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Demonetisation: Impact on the Economy

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ABSTRACT

The argument posited in favour of demonetization is that the cash that would be extinguished would be "black money" and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy. Further, the impact of such a move would vary depending on the extent to which the government decides to demonetize. This paper elucidates the impact of such a move on the availability of credit, spending, level of activity and government finances.

Keywords: *demonetization, cashless transactions, credit, tax evasion*

INTRODUCTION

The government has implemented a major change in the economic environment by demonetizing the high value currency notes – of Rs 500 and Rs 1000 denomination. These ceased to be legal tender from the midnight of 8th of November 2016. People have been given up to December 30, 2016 to exchange the notes held by them.1 The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat. The reasons offered for demonetization are twofold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the "black economy".

There are potentially two ways in which the pre-demonetization money supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash.

OBJECTIVES OF PAPER:

- To analyze the current the immediate impact of demonetization on Indian economy;
- To work out the probable consequences of the demonetization.

RESEARCH METHODOLOGY

The present study is theoretical and analytical in nature and is based on secondary data. Reports and publications of govt. of India obtained from various research papers published on the concerned study and through government official websites and other data has been collected from internet.

There are broadly four kinds of transactions in the economy: accounted transactions, unaccounted transactions, those that belong to the informal sector and illegal transactions. The first two categories relate to whether transactions and the corresponding incomes are reported for tax purposes or not. The third category would consist largely of agents who earn incomes below the exemption threshold and therefore do not have any tax liabilities. The uses that cash is put to for these various segments of the economy can be summarised in the form of Table 1. Finally, there would be demand for cash for illegal purposes like bribes in elections, spending over sanctioned limits, dealings in crime and corruption. If one takes a snapshot of the location of cash at any given point of time, it is difficult to predict what the breakup of the cash according to these categories would be, but it would be safe to say that each of these components would be represented in that snapshot.

Table 1: Demand for Cash by various agents in the economy

Description of the activity	Unaccounted transactions (legitimate transactions but not tax paid)	Illegal transactions (corruption, crime, etc.)	Informal sector transactions	Accounted transactions
Medium of Exchange	Incomes are earned through exchanges in cash, payments are made in cash	Payments for crime	Incomes are earned in cash and spent in cash	Transaction demand for money
Store of value	Balances held in the interim until alternative investment options become available (there exist a number of instruments which yield better return than cash – real estate, lending in the unaccounted or informal sector, and so on.)	Balances held in the interim until alternative investment options become available (there exist a number of instruments which yield better return than cash – real estate, lending in the unaccounted or informal sector, and so on.)	Savings as well as precautionary purposes (as yet unbanked in the psychological sense)	For emergencies (precautionary demand for money)

IMPACT OF DEMONETIZATION ISSUES & CHALLENGES

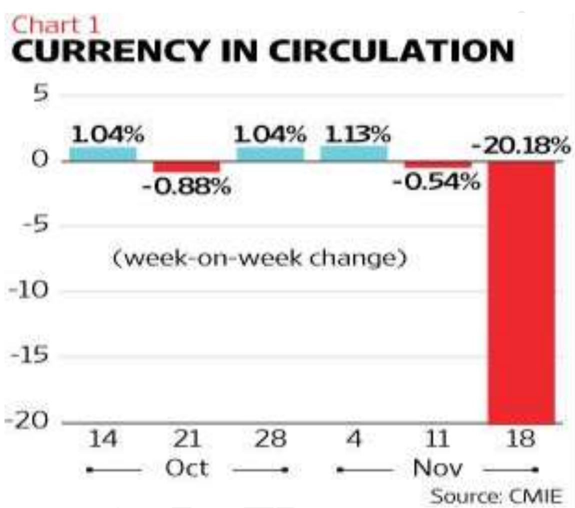
Demontization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts.

