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PAPERS

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EDITORIAL

In the past few months, we have witnessed some historical events, which could transform economies around the world.

From a global perspective, we saw an unexpected vote in favour of Brexit in the UK referendum. While the pound fell to a 31 year low, London's dominance as a financial center has ensured stability in the European Union (EU). Indian markets remained broadly resilient to the news, indicating strong fundamentals. Furthermore, Brexit has prompted talks on creation of bilateral trade agreements between UK and India which were earlier not possible due to stringent EU regulations.

We also witnessed the continuation of the oil glut, which is hindering Central Banks of economies such as U.S. and UK from meeting their inflation targets. Globally, countries are no longer coordinating their monetary policy regimes. While U.S. has stated that there will be no more quantitative easing (QE), UK has indicated continuation of its QE program.

Contrary to expectations, the new RBI Governor Dr. Urijit Patel, in his first monetary policy review, cut the repo rate by 25 basis points to 6.25% (lowest in 6 years). This will put pressure on banks to pass the benefit of low interest rates, despite their NPA troubles, to customers in order to boost growth. He also made some very interesting changes. The usual practice of announcement of monetary policy review has been changed from 11 am to 2:30 pm. Also, unlike the previous RBI stance of achieving an inflation target of 5% by 2018, he has set the 5% inflation rate target to be achieved in the next 5 years. The accommodative stance of monetary policy, along with good monsoons boosting rural demand, and higher urban consumption as a result of the Cabinet approving the salary hike recommended by the Seventh Pay Commission, the momentum of growth is expected to rise.

Nirmala Sitaraman, Union minister for commerce and industry has declared that Goods and Services Tax (GST) will be implemented across the country from April 1, 2017. This is a welcome news, as it will reduce the complexities of multiple indirect taxes, improve transparency and ease of doing business, and reduce tax evasion. However, uncertainty over the GST rate and arbitration procedure, has led to several debates over pros and cons of implementing GST in India.

Against this backdrop, we present 3 papers in this issue of TJEF.

Managing Editor

Monica V

Aims and Scope

1. TAPMI Journal of Economics and Finance is a peer-reviewed journal. We seek articles in the areas of Banking, Economics and Finance.
2. The main purpose of the journal is to encourage quality submissions from business students.
3. We encourage submissions from students enrolled in leading business schools in India and abroad.
4. We also encourage submissions from practitioners.
5. Our aim is to provide constructive feedback on all submissions.

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TAPMI Journal of Economics and Finance

ECONOMIC GROWTH V/S INFLATION FOR INDIA

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Introduction

There is great debate over the belief whether inflation promotes economic growth or not. The relationship between inflation and growth is a controversial one not only in theory but also in empirical findings. A group of economists supporting Keynes are of the opinion that inflation is a factor that contributes to economic growth. Keynesian theory states that inflation leads to redistribution of income and wealth. Keynes favors mild inflation on the grounds that it tends to increase business optimism due to rising prices, resulting in high profit expectation that stimulates further investments, output, employment and income. However, another group of economists are of the view that inflation does not contribute to economic development but on the contrary, works as an inhibitor. For instance Milton Friedman completely disagrees with the policy of development through inflation. We have tried to investigate the interactive effects between inflation and economic growth for India and the need for regulating inflation in its current developing phase.

The Relationship between Economic Growth and Inflation

The relationship between inflation and economic output is very delicate. Investors highly value GDP growth, as cash flows that are the key driver of valuation/performance of company's stocks won't increase if economic output of a country is falling or is in a steady state. On the other hand, if there is too much growth in GDP it leads to an increase in inflation, which undermines stock market gains as the money and future profits become less valuable than they are today. Today, most economists agree that a growth rate of 2.5 – 3.5% is

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safely attainable without any negative effects.

Over time, the growth in GDP would lead to inflation, and the rate will keep on rising as inflation engenders inflation. Once this progression starts, it doesn't take much time for it to become a self-reinforcing feedback loop. The Rational Expectations Theory suggests that in the times of increasing inflation, households tend to spend more money as they are aware of the fact that the money will be less valuable in the future. Because of more expenditure by the people, there is an increase in GDP in the short run that leads to further increase in the prices of the goods and services. Also, a very peculiar feature of inflation is that the effects of inflation are nonlinear, i.e. 10% inflation is not just twice as harmful as 5% but much more than that. Most advanced economies have learned these lessons through experience. In 1980s when there was a prolonged period of high inflation in the US, the economy was restored only by going through a painful period of high unemployment and lost production, as prospective capacity remained idle.

So what is the ideal inflation level? While some economists insist that advanced economies should aim to have 0 percent inflation i.e. stable prices, the general consensus is that a little inflation is actually a good thing.

Relationship between GDP and CPI Growth Rate for India

The graph below plots the quarter on quarter GDP growth rate and CPI growth rate. It can be observed that economic growth rate is inversely related to CPI growth rate.

