Impact of Demonetization on Indian Economy

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Abstract

The present Demonetization is a generation's memorable experience and is going to be one of the economic event of our time. It's impact is felt by every Indian citizen .Demonetization affects the economy through the liquidity side. It's effect is widespread because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes there occurred huge gap in the currency composition as Rs 100 and Rs 2000 is the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination. Since our economy is an under banked economy, present demonetization have caused a severe social experiment, across the segment of our population. At the first place and on a short term basis the move would benefit the Government which shall effectively deploy its resources to percolate the impact to the poor and needy of our country. The paper will analyse the impact of present demonetization on various sectors of the economy.

Keywords: Demonetisation, Economy, cashless transactions, Currency

Introduction

Demonetization is a process by which a series of currency will not be legal tender. The series of currency will not acceptable as valid currency. The Indian PM on 8th Nov. 2016 announced that from today onwards rupees 500 and 1000 rupee note will not be a legal tender, people have given time upto December 30, 2016 to exchange the notes held by them. 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 limited place on the amount that individuals can withdraw. The move was targeted towards tackling black money, tax evasion, corruption ,counterfeit notes that could be contributing to terrorism financing activities and to promote cashless or digital economy.

In the post demonetization period i.e. period between 2011-16 the increase in the notes of all denominations had grown by 40% and those of Rs. 500 had increased by 76% and those of Rs. 1000 by 109% and during that time period economy expanded by only 30% . According to RBI, on march 2016 currency in circulation amounted to Rs. 16,415 billion and out of this total money in circulation the amount of 500 denominating was accounted 47.8% in value and Rs. 1000 notes another 38.6 % together they form more than 86% of the value of notes in circulation and from total currency in circulation there amount is Rs. 15347 billion (i.e. 11% of GDP). By making the larger denomination notes worthless, individuals and entities with huge sums of black money earned from parallel cash systems were forced to convert the money at a bank which is by law required to acquire tax information from the entity. If the entity could not provide proof of moving any tax payments on the cash, a tax penalty of 200% on the cash owed was to be imposed.

India's past experience with demonetisation

The first demonetization took place on 12th January 1946, Rs. 500, Rs. 1000 And Rs. 10,000 Notes were declared invalid as legal tender. New notes of Rs. 1000, Rs. 5000 and Rs. 10,000 came into economy in 1954. Later On 16th January 1978, the Morarji Desai led Janta Party demonetized bank notes of Rs. 1000, 5000 and 10,000. Currency worth INR 1.46 billion (1.7 % of total notes in circulation was demonetized of this Rs. 1 billion was tendered back) . In 1978 the value of demonetization was very small (only 0.1% of GDP) RBI introduced a new bank note of Rs. 500 into the economy in 1987 to contain inflation .On 8th November 2016, the old bank notes of Rs. 500 and Rs. 1000 were barred from being legal tender and new notes of Rs. 2000 and Rs. 500 were introduced. This time demonetization covers more than 86% of the total currency in circulation (11 % of the GDP) Also denominations of 1, 2, 3, 5, 10, 20, and 25 paisa were in circulation till June, 2011 but were then withdrawn, 50 paisa coins are still in circulation and are called small coins.

The first and second demonetisations affected really high value notes which formed a small part of notes in circulation. At that time it was considerable less percentage of GDP. RBI earlier removed pre-2005 notes of all denominations from circulation as thy have fewer security features compared with subsequent notes. The process of removing the older notes from circulation continued for nearly one year. The deadline was extened till December 2015 and those notes continued to remain legal tender till November 8. This was not exactly demonetization but removing from circulation and has now subsumed into the present demonetization.

Demonetisation is an Attack on cash

Firstly who holds black money in cash? Mostly corrupt people. Their payoffs are in suitcases and hoarded in their houses. These are balances held till they find their target investments. A lot of black money itself is mainly held in gold and land. Black money is the currency of black economy. The government cannot do much about this ideal cash. It remains stagnant if it remains legal tender. But to remove the legality of it and the government is able to alter the cost benefits equation of corruption. Demonetisation attacks currency supply of the black economy. But removing the cash available to buy these gold and you affect the supply chains in black economy. When the flow gets interrupted the cost of corruption increases and payoff reduces dramatically. Such action attacks the chain that processes black money.

It is possible that as a result land prices and gold prices will fall, middle class will be able to purchase land. If gold purchases are reduced, the forex pressure on INR will ease a bit Thus legitmate money which was being period out of the economy gets an opportunity. Further, it prevents the black money processing chains from forcing white money into black.