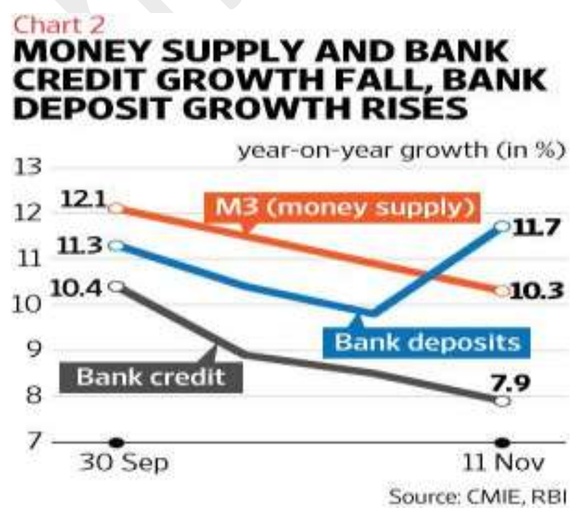
1. Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.
2. **Liquidity crunch (short term effect):** liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Current reports indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 mn Rs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.
3. **Welfare loss for the currency using population:** Most active segments of the population who constitute the „base of the pyramid" uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class. There will be a trickle up effect of the liquidity chaos to the higher income people with time.
4. **Consumption will be hit:** When liquidity shortage strikes, it is consumption that is going to be adversely affected first.
   Consumption ↓→ Production ↓→ Employment ↓→ Growth ↓→ Tax revenue ↓
5. **Loss of Growth momentum**- India risks its position of being the fastest growing largest economy: reduced consumption, income, investment etc. may reduce India"s GDP growth as the liquidity impact itself may last three -four months.
6. **Impact on bank deposits and interest rate**: Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply take place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization will

produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

7. **Impact on black money**: Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depend upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. such a nationwide awareness and urge will encourage government to come out with even strong measures.
8. **Impact on counterfeit currency**: the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn‟t have the digital transaction culture. Overall economic activies will be dampened in the short term. But the unmeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.





(Source http://www.livemint.com/Money/a41xHhBLr2NnAM7RhbPrnM/The-initial-impact-of-demonetisation-in-two-charts.html)

RBI data now reflect the initial impact of demonetisation on monetary indicators. Chart 1 shows that currency in circulation plunged a huge 20.18% in the week to 18 November, after falling marginally in the previous week. This effect is likely to be even larger in the next few weeks.
Chart 2 shows how year-on-year growth has slowed in money supply (M3) and bank credit in the week to 11 November (the latest date for which data is available), while bank deposit growth has increased sharply. Note that growth in bank credit and in money supply has been slowing down

even before the demonetisation was announced. These trends will be further reinforced in the next few weeks, as the deflationary shock ripples through the economy.

SHORT-TERM AND MEDIUM-TERM IMPACTS

Very short-term impact

The demonetisation, by removing 86 per cent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy. This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash. In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organised retailing. For instance, transport services, kirana, fruits and vegetables and all other perishables, would face compression in demand which is backed by purchasing power. This in turn can have two effects: while it is expected that supply exceeds demand, there would be a fall in prices, however, if supply too gets curtailed for want of a medium of exchange, prices might, in fact, rise. Thus, while generally people seem to expect prices to fall, it is quite possible that prices would instead rise.

Another sector where one expects to see effects in the very short run is the real estate space. With contraction in demand from one set of agents – say agents who have earned unaccounted incomes and placed them within the real estate space – either prices within this segment would fall or transactions would cease to happen. While of itself, this would be considered a positive development and evidence of a correction in the unaccounted incomes, it could lead to a compression in investments in the construction sector which can have adverse income and employment consequences for the economy.

Short-term effect with incomplete replacement:

If, on the other hand, the authorities choose to replace only a fraction of the total cash that was surrendered by the people to the banking sector, then one would witness some other changes/effects in the economy. For transactions to be restored to the pre-change level, a number of agents who are using cash as a medium of exchange have to move to using digital versions of money as the medium of exchange. While this change is gradually happening in the economy, if it is forced by making cash inaccessible, the compression in demand as well as in income generation in the economy would continue for a longer period until people get familiar with the functioning and use of these media.

Medium-term effects:

In the medium term, the effects would be related to the extent to which the currency is not replaced within the economy. If the entire currency is replaced, there would not be any major effects on the economy. However, it is to be expected that the entire currency would not be replaced – to the extent currency is extinguished and to the extent some of the currency remains as bank deposits, there would be some impact on the economy. The first effect would be a compression of the economy to the extent the extinguished currency was working as a medium of exchange. The currency that is placed in the banks but not withdrawn, it is argued, would generate an expansion in deposits in the economy. In the discussions on demonetisation, there is a consistent reference to the resultant increase in credit creation in the economy. Like Finance Minister Arun Jaitley says, "Bank deposits will increase and they will have more capacity to support the economy."4 The total cumulative credit that can potentially be generated is defined in terms of the reserve ratio. Total credit potential = incremental deposit generated*(1/reserve ratio) In India, the cash reserve ratio is 4 per cent while there is a statutory liquidity ratio of 22 per cent5 . In determining the credit creation, it is important to take into account only the CRR and the additional credit creation can be 25 times the amount of money deposited in the banks as a result of the proposed demonetisation. This amount however, will be generated only if there exists an equivalent demand for credit in the economy.