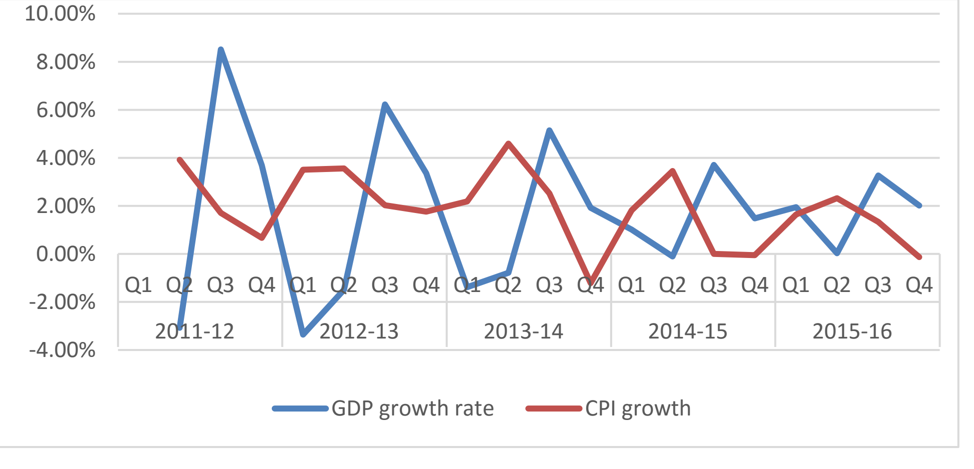

Figure 1

A regression analysis between economic growth rate and inflation growth rate yielded the below result.

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	0.034787	0.010299	3.377768	0.003576
X Variable 1	-0.95433	0.428579	-2.22673	0.039773

Table 1

Regression Statistics	
Multiple R	0.475191
R Square	0.225807
Adjusted R Square	0.180266
Standard Error	0.028079
Observations	19

Table 2

It can be observed that there is a significant relationship between GD growth rate and inflation growth rate represented by a negative correlation coefficient. The value of adjusted R square is low due to other factors like exchange rate, technological development, natural resource availability, social and political conditions that influence the economic growth.

Major Reasons why Economic Growth and Inflation Control can't go together

When inflation is high, interest rates are hiked. The reason being, a high interest rate will discourage additional borrowings. This shall reduce the amount of money people have in their hands to spend. Traditional economic theory suggests that as demand falls, prices also fall. Thus, RBI aims to control inflation by increasing interest rates. When economic activities falter, a cut in interest rates is required. This is because companies need to borrow in order to invest in new projects. A fall in interest rates reduces cost, thereby increasing profitability. This encourages borrowing, which in turn, helps fuel the economy.

A high interest rate is detrimental to growth. Companies discontinue expansion or growth plans due to high interest rates. They are forced to cut costs to maintain profits. This passes across the economy including the labor market. A low interest rate can cause a rise in inflation. This is a result of more money in the system. This leads to an overall price rise as demand increases. A high interest rate controls inflation but retards growth. In contrast, a low interest rate is beneficial for overall economic growth. Therefore, both economic growth and inflation cannot be targeted together.

RBI's Stance

The goal of RBI's monetary policy is primarily price stability, while keeping in mind the objective of growth.

The Dr. Urjit Patel Committee Report posited a few key recommendations; in 2014 a "glide path" for disinflation was announced. The aim was to maintain the CPI inflation at 8% by January 2015 and below 6% by January 2016. The Agreement on Monetary Policy Framework between the Reserve Bank of India and Government dated February 20, 2015 wants to maintain the consumer price index-combined (CPI-C) below 6% by January 2016 and 4% (+/-) 2% for the financial year 2016-17 and all subsequent years. Whilst formulating the monetary policy we focus on price stability and growth. However, the focus on each of these objectives varies across time depending on the evolving macroeconomic conditions. Various changes in the economic environment will dictate alteration of the objectives to facilitate the maintenance of price stability to ultimately achieve growth.

The Reserve Bank of India controls the amount of money in the system as well as the dominant interest rates. It reviews its policy regularly through the credit policy. This is dependent on multiple macro-economic factors like inflation, industrial production data and job growth. This often leads to a debate over growth and inflation control. India has never followed inflation targeting as a tool to control inflation. But, according to Narasimham and Rajan committee the central bank clearly lacks direction and needs one tool to focus on develop their monetary policy. They say that in a country like India where the central bank is independent of the government and the inflation rate is considerably low, a monetary policy targeted around keeping the inflation rate low and stable will accelerate output growth. Inflation targeting helps in reducing inflation volatility and inflationary impacts of shocks. It also leads to increased anchoring of inflation expectation.

There was a lot of backlash regarding this move as people felt that the central bank has various factors to monitor such as price stability, growth and financial stability and that India does not have the framework for the successful implementation of IT such as developed financial markets, confidence of global markets, and independence of RBI. Inflation targeting would also restrict the RBI’s ability to respond to financial crises or unforeseen events. It could also lead to potential instability in the event of large supply side shocks.

