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Note ban's impact in 2017

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Demonetisation was a large adverse shock. We now have some sense of how currency notes will come back into the economy. Now the interesting question is: Will the recovery be quick or slow? A slow recovery is likely.

Let's start with the monetary shock. New notes came in at a slow pace from November 11 onwards. At some places, the old notes continued to be used for transactions. Old notes are now dwindling away; they will all be back with the Reserve Bank of India (RBI) by December 31. In late December, we have the biggest mismatch between the currency required to sustain ordinary business activities and the currency actually in place. Pay days in early January could be difficult days.

If the old notes are to be exactly replaced, this process runs till May 2017. The actual delay will be lower: Presses are making ₹2,000 notes, and not all the erstwhile cash in circulation was required as a medium of exchange. But the ₹2,000 notes are an inadequate medium of exchange, and the behaviour of people has changed; everyone will now hoard more cash. My guess is that December is the bottom, and normalcy on cash availability will come by end-March. The first round of disruption to the economy would be for five months: November to March.

In 2008, monetary policy did well. RBI wisely ignored the exchange rate, and rapidly switched gears to cutting rates. Both elements (lower rates and weaker rupee) helped prop up the economy. In 2016 and 2017, the monetary system has been disrupted and it is hard for monetary policy to help.

The second shock is to exports. In September 2008, with the Lehman shock, seasonally adjusted ("SA") non-oil exports fell by 161 per cent annualised. This time, export demand is soft but unchanged. All that has happened is a disruption of domestic production. In November 2016, this decline was 76 per cent (annualised). This is a surprisingly large number, considering that nothing changed with export demand, and suggests a significant disruption of production.

SNAKES & LADDERS

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The third shock is to investment. Demonetisation has created uncertainty because it casts a cloud on the performance of the economy in 2017 and 2018. It also suggests a new level of policy risk; we used to think Indian institutions ruled out such actions. In 2008 also, there was high uncertainty, which adversely affected investment. It was the finest hour for the key persons at the ministry of finance, RBI, Securities and Exchange Board of India (Sebi), and Prime Minister's Office; their actions made Indian policy capabilities look good and created confidence. This time, policy work on an array of issues has stalled as demonetisation has absorbed the economic policy leadership.

The fourth shock is to banking. In 2008, treasury activities of banks were in a tizzy, and the first signs of the great NPA (non-performing asset) crisis became visible. The humdrum business of account opening, credit cards, home loans and financial services for SMEs went on all over the country without disruption. This time around, most bank employees are absorbed in counting currency notes. For a few months, India has a sharp decline in the production of banking services. The macroeconomic downturn may worsen the corporate NPA problem, and demonetisation may directly induce defaults by individuals.

The fifth shock is to demand. Production planners in the large firms make decisions about how much to produce based on the flexibility of their production process and on forecasts of sales. On November 9, every firm in India had to revise its forecasts for sales and then adjust its production process. A few data points are now visible about these developments.

In September 2008, the shock was on television and outside India. There was a shock to export demand. Not much happened in India. As an example, the sales of automobiles grew robustly in September 2008. The blow to sales came with a lag, from October to December 2008. These developments shaped the production planning.

This time around, there is an adverse impact on sales right away, that is, in November 2016. This is more visible in cheaper things. Sales of two-wheelers fell by 169 per cent (SA annualised) and sales of three-wheelers fell by 289 per cent (SA annualised). In contrast, sales of cars fell only by 37 per cent. Production managers are absorbed in revising forecasts about sales in coming months, and adjusting production. These adjustments tend to come with a lag because the shock was unanticipated and (removed 'because') the production process had limited flexibility.

This kind of shock plays out slowly. At first, all that happens is inventory adjustment. For example, in November 2016, while the sales of cars fell by 37 per cent (SA annualised), production went up by 96 per cent (SA annualised). The production process is inflexible and inventories have risen. When inventories build up to uncomfortable levels, and the outlook for sales looks weak, production cutbacks begin. This gives reduced purchases of raw materials and labour. Consumer companies buy less of raw materials, and then raw materials companies buy less labour. Then workers buy less of consumer goods, which enlarges the shock.

The key intuition of macroeconomics is about many moving parts, all of which feed into each other. Banks crimp lending, which affects demand. More uncertainty and reduced margins make firms invest less, which hurts demand. Less cash gives less buying, which hurts demand. Inventories pile up, and then firms cut back on production. This means buying fewer raw materials and labour. The workers who are laid off buy less, and that exacerbates the problem. This is the process that will play out in calendar 2017.

In this macroeconomic trauma, some written contracts or implicit contracts will be violated. Some firms will fail. Everyone is trying to survive the storm but some will falter. The NPA crisis will deepen. These are the deeper disruptions, which will have a more sustained adverse impact on GDP beyond 2017.

Many people feel that once cash is back to normal levels, that is, May 2017, life will return to normal. Macroeconomies do not work like that.

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