Impact of Demonetization

This is for the third time in the Indian history that Indian high value currency has been stripped of its status as a legal tender, the first two instances of demonetization did not have impact like the recent one. This is primarily, because, this time, the demonetized currency represents more than 86 % of the total currency in circulation. The wiping out cash balances in the economy will eliminate a number of transactions for a while since there is no medium of exchange available. In a country where 68 % of the transaction are cash based (as per CLSA data), a move like this is definitely going to have several long as well as short term impacts. The impact will be more severe on the persons who earns income in cash and spend it in cash. The impact of this change too would be felt differently across the different segments of the economy. Agents operating within the formal sector and agents who are familiar with the modern technology would be placed on different footing compared to other agents who need to make the transition.

Impact on bank deposits and Interest Rates

The growth in bank deposits, which was at a 53 year low at the end of march 2016, has been a spike ever since the demonetization was announced in India. The total deposits collected by banks amounted to Rs. 6 trillion by 23rd of Nov. 2016. With this rate of money deposited it is expected that entire 15 trillion of currency demonetized is expected to be deposited by end of Dec. 2016. If most of these deposit being made in the banks are emergency saving of households, most of these deposits will be withdrawn after government uplifts the withdrawn limited .

Due to huge surge in liquidity after demonetization major banks in India have sharply reduced their deposit rates which is natural considering that any cuts to lending rates have to be accompanied by cuts to deposit rates .These rate cuts will definitely boost consumption. They will work to get the temporary derailed economic growth back on track. Apart from cutting deposit rates, banks also reduced their lending rates as well . It will translate into lower interest rates on existing floating rate loans and on new loans too. The reduction in lending rates is expected to stoke lending by tempting consumers to take loans for purchasing expensive consumer discretionary items like vehicles and house. Any increase in economic activity due to more consumption on account of lower rates can be beneficial to India. Like Finance Minister Arun Jaitely says “ Bank deposits will increase and they will have more capacity to support the economy.”The additional deposits will surely stimulate the potential credit that can be created in the economy.

Impact on financial markets

Indian equity markets have been on a secular falling trend since the government demonetized the 500 Rupees and 1000 Rupees currency notes . The two benchmark equity indices - the nifty 50 and the S & P BSE Sensex - fell on each trading day since the demonetization except for November 8 until November 22, the BSE sensex fell 5.9 % during the same period the Nifty fell 6.3% Due to rise in the US Dollar, the dollar equivalents of the sensex and the nifty fell more than 8% each. Apart from demonetization, Donald Trump's victory and concerns about his restrictive trade philosophy led to foreign investors pulling out of Indian equities.

However, once the short term impact of demonetization is over Indian equities will likely bounce back sharply. A rate cut from the Reserve Bank of India would be helpful and easy monetary conditions are generally beneficial for equities consumption - driven sectors and stocks will continue to be hit in the short term.

Impact on Inflation

Demonetization will surely bring down inflation. Due to demonetization consumers are refraining from making any purchases except essential items from the consumer staples, health care and energy segments. Activity in the real estate sectors, which includes a lot of cash and undocumented transaction ,slowed down significantly Metropolitan and Tier-1 Cities reported up to 30 % fall in house prices. Food item inflation, measured changes in the consumer food price index, accounts for 47.3 % of the overall CPI. Due to more than 86 % of currency notes is out of financial system and demonetization being slow, the supply and demand of food items fell. It will exert more down ward pressure on inflation. It is also expected that there will be good harvest this year following a good monsoon. So, supply of goods will increase . However there may be less demand following reduction in money supply due to demonetization, Thus inflationary pressure will continue to be low following demonetization of currency.

Impact on Black Money

Black money or black income are dirty money is that money on which tax is not paid to the government and so it goes unaccounted in the duration of country’s tax assessment period and hence cause big revenue looses to the government. Central government recent decision to demonetize the high value currency is one of the major step towards the eradication of black money in India. But there are various view of experts on demonetization , as some argue that it will curb black money and other argued in negative.

In India all sections of the society are accustomed to use cash transactions and this habit is unscrupulously misused by some bad elements of the society . Such habit resulted in even people with accounted money are started using cash transaction for high value transaction. It resulted into parallel economy with unaccounted money even much stronger than regular economy. In this back ground demonetization will address issues like black money and corruption and will also help the economy to become more digital . The move will unearth the black money . Any abnormally high deposits will be scrutinized and will be subject to a 200 % penalty . At least a part of the money being deposited will be subject to tax and penalty. This will result in an increase in the government revenue and hence reduce the budget deficit.