Conclusion

A macroeconomic policy ideally should aim at high economic growth accompanied with low levels of inflation. However, in reality, accomplishing both a low inflation rate and a rising economic growth is never possible. However, low inflation rate does not indicate slow economic growth. In situations of excess money, consumers begin the process of bidding which results in escalation of the cost of goods. In the case of Indian economy, a number of studies failed to establish any conclusive relationship between inflation and economic development. Low level of inflation is advantageous for development, but once inflation goes below a certain level it retards economic development. Therefore, it is mandatory to perform inflation control at an acceptable level to promote optimum economic growth.

Appendix

Year	Quarter	Total Gross	CPI	GDP growth rate	CPI growth
2011-12	Q1	19717.87	106.489		
	Q2	19109.98	110.658	-3.08%	3.91%
	Q3	20737.12	112.553	8.51%	1.71%
	Q4	21501.59	113.311	3.69%	0.67%
2012-13	Q1	20779.26	117.29	-3.36%	3.51%
	Q2	20468.18	121.458	-1.50%	3.55%
	Q3	21743.09	123.922	6.23%	2.03%
	Q4	22474.99	126.098	3.37%	1.76%
2013-14	Q1	22164.9	128.856	-1.38%	2.19%
	Q2	21990.4	134.773	-0.79%	4.59%
	Q3	23122.19	138.172	5.15%	2.52%
	Q4	23566.2	136.493	1.92%	-1.22%
2014-15	Q1	23805.34	138.971	1.01%	1.82%
	Q2	23781.78	143.769	-0.10%	3.45%
	Q3	24661.67	143.769	3.70%	0.00%
	Q4	25026.12	143.689	1.48%	-0.06%
2015-16	Q1	25514.35	146.048	1.95%	1.64%
	Q2	25520.95	149.446	0.03%	2.33%
	Q3	26353.58	151.445	3.26%	1.34%
	Q4	26883.03	151.245	2.01%	-0.13%

Table 3

Source: RBI website

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GST RATE AND ITS EFFECT ON GOVERNMENT REVENUE

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Introduction

The aim of this research paper is to critically examine how important it is to have the appropriate rate of GST and how this rate will affect government revenue. This is done by analyzing the various factors that affect the appropriation of the GST rate. We will also examine the impact of GST on inflation and the effects of having a high or low RNR rate. We conclude by examining the long-term effects of implementing GST.

Need for GST

In developing countries like India, the government plays an important role in augmenting the growth and development, given the paucity of private capital and initiative. The government is also responsible for supporting the economically backward classes, maintaining law and order and security of the country (9). To carry out these responsibilities, the government needs sufficient revenue. Revenue collection is done through various means like taxes, fines, fees and charges, and foreign grants of which taxes form a major chunk.

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Row Labels	Sum of Revised 2014-15	Sum of Budget 2015-16
Direct	**705628.0**	**797995.0**
Corporation tax	426079.0	470628.0
Income tax	278599.0	327367.0
Wealth tax	950.0	
Indirect	**545763.2**	**651495.6**
Customs	188713.0	208336.0
Service tax	168132.0	209774.0
Taxes of union territories	3437.8	3577.0
Union excise duties	185480.4	229808.5
Grand Total	**1251391.2**	**1449490.6**

Table 1: Revenue from taxes, Source: (8)

The government earns 14,49,490 crores from taxes, the breakup of which is given in Table 1. Indirect taxes contribute a significant 44.95% to the total tax revenue. Hence, it is important to streamline this tax base. Introduction of GST will remove the multiplicity of taxes and simplify the tax structure.

Revenue Neutral Rate (RNR)

Since GST is a value added tax that provides tax credits for the taxes charged on the preceding stage of production, it will eliminate the cascading effects of taxes. This, in turn, might reduce the total government revenue from indirect taxes. To avoid this loss in revenue, the government will have to raise its taxes. This increased tax rate that ensures the government earns consistent revenue is called the revenue neutral rate (RNR). The committee headed by the Chief Economic Advisor of India, Arvind Subramanian, submitted a report that suggested an RNR of 15-15.5%. The principle behind calculating this RNR is defined by the following basic equation:

$$t=R/B$$

where *'t'* is the RNR, *'R'* is equal to the revenue generated from the current sales tax (12.5%) and the exercise tax (14%). This revenue which will be replaced by the GST is estimated to be 3.28 lakh crore from the center and 3.69 lakh crore from the state, which sums up to 6.97 lakh crores (Excluding revenues from petroleum and tobacco for the Centre, and from petroleum and alcohol for the States) or 6.1 per cent of GDP. Now the total potential tax base *'B'* should be determined to calculate the RNR(1).

The committee has used three methods to determine the total potential tax base; the macro approach, the indirect tax turnover (ITT) approach, and the direct tax turnover (DTT) approach. This paper will explain the macro approach. In this approach, the tax base is calculated using the data from national income accounts. As per the Arvind Subramanian report, the base ranges from 59 per cent to 67 per cent of the GDP. This calculated base excludes the basic food items, petroleum, and electricity(1).

As stated earlier, the total revenue to be replaced by the GST is 6.1 per cent of the GDP. By using the basic formula $t=R/B$, the GST RNR ranges from 9.1 (0.061/0.67) to 11.1 per cent (0.061/0.55). For OECD (Organization for Economic Co-operation and Development) countries, there is commonly a loss of 10 to 20 per cent in revenue (1). Taking this loss into account the RNR ranges from 9-11 per cent to 11-14 per cent(1).