Table 2: Potential credit creation based on Reserve Ratios

Percentage remaining in account	Value in account	Potential credit creation	Potential credit as multiple of stock of debt today
70	992600	24815000	3.082345
60	850800	21270000	2.64201
50	709000	17725000	2.201675
40	567200	14180000	1.76134
30	425400	10635000	1.321005

Table 3: Potential credit creation based on historical trends

Percentage remaining in bank account	Value in bank account	credit potential	% of total credit	% of total incremental credit
100	1,418,000	1,684,119	20.9	198.4
90	1276200	1,515,707	18.8	178.6
80	1134400	1,347,295	16.7	158.8
70	992600	1,178,883	14.6	138.9
60	850800	1,010,471	12.6	119.1
50	709000	842,059	10.5	99.2
40	567200	673,648	8.4	79.4
30	425400	505,236	6.3	59.5

Note: These figures are based on the ratio of deposit to credit for the year 2011-12. The projections are done using the ratio for 2011-12 since in subsequent years the ratio declined due to low off-take of credit in the economy.

IMPACT ON MACRO VARIABLES

Apart from the transition issues faced by banks, in judging the impact on the economy, it is important to differentiate between the two changes that the demonetisation can bring about in money supply. The first change, i.e., cash being extinguished, to the extent it was being used as medium of exchange, would result in a compression in incomes, employment and consumption in the economy. On the other hand, the effect of the second change, i.e., cash being only partially replaced in the system would have the opposite effects of expansion in potential credit creation. The potential credit creation would translate into actual credit creation provided there is sufficient demand for credit. If the demand for credit in the economy is large enough, the potential credit can be realised. Of the credit created, other things remaining the same, it can be expected that at least a part of the credit, will be for productive purposes. This would mean expansion in investment in the economy and subsequently an increase in GDP and employment. If there is increase in investment in the economy, the demand for capital goods rises. If output can expand in this sector, there would be an expansion in the income generation and in demand for goods and services. Sectors that are not operating with excess capacity cannot meet the expanded demand with increased output, leading to increase in prices. This would hold for agriculture as well as any industry with long gestation lags to investment. In other words, in the short run there is a possibility of increase in inflation.

MSME is one segment of the economy which is credit constrained. Expansion in the potential credit in the economy could expand the credit available to this segment of the economy which is more employment intensive than the organised manufacturing. In other words, if the access to credit for this segment can be improved, it can generate many positive spin-offs. One reason why this segment might get better access to formal sector credit would be if all their transactions move to the digital format, thereby making available to the lending institutions evidence of credit worthiness. However, for this the transactions need to move digital before they can get access to credit. In other words, unless the banking sector is exploring more risky asset categories, they would not be the beneficiaries of the expansion in potential credit. It should be kept in mind that credit is not the only constraint faced by the MSMEs. There is a cost of compliance with regulation in the formal sector both of tax legislation and other legislation which would increase the cost of operation. In the absence of economies of scale, after incurring all these costs, some of the MSMEs might not be viable in the new environment. In other words, the decision to move from the informal sector to formal sector is a non-trivial decision for the units and merely changing the access to credit might not be adequate to alter the status quo. Under those circumstances, they might explore the use of alternative currencies as a means for survival. It is, however, not correct to assume that expansion in credit will definitely materialise. In the last two years, the demand for credit in the economy has been sluggish at best. In comparison to a credit deposit ratio of 1.53 in 2011-12, the figures for 2014-15 were as low as 0.54. While there might be many factors that contributed to this outcome, what is of consequence is that the demonetisation has been introduced in this environment where demand for credit is rather low. A compression in demand in the economy would further depress the sentiment driving investments. In other words, demand for credit would continue to be low and the potential credit will not be realised immediately. The first consequence of this would be a fall in the interest rates in the economy which could revive some of the sentiment since firms with outstanding debt would have lower interest liabilities and hence, can see improved balance sheets. The compression in demand would mean a decline in imports while exports might not be adversely affected. This change in the balance of trade would induce an appreciation of the currency. Along with lower interest rates, this could result in inflow of investment by FIIs as well.

