

Demonetization of high-value banknotes fuels concerns about a downturn of the India's economy

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Asian economies continue a moderate recovery trend on the back of stable domestic demand, export recovery and emerging effects of economic stimulus. Looking at the GDP figures for the Oct to Dec 2016 quarter in the region that have already been released, Vietnam grew by +6.7% YoY, slightly accelerating from +6.6% YoY the previous quarter, while Singapore saw growth of +2.9% YoY, substantially higher than the previous quarter at +1.2% YoY.

Meanwhile, there are growing concerns over an economic downturn in India that has maintained the highest growth in major Asian countries and regions. Last November, the Indian government scrapped its high-value rupee notes in its efforts to clamp down on the flow of illicit funds (see note below). In the medium and long term, the demonetization of the banknotes is expected to have positive effects, such as preventing illegal wealth amassment or improving tax collection. On the other hand, the high-value banknotes that were removed from the economy in November, accounted for over 80% of the value of total currency in circulation and also cash is a more popular form of payment for general business transactions in India. Therefore, a banknote shortage due to the delay in supply of new banknotes would disrupt economic activity, resulting in weakness in discretionary consumption of expensive durable goods or subdued corporate investment. In consequence, the economy is likely to show weaker growth in the near-term. In fact, according to major related economic and monetary indicators, an adverse impact of demonetization on the economy has become pronounced since last November, such as a decline in the sales of automobiles and motorcycles and a drop in business confidence (see table 1).

As discretionary consumption accounts for about 10% of India's GDP, the country cannot be optimistic about a transitory impact of the demonetization on growth. However, the economy is expected to gradually revert to a growth path in the upcoming fiscal year (beginning April 1) that would see an easing in a shortage of new banknotes in circulation, mainly driven by domestic demand, buoyed by a pent-up demand for discretionary consumption after the decline coming from the demonetization and by an improvement in corporate investment. However, growth of bank deposits is lower relative to a decrease in the amount of money in circulation. In addition, the collective worth of the old banknotes that have not been exchanged for the new ones either over the counter of bank branches or by way of deposits in banks, is estimated to total as much as 2.3 trillion rupee (1.7% of GDP) (see chart 1). The policy of demonetization will lead to a "loss of wealth" for currency holders who are unable to or unwilling to convert their entire holdings of old banknotes. This could result in pushing down spending by private economic entities to as much as levels of wealth loss due to demonetization and therefore, it should be closely watched going forward.

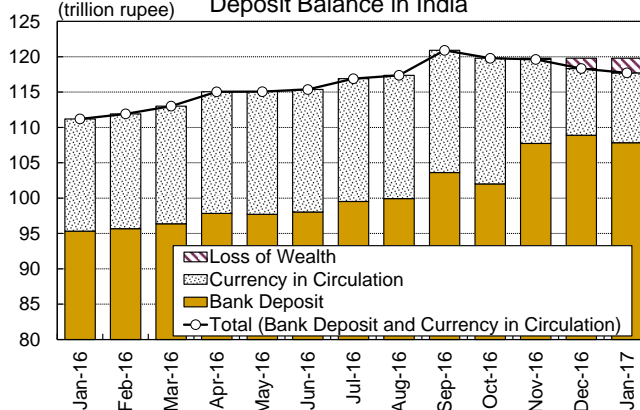
Note: The Indian government announced its decision on the night of Nov. 8, 2016 to demonetize Rs.500 and Rs.1,000 notes with effective from the 9th and to introduce new Rs.500 and Rs.2,000 notes in exchange for the old ones. Currency holders were allowed to exchange the old banknotes for the new ones until Dec. 30 2016 either over the counter of bank branches or by way of deposits in banks. However, the government placed the cash withdrawal limit for ATMs and the over-the-counter exchange of the old currencies.

Table 1: Major Indian Economic Indicators Related to Demonetization of High Value Notes

		2016 Sep	Oct	Nov	Dec
Amount of money in circulation	(YoY,%)	15.2	17.2	-23.6	-40.0
Bank deposits	(YoY,%)	12.0	9.8	15.3	15.2
Bank lending	(YoY,%)	11.2	9.1	6.2	5.2
Sales of automobiles	(YoY,%)	19.9	4.5	1.8	-1.4
Sales of motorcycles	(YoY,%)	21.6	8.7	-5.9	-22.0
Manufacturing PMI	(DI, points)	52.1	54.4	52.3	49.6
Services PMI	(DI, points)	52.0	54.5	46.7	46.8
Rupee exchange rate	(Rupee/US dollar)	66.61	66.78	68.84	67.92
Yield on 10-yr government bond	(%)	6.82	6.79	6.25	5.52

Note: Figures of Rupee exchange rate and yield on 10-yr government bond represent the value of each month end.
 Source: Society of Indian Automobile Manufacturers, Bloomberg, Reserve Bank of India, BTMU Economic Research Office

Chart 1: Amount of Currency in Circulation and Bank Deposit Balance in India (trillion rupee)



Note: The wealth loss shows the difference in the total number of the wealth loss as at Oct-end 2016 and Dec-end 2016.
 Source: Reserve Bank of India, BTMU Economic Research Office

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