The aforementioned approaches have their own merits and demerits because of the underlying assumptions and data used. The Subramanian committee evaluated these and made suitable adjustments to arrive at an RNR rate of 15-15.5%

Standard Rate of GST

The standard rate is calculated using the below mentioned formula (1):

$$R=\alpha LG+\beta SG+\gamma SS+\mu DG$$

Where *'R'* is the RNR, *'LG'* is the lower rate on goods, *'SG'* is the standard rate on goods, *'SS'* the standard rate on services, and *'DG'* the demerit rate on goods; α, β, γ, and μ are the respective shares of these four rates in the underlying tax base, and together add up to 1[(1)]. Hence the whole rate structure depends on policy choices about exemptions, what commodities to charge at a lower rate, and what to charge at a higher rate. Figure 1 shows the standard rate of GST in some emerging economies.

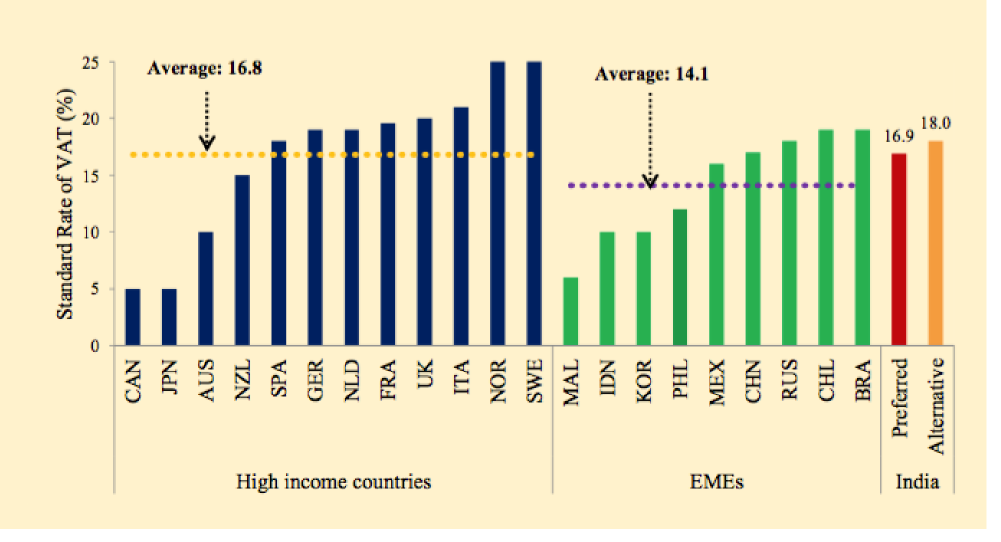

Figure 1: Standard rate of GST in high income and emerging markets economies, Source: (1)

The average standard rate in emerging market economies (EME's) is 14.1% and the highest standard rate is 19% while for high income countries, the average standard rate is 16.8%. As India is an emerging market economy, an RNR of more than 15-15.5% will lead to a standard rate of 19-21%[(1)].

It should be kept in mind that GST is a regressive tax, which means that an increase in price due to increase in tax rates will extract a higher proportion of income from a consumer belonging to a lower income group. Developed countries can effectively offset the impact of regressive taxation by increasing their government spending and introducing many social security schemes. But India, being an emerging economy, will be unable to do so in their already limited budget. Hence India needs to be cautious of very high interest rates.

Learnings from other countries

As observed in countries like Australia, New Zealand and Canada, the implementation of GST will lead to a one-time price increase in the short-run but this inflationary effect will be stabilized in the long-run.

Canada follows a dual-rate GST system like the proposed GST system in India. Its initial GST rate of 7% lasted for 15 years after which it was reduced twice by 1% in 2006 and 2008. Canada has been decreasing its dependence on the consumption tax, which is contrary to the world trend. Many studies have proved that consumption tax is the most efficient way of taxation(5). This means that a reduction in consumption tax leads to a very small change in the economic well-being of people as it causes a very small distortion effect on an individual's decisions and does not change their investment decisions or the type of economic activity they practice. So the cut in the tax rate would only lead to a minimal increase in the consumption expenditure in the short run and might not lead to an increase in savings or investment to have any long term effect. Hence, Canadian government's decision to reduce the GST rate may not be in the best interest of the economy at large.

Also, the GST system has become increasingly complex over time like the sales tax on manufacturing goods(5). This is mainly due to the complexity of Canadian tax legislation, the number of taxes companies are subject to, and the multi-jurisdictional tax system. Furthermore, as more people came under the purview of the taxation system (because GST is a broad based tax), more people had to deal with this complex tax structure increasing their adjustment costs. A useful learning from Canada's example is that a country should keep the taxation structure fairly simple to comply with. Also, as consumption tax is the most effective way of taxation, India should increase its dependence on indirect taxes.