Demonetisation fallout: ADB reduces India GDP growth forecast to 7% Some rating agencies have estimated a decline of around 40 basis points in GDP growth for 2016-17 and of a smaller magnitude in 2017-18. These estimates are based on quicker liquidity injection and a sharp shift to cashless transactions. However, there is a section of the population which will still like to deal in cash because of religious beliefs. The estimation of a 40 basis point decline in GDP, given the casual nature of employment for nearly 80% of workforce, may not materialize, at least in the time frame envisaged. In our view, the dent in GDP growth may be larger than anticipated and recovery to the normal growth trajectory may take three to four quarters. It is indeed difficult to predict the likely growth trajectory post demonetization. But assuming that the formal sectors maintain the observed growth (average of last 10 quarters) and the informal sectors have a flat growth in the third quarter (Q3) of 2016-17 (with an estimated contraction in informal economic activity in trade, road transport and construction sectors by 5%), Q3 growth may decline to 4.1% in a best case scenario. In case the contraction extends to industrial and professional services sector and is a little sharper in construction and trade, Q3 growth may dip as low as 1.5%. Growth is expected to recover gradually in the fourth quarter (Q4) of 2016-17 and in the first quarter (Q1) of 2017-18 before returning to its normal trajectory thereafter. It is indeed true that increase in liquidity in the formal banking sector will increase GDP growth originating in this sector, but with its share of around 6% in GDP and with an increase in growth of 0.5 and 1.0 percentage points factored in, this sector's growth in Q3 and Q4, respectively, its overall impact on GDP growth assessed may not be significant. The impact of easy availability of credit to the formal sector on account of this additional liquidity may take some time to materialize, and in Q3 and Q4 it may not be significant. Further, a decline in demand in general may also keep the demand for investible funds at moderate levels. How these informal sector issues will get incorporated into the quarterly GDP numbers of the ministry of statistics and programme implementation is important as the quarterly estimates of GVA are compiled by the benchmark-indicator method. The previous year's annual estimates are extrapolated with the growth rates observed in indicators such as quarterly estimates of forecast crops and livestock, index of industrial production, steel and cement dispatches, sales tax returns, sale of commercial vehicles, deposit and credit growth of banks, service tax, revenue expenditure of government, all of which are for the formal sectors. The inherent assumption in this tracking approach is the assumption of uniformity of growth for the formal and informal sector. This assumption has little relevance under the current circumstances, and we may still be surprised with a better official rate of GDP growth for Q3 and Q4. If so, we have to take it with a pinch of salt.

EFFECTS ON GOVERNMENT FINANCES:

The effects of demonetisation on government finances can be divided into three categories: the impact through RBI's finances, the impact through taxes and the impact through credit available to finance deficits.

Through RBI's finances:

The RBI earns seignior age through the printing of currency. In the demonetisation, a part of the currency will be extinguished. For this part of the currency, the RBI can print the notes given the assets on its books, but there would be no takers. In other words, this part of the currency would be like new money that can be introduced into the economy and hence yields seignior age to the RBI once again when released into circulation. RBI, however, cannot lend this to the government since that would involve additional liability buildup on its balance sheet. So, this currency can only be released when foreign exchange is being converted to rupees for instance and not sterilised thereafter. At this point there would accrue some dividends to the government as well. However, to the extent the government and the RBI seek to move the economy towards digital instruments, this option might not be exercised and the dividend might not accrue.

Impact through taxes:

There are multiple channels through which taxes will be affected:

- At the point of transition to the new regime, people have attempted to convert cash balances into commodities like gold or luxuries. On these transactions the governments would have a spurt of taxes. This would however not last beyond the transition phase.
- In the subsequent period, the impact on indirect taxes would be negative because of the compression in demand.
- On property taxes, some local bodies have given people a window of opportunity to pay old as well as current taxes in the scrapped notes. This would result in an increase in revenue collections in property tax.
- On income tax there can be two potential effects: first, with compression in the economy, there could be a reduction in the tax collection. In the unlikely event of people choosing to deposit unaccounted balances in the bank and pay taxes and penalty on the same, or if the tax department through investigation, finds that some of the deposits are not explained income tax collections would increase. For any individual depositing balances above Rs 10 lakhs, the tax and penalty together would absorb the over 90 per cent of the deposited amount. This would serve as a disincentive for people with large balances to come and deposit the same into accounts. In other words, the government cannot expect to get major collections in terms of the tax and penalty on unaccounted incomes revealed.

