(-)33,039	(-)54,227	111,83,531	111,62,344

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Conclusions

- *The GVA numbers for FY17 in the second column have been drawn up on the assumption of growth of 7.6% for the year which was our assumption prior to the demonetization with GDP growth projected at 7.8%.*
- *Under the conservative approach GVA will grow by 7.3% which is 0.3% less than what was projected.*
- *Under the aggressive approach GVA will slow down to 7.1% which is 0.5% lower than the initial estimate.*
- *Assuming that the transition from GVA to GDP would remain unchanged at 0.2% (i.e. GVA 7.6 and GDP 7.8%) as per initial estimate, **overall GDP growth would be affected by 0.3-0.5%***

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