Another useful learning can be taken from the example of Malaysia that faced a lot of opposition from its businesses even after providing 1.5 years to prepare for the change in the tax regime(6). Since India plans to implement GST from 1^{st} April 2017, it may be very challenging for the businesses to adjust to this change in less than nine months.

Using Malaysia's strategy, India could also release a probable tax structure for each segment to aid this transition.

Inflationary impact

It is essential to understand the inflationary impact of GST on different goods and services. Some necessary goods will be exempted from taxes as the poor may not be able to afford them at high prices. For example, if we consider the pharmaceutical sector, it expects to gain from the overall increase in efficiency due to costs saved on the supply chain. However, if the rate is more than 12%, it will have a negative effect as healthcare is a necessity and it should be charged at a low rate with input credit funds available so that the end cost does not increase considerably(2). It will be interesting to see how existing indirect tax exemptions and inverted tax structures are modified to ensure that the overall costs of pharmaceutical products do not increase on account of GST.

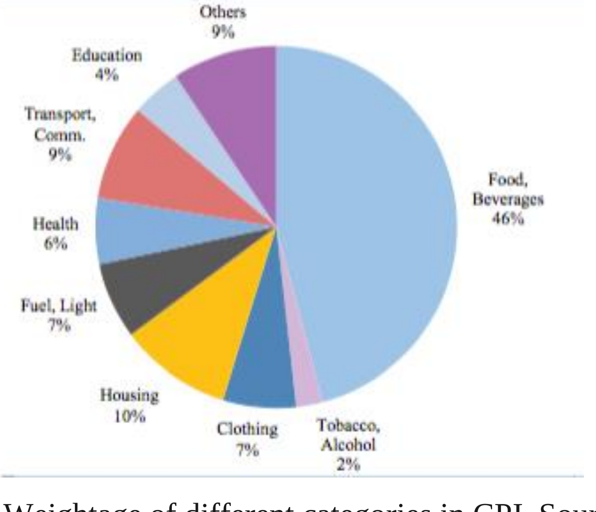

Figure 2: Weightage of different categories in CPI, Source: (1)

Moreover, a major part of the Consumer Price Index (CPI) basket (as shown in exhibit 3) which includes categories like food and beverages, clothing and rent, are either exempted or taxed at low rates as these are essentials for the lower income group. The effective tax rate on CPI is 10.4%. However, this includes goods outside the purview of GST like petrol, diesel, and alcohol. If we exclude these items, only 46% (approx.) of the CPI will be taxed. Out of this, 32% is taxed at a low rate and only 15% is taxed at a normal rate. This builds up to an effective tax rate of 7% on CPI because these excluded goods are charged at very high rates (1).

However, if a good is exempted from taxes, it does not necessarily mean that the net tax charged on that good is zero. This is primarily because the embedded taxes on inputs, like the taxes paid on fuel during the transportation of these goods, are carried forward to the final product. Also, if food, fuel, and light are exempted from taxes and the Public Distribution System (PDS) continues to subsidize, the net price impact on the consumption of these goods for the poor will be minimal.

The proposed GST structure is a dual-rate tax structure and its inflationary impact will depend on the RNR rate and the standard rate. An RNR of 15% with a lower rate of 12% and a standard rate of 17-18% will have no inflationary impact(3). This is so because the revenue received by the government remains the same. Moreover, while the prices of some goods will go up, the prices of some other goods will go down negating the inflationary pressure. A higher RNR of 17-18% with a lower rate of 12%, a standard rate of 22% will have an inflationary impact of 0.3% if only the headline tax rate is considered. Furthermore, when the change in price is adjusted to the cascading input taxes, the net inflationary impact will be around 0.7% (1).

Effect of different rates of RNR

Since we don’t know the RNR rate, we can only speculate the effects of a high and low RNR rate. If a low rate of RNR is set, it will lead to a fall in revenue. As the center has promised to compensate the states for any loss of revenue over a five-year period, it will have a huge negative impact on the center as it has to support the states while it faces fall in its own revenue. Also, if this compensation is delayed, then it will lead to a loss of trust between the center and the state. The loss in revenue can also lead to a reduction in the growth rate of the country and this will further reduce the revenue(4).

We need to keep in mind that India is a developing country with diverse needs. Economic and social disparities have to be addressed while we simultaneously invest in education, healthcare, transport, energy, infrastructure etc. to boost development. This requires huge capital investments. GST rate will be set in order to meet these investment demands and any loss of revenue due to a reduction in rate will defeat the purpose of this taxation system.

Conclusion

In the long-run, GST is expected to benefit the economy in many ways. It provides credits on input taxes paid at the previous stage of production, decreasing the burden of tax on the end consumer. It also fosters greater compliance due to its multi-point collection system and an invoice trail that minimizes tax evasion because one needs to issue and obtain invoices in order to set-off the taxes from the previous stage of production. It increases the efficiency of the supply chain by saving travel time due to a reduction in hindrances and better warehousing and distribution of goods, leading to more cost-efficient decision making. On the whole, it will induce growth in the economy by creating an integrated economy with a common market while increasing the ease of doing business by streamlining the tax structure

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TAPMI Journal of Economics and Finance

FALL IN BANK DEPOSITS

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INTRODUCTION

Reserve Bank of India's bimonthly report in March revealed that the deposit growth in the fiscal year 2015-16 has slipped to 9.9%, the lowest in the last five decades. India is an economy, which is considered as saving centric, and the country's banking system provides the depositor with one of the highest interest rates ranging from 4.5%-7.5% on time and demand deposits (up to Rs. 1 Crore). Inflation has seen a downward trend and the economy is moving towards faster growth. In spite of all these reasons, Indian banks are facing liquidity crunch due to low deposit growth that has also led to an increase in the credit-to-deposit ratio to 77.6% in March 2016 from 76.5% in the previous year.