On the other hand few economist are of the opinion that the size of the black economy in India range from 20 % to 60 % of GDP or can be more than that but the currency in circulation is just 12 % of GDP. If more than 50 % of money in circulation is black money and most of it will find its way back to the banking system one way or another. Expert black money holders, tax evaders and corrupt official may not slash these money in cash in their homes due to sheer scale of logistics. Usually black money is used to purchase the following items – Gold, precious metals, precious stones, real estate ,high end consumer goods. The total quantity of gold precious metals and high end consumer goods in the market that is disclosed and purchased is unknown. Their price is reasonably known. The quantity of real estate is known but their prices are not known to the government. This sort of black money driven consumption is out of preview of the legitimate formal economy. The effect of demonetization on such consumption will be positive either this consumtion will cease thus reducing illegal imports of gold, precios metals etc.

Impact on GDP

The Indian economy which is the “fastest growing emerging economy’ in the world and the only bright spot among emerging markets seems to have slowed down due to shock theory of demonetization. Indeed the recently released growth figures from the CSO hints at slowdown in the economy even during the quarter before demonetization happened. While this is indeed cause for concern with projected growth figures revised downward from 7.6 % to 7.1% for the financial year ending March 2017, What is cause of greater worry and even alarm is the view among some economists including the former prime minister Dr. Manmohan Singh that the current and ongoing event to flush out black money would shave out a good 2% of the GDP. The GDP formation could be impacted by this measure due to reduction in the consumption demand. However the recent rise in festival demand is expected to offset this fall .This expected fall in GDP may not be significant as some of this demand will only be deferred and it will surely reenter the stream once the cash situation becomes normal., The present slow down in the economy is due to slow down in manufacturing mining and construction sector .Economists expect the slowdown in industrial and services growth to be offset by healthy growth in the agriculture sector.According to the latest figures, however, we don't have to worry because we have even over shot china, which grew at 6.8 in October- December last year, and this is despite of demonetizations.

Impact on Government Revenue

Demonetization measure will flush out vast hoards of illegal cash, bring more money into the banking system and check tax evasion. In a country where huge volumes of business and trade are transacted in cash, often escaping the taxation net. Due to demonetization more taxes will be collected due to higher deposits in banks that can be taxable as well as increased compliance due to greater scrutiny oversight by the income tax department. The government too might be tempted to announce lower rates for taxes and other aspects which are known as fiscal measures. In this context it is worth remembering that fiscal stimulus which is by lowering taxes and and providing more incentive to consumers as well as producers by boosting supply can be complimented and supplemented by monetary measures which is by boosting demand for goods and services by lowering lending rates there by putting more money in the hands of consumers

Digitalization of the economy

India is incredibly cash centric economy, Cash account for upwards of 95 % of all transactions, 90% of vendors didn't have card readers or the means of accepting electronic payment, 85% of works were paid in cash and almost half of the population didn't have bank accounts, cash on delivery was the preferred choice of 70 % of online shoppers.

By temporarily turning off the engines which drove the cash economy India hoped that more people could be brought into the hold by using track able and taxable. Digital financing vehicles like debit cards and e-wallet etc. Whether or not India was ready for this cashless revolution is another question.

India is currently in the middle of an all out movement to modernize the way things are paid for, new bank accounts are being opened at a heightened rate, e- payment services are seeing rapid growth , cash on delivery in e-commerce has crashed and digitally focused sectors like the online grocery business have started booming. Even the vegetable vendors on the streets have opened up paytm accounts. Modi's demonetization initiative has been a boom for India's e-payment period Paytm reported a three timer surge in new users- tackling on over 14 million new accounts in November Alone. These changes indicate towards a more inclusive society in the future. Digitalizing a winder swath of the economy is meant to be a fix for many aspects of India's society that the government aims to reforms first of all it creates a way for all purchases to be tracked and recorded which can work towards lifting the effectiveness of the black market as well as stemming the flow of capital that destined to fund terrorist activities.

Economic digitization also increases the government ability to enhance its taxation systems. India's informal economy is responsible for roughly 45 % of GDP and 80 % of employment currently only 1 % of India's population pays income Tax. India hopes to create a cleaner, more transparent economy via digitalization that will lead to an improved climate.

Conclusion

The demonetisation undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued 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, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetisation on the economy and its agents. All though the comprehensive long term impact of these demonetization measure can not fully as curtained at this stage, the overall economy is expected to benefit from a decreased in unaccounted cash transactions and an elimination of counter feit currency notes, leading to more effective tax collection and increased transparency in ascertaining transaction costs. An increase in transparency is also likely to improve attractiveness for foreign investors , while higher bank deposits and formalizing larger hither to un accounted for income streams is expected to improve the fiscal deficit of India.

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