Through financing of fiscal deficit:

The generation of additional deposits and credit, as a result of the SLR requirements can make more credit available to governments. Given the FRBM (Fiscal Responsibility and Budget Management) limitations, the amount of borrowing that governments can take on may be limited and the additional supply can mean a decline in the interest rate that governments pay on their debt. This could be a positive spin-off for the governments.

Positive Effects of Demonetization?

In what could be termed as the mother of all reforms, Prime Minister Modi's demonetisation move will have far reaching implications. This is not to dispute that the transformative step has brought some hardship for the citizens, but those are temporary and will blow over soon. For the larger benefit of the nation, we the citizens can bear such hiccups with a smile. After all, this is how we as citizens can contribute in policy making and nation building. While bank employees are working overtime to make Modi"s ambitious demonetisation drive a success, let"s discuss its many-fold impacts.

1. Black money: At one stroke the Prime Minister has choked the supply of black money stacked inside the country. Of the Rs 17 lakh crore of total currency in circulation in the country, black money is estimated at mind-boggling Rs 3 lakh crore. Black money is nothing but a plunder of the nation. Black money operators run a parallel economy which shakes the very foundation of the Indian economy. With Modi's demonetisation move, all domestic black money will either be deposited into the banks with heavy penalty or be simply destroyed.

2. Economy: Demonetisation will have a huge resultant effect on the Indian economy. The clean-up of illegal cash will help turn around the economy. First, it will bring more borrowings to the exchequer, improve inflation outlook and increase India's gross domestic product (GDP). Second, it will revive investment opportunities and give a fillip to infrastructure and the manufacturing sector. Third, it will help reduce interest rates and lower income tax rate.

3. Note bank politics: In the run up to the crucial assembly elections in Uttar Pradesh, Punjab, Goa and Uttarakhand, Prime Minister Modi'sdemonetisation announcement has come as a shock and awe for the political parties and politicians for whom black money is a lifeline. The pulling out of the old Rs 500 and Rs 1,000 currency notes will help make the election process clean and transparent. But it has brought tough times for the political parties and politicians who believe in the idea of purchasing votes in exchange for notes. That is precisely the reason a rainbow coalition of a galaxy of regional parties and the Congress is building up against Modi, because their political interests are badly hurt.

4. Real estate cleansing: It is said that real estate is an industry built on black money. The extent of black money floating around in the sector is huge. According to an estimate at least 40 per cent of real estate transactions in Delhi-NCR are in black. Modi's demonetisation move will curtail the flow of black money into the real estate sector. This will help in making the much needed correction in the sector. The impact: An unexpected dip in land and property prices.

5. Hawala transactions: Demonetisation has crippled the hawala rackets. Hawala is a method of transferring money without any actual money movement. Hawala route is used as a means to facilitate money laundering and terror financing. Hawala rackets run again on black money. With black money suddenly being wiped out of the market, thanks to demonetisation, hawala operations have come to a grinding halt. According to an India Today report, one of the hawala operators in Mumbai has destroyed currency notes worth about Rs 500 crores.

6. Counterfeit currency: Demonetisation has dealt a death blow to the counterfeit Indian currency syndicate operating both inside and outside the country. Counterfeit currency seriously devalues the real worth of Indian currency. A study conducted by Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency (NIA) suggests that fake Indian currency notes (FICN) amounting to Rs 400 crore are in circulation in the country at any given point of time and around Rs 70 crore fake notes are pumped into Indian economy every year. The estimation is based on recovery and seizure made by various agencies. But the actual figure

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could be much larger. A One India report, quoting an Intelligence Bureau dossier, says fake Indian currency worth Rs 12 lakh crore has pumped into Indian financial system over the years. Needless to say that most of the fake currencies circulated in India are of Rs 500 and Rs 1000 denominations. It is also pertinent to mention that the fake currency floating inside the Indian financial system is not counted within the Rs 17 lakh crore of total currency in circulation in the country.

This is an open secret that Pakistan has been printing fake Indian currency at its government printing press in Quetta and its security press in Karachi. The enemy nation funnels the counterfeit currency through the frontier at Jammu & Kashmir and via India's porous border with Bangladesh and Nepal. With Prime Minister Modi's decision to pull out the old Rs 500 and Rs 1,000 notes and replace them with new Rs 500 and Rs 2,000 series has completely stalled the circulation of counterfeit Indian currency. Experts say the new currency notes have come with advanced security features which are almost impossible to replicate. So Pakistan has no option but to shut shops of its fake Indian currency.

CONCLUSION

If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries shows that the move was one of the series that failed to fix a debtburdened and inflation-ridden economy. It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

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