In all this debate, the question arises why deposits in banks are so important for India's growth and if the nation is really growing at a high growth rate then why are deposits in the banking system decreasing to such a large extent?

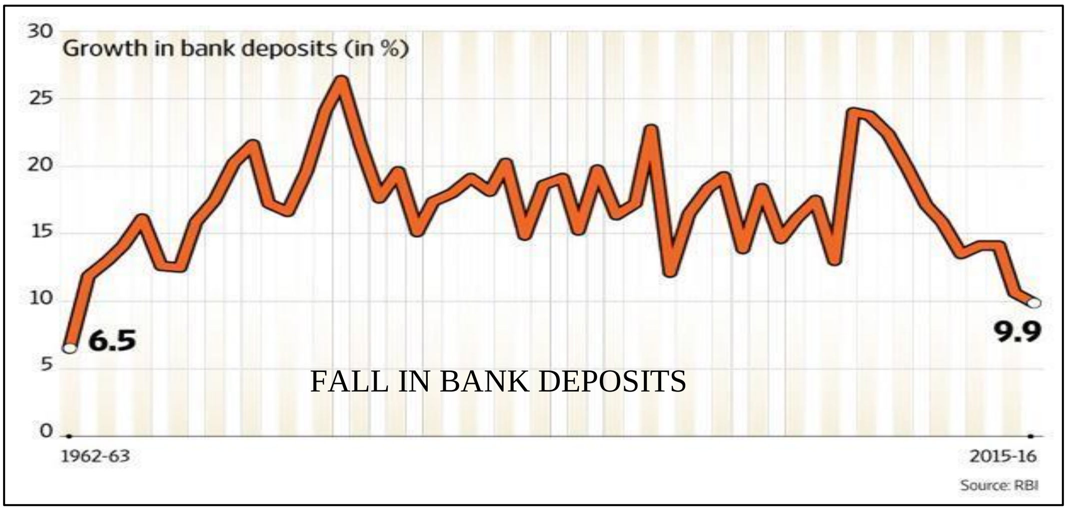

Figure 1: Growth in bank deposits (in %), Source: RBI

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NEED FOR DEPOSITS

India is a developing country rapidly moving towards better technology and efficient ways of working. Similarly is the financial market of the country, which is currently in its growing phase. Financial market is a market where direct trading takes place in equity, bonds, currency, commodities etc. Here the investors and people in need of funds meet directly without the need of intermediary like banks. As the financial market of the nation grows and become more efficient, the need for banking sector becomes less important. However in India where financial markets cope with the problem of adverse selection and moral hazard, banks play an important role in transferring funds from investors to borrowers.

Moreover banks work on the principle of spread, which is the difference between the interest paid on deposits and interest earned on loans. As deposit growth falls and demand for loan increases, banks need to increase the rate of interest on their deposits resulting into less spread for banks and reduction in profitability.

Also, with the current credit-to-deposit ratio of 77.6%, banks are lending 77.6 rupees for each of Rs. 100 of deposit. As banks need to maintain other reserves under CRR and SLR, lending such a high amount can lead banks to run into a liquidity shortage, which is not a favorable situation for the banking system as a whole.

As a result of all these factors, deposits have become a crucial component in the banking system to facilitate the smooth flow of funds from investors to borrowers.

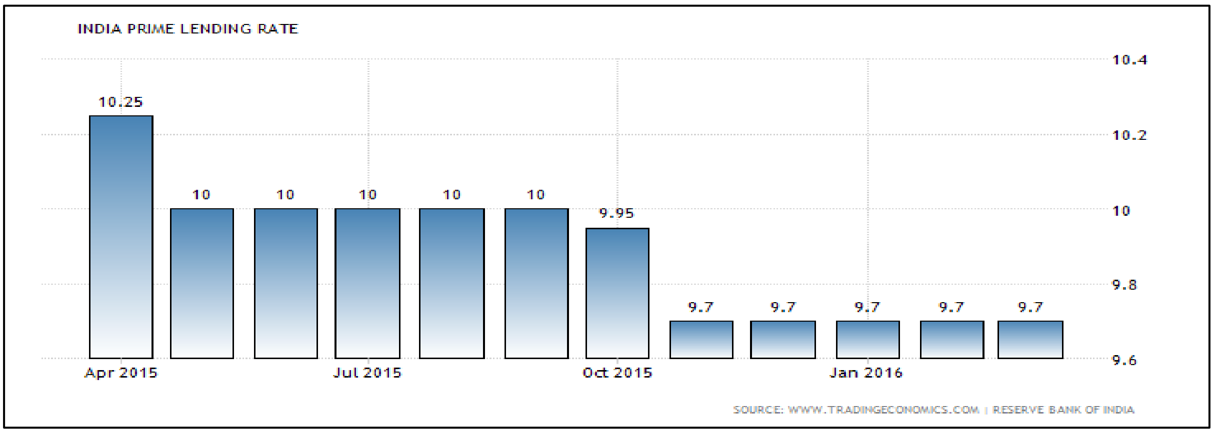

Figure 2: Prime Lending Rate in India from April 2015 – March 2016,
Source: www.tradingeconomics.com

REASONS FOR FALLING DEPOSITS

In countries like India and China people tend to save more for the future than consuming today. As a result of this saving habit of citizens, the Indian economy was hit to a lesser extent during the Financial Crisis of 2008, but what has led to the reversal of this trend in current times? Though there is no sure answer for this question, few factors explain the reversal to some extent.

In the past when the country was facing a double-digit inflation, banks were providing high interest rates on deposits to reduce the impact of inflation on people's savings. But as inflation eased, interest rates on deposits have not reduced in the same proportion providing people with higher real rate of interest. This has resulted in people earning same returns with fewer funds parked in the banks. This could have resulted in reduction of deposits in banks.

Moreover the behavior of present generation is changing, as people want to fulfill more of their present demands than saving for the future. The availability of various insurance schemes in the market to face future uncertainties has made this task of present consumption more attractive, preventing people from worrying about future thereby saving less.

Second of all, as the financial market in the country is growing and becoming more efficient, new and better products like Mutual Funds, Equity Traded Funds, Bonds, Real Estates etc. are becoming available to people to earn more profit with the same amount of money invested. Also, the returns provided by these investments are far above the inflation rate resulting in more returns in nominal as well as in real terms. Another reason for the growing popularity of financial products is the liquidity they provide. As a result people who are willing to take risks to earn higher profits are moving towards these products rather than parking their funds in banks.

Another reason that can also be considered as one of the factors for falling deposits growth is increase in the maximum limit under the Liberalized Remittance Scheme. Under this scheme, the RBI defines the maximum permissible amount that Indians can remit to other countries. The maximum amount under this scheme has been raised to $250,000. As a result of this, people have started sending more money to their parents, children or relatives in foreign countries instead of saving them in bank accounts. This can be validated from the fact that the transactions under this scheme have seen a jump from $106mn to $449mn from May 2015 to Feb 2016.

The largest factor that is contributing to this rise is the amount sent by parents to children who are studying abroad. This shows that our education system is not only incapable to retaining its talent but also is one of the major causes of money leaking out of the economy.

The points discussed identify the fact that people presently are reluctant to put money in banks. But what if in the previous years the funds deposited by people was just higher deposit growth than normal rate and presently that trend is only getting reversed to attain its normal pace. This can be inferred from the fact that during the period of Financial Crisis, markets were facing great uncertainty and the economy was experiencing double-digit inflation. People were losing jobs and were more focused on saving to secure their future consumption as much as possible, which led to very high growth in deposits. As the economy recovered from recession over the years and inflation rates have fell, people have reverted to their actual rate of spending bringing the deposits growth down.

The other factor that is more perplexing is that in the situation when deposit growth is at its all-time low, currency in circulation is seeing a high growth of 14.6% as compared to 11.32% growth over the previous year.

In the scenario where not only advance ways of doing banking are coming up every day resulting in improvement in efficiency of transactions but also schemes like Pradhan Mantri Jan Dhan Yojana(PMJDY) which are trying to put ideal money into circulation by opening up bank accounts, high growth in currency in circulation despite fall in bank deposits raises questions. Though this increase can be described by few factors, actual reasons remain uncertain.

Elections could be seen as one of the reasons for the rise in currency, as it is a phase where large amount of money is spent by political parties for funding their campaigns and to lure the voters by offering them cash. The rumor of each voter in Tamil Nadu getting somewhere between Rs.3000 to Rs.6000 during the Assembly Election in April – May 2016 added fuel to this fire. Even Mr. Raghuram Rajan hinted this as a possible reason for an increase of Rs. 50,000 crores more money in the hands of the public than what was expected by the Central bank. Another interesting fact that came to light during this period was that the amount of money with the people had not only increased in the poll bound states but also the neighboring states.

But if we were to believe the above reasoning then didn't we have more states going for elections last year? Why didn't the level of deposits fall in the last year or the year before it during the elections? Or is it that the states that went to polls last year (Bihar, Delhi- 2015) or in 2014 (Parliament, Maharashtra, Haryana, Andhra Pradesh, Jammu & Kashmir, Jharkhand) had a better follow up of electoral policy than the states that had elections this year (Kerala, Tamil Nadu, Assam and West Bengal).

Another factor which gives rise to the possibility of high currency in circulation is the rise in service tax from 12.36% to 14% and with the introduction of the Swachh Bharat cess and Krishi Kalyan cess, it reaches to 15%. Because of this rise, people may be seen as reluctant to put large sums in banks due to increase in transactions costs or ATM charges. Though the cost may be lower on transaction basis but combined cost may result in keeping people away from depositing in banks. Moreover with the rise in service tax people may be more willing to pay for services in cash instead of through bank accounts as transactions from accounts are recorded whereas cash payments cannot be traced and can be used as a means of saving tax.

All this presents one side of the picture that concludes that people are not depositing at the same rate as of before but there is second angle to the picture. What if people are still saving at the same rate but they do not have enough income to save which is leading to the fall in deposits growth?

The data based on Quarterly Employment Survey (QES) of number of jobs created in select eight industries shows that the number of jobs generated in 2015 is only 135,000 which are very low as compared to that of jobs created in 2014 that were 421,000. This fact puts another problem in picture that though the economy is growing at a rate of 7.4% currently it is facing difficulty in translating the growth into increased jobs to accommodate the growing workforce of the country. Moreover, in the rural regions the fall in income due to crop failures caused by two successive droughts is aggravating the problem. This has resulted in farmers losing their crops and worsening the situation in both urban as well as rural areas.

Changes in employment in selected sectors (in lakh numbers)					
Year	Q1	Q2	Q3	Q4	Full year
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	
2009	2.50	-1.31	4.97	6.40	12.56
2010	0.61	1.62	4.35	2.07	8.65
2011	1.74	2.15	3.15	2.26	9.30
2012	0.81	0.73	--	**1.68	3.22
2013	1.07	0.86	1.43	0.83	4.19
2014	0.36	1.82	1.58	1.17	4.93
2015	0.64	-0.43	1.34	-0.20	1.35
** This is combined figure for Q3 and Q4					
Source: Labour Bureau					

Table 1: Changes in employment in selected sectors (in lakh numbers), Source: Labour Bureau

The actual reason for such a high fall in growth of deposits is still unknown. In a scenario, where the economy is booming and with the pressure from industry to reduce the interest rates is continuously growing, banks will be required to reduce interest rate on their deposits as well so as to maintain their Net Interest Margins (NIMs). However, as banks are already facing the problem of lower deposit growth, reducing deposit interest rate may make the situation worse forcing banks to face a highly constrained situation from both low deposits as well as high loan demands. Therefore the banks will be required to come up with schemes that can give investors attractive payoffs to deposit money in the bank and to focus on making the banking system more robust so as to not only reduce the growing NPAs but also control the increasing growth of currency and inject back the money which is currently out of the system.

Post March 2016, the deposit growth has increased in banks. So this fall in deposits growth in FY2015 may be considered as one time phenomenon but if such a trend continues to persist in the future, banks should not only focus on finding the root cause of such a high decrease but also try to find new avenues to earn its income so as to bear the brunt of its reduced NIMs.

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Winning Article of the Intelligent_Insights Article Writing Competition on Brexit

IMPACT OF BREXIT ON EU

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Love gone bad! No I am not referring to any Bollywood couple's breakup but Britain's exit from the European Union (EU). On 23rd June 2016, the people of Britain voted for the most important decision of their life which will impact not only them but also the future generations of Great Britain and EU. BREXIT will surely transform the economic, political and social landscape of EU.

ECONOMIC - Official trade statistics show that EU is the destination for half of British exports. But Britain's share of intra EU exports and imports is only 10.1% and 6.0% respectively. This number is also inflated because goods exported by Britain out of Europe are transited through Rotterdam port in The Netherlands. This phenomenon is termed as ROTTERDAM EFFECT

UK' Export to EU	UK's Import from EU	UK's share in total intra – EU exports	UK's share in total intra – EU imports
402.3 Bn Euro	344.2 Bn Euro	10.1%	6.0%

Foreign investments in EU might dry up as companies use Britain as gateway to Europe because of Zero–tariff environment and free movement of labour and capital. Britain with 28% has the highest foreign investment in EU.

EU will have to find a replacement for London which has long served as the financial nerve centre of EU. Many investment banks having headquarters in London will have to move out of London so as to serve the European market. Germany which imports 14% of financial services will be the biggest loser in EU because of increase in cost of financial services.

IMPACT OF BREXIT ON EU

POLITICAL - For starters EU would lose an influential member which would have helped them to crack trade deals and have a say in World politics and economics. There will certainly be a shift in the power of decision making in EU. Germany and France will want the decision making power to shift towards them which might create further political frictions.

SOCIAL - Another pressing issue is immigration. The free movement of labour might be restricted in Britain due to BREXIT. This will result in surge of low wage migrant labourers from Africa and Middle East to EU. This might add fuel to the existing anti-immigration movements in EU and may lead to further political differences amongst EU members.

SECURITY - With the growing threat of ISIS, security is a key issue for EU. Britain is home to world class intelligence agencies like MI5 and MI6. BREXIT will put EU at the back foot in counter terrorism and intelligence operations. The plans for building a unified European army will also be hit.

The EU after BREXIT will be an impaired regional and a geo-political union as compared to the current EU, which already punches far below its economic weight in regards with global and regional diplomatic and strategic matters.

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