

Summarizing the impacts of demonetization on Indian economy

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Abstract

Demonetization means that a currency unit is no longer legal tender money. It is a process by which a particular form of currency is withdrawn out of circulation in the economy. The government of India also adopted this measure with an aim to address the corruption, counterfeit currency, black money, etc. This paper seeks to analyze the impacts of demonetization on Indian economy.

Keywords: demonetization, black money, digitalize economy

Introduction

On November 8, 2016 the government of India demonetized the high value currency notes –of Rs. 500 and of Rs. 1000 denomination. Such notes, valued at ` 15.4 trillion, constituted 86.9 per cent of the value of total currency in circulation (RBI).The government was planning to introduce new notes of 500 and 2000 denomination and eliminating the existing notes in circulation. It was one of the measures taken by the government to reduce corruption, increase the savings and to digitalize the economy. It is third time in the economic history of India that government has demonetized the currency (first in 1946, second in 1978).

Objective

1. To study the short term and long term impacts of demonetization on Indian economy
2. To analyze the impacts of demonetization on various sectors in Indian economy

Research methodology

The paper is based on secondary data. The data has been collected from internet.

Rationale behind demonetization:

1. Black money was one such reason for which demonetization could be helpful. What black money is? Black money in simple terms is the unaccounted transactions which may belong to informal sector, illegal activities or may be legitimate one but not reported to the authorities. Demonetization was one of the various steps required for eliminating black money.
2. Terror financing is one of the major problems which needed to be addressed. There is a method of transferring money without actual money movement, which is known

as hawala transactions. These hawala transactions are again backed on black money. Terror financing is sourced by these transactions and fake currency, where a multi-layered network of hawala operators work for it.

3. To address the problem of corruption
4. Counterfeit currency means fake currency. Which is a major source for terror financing as well as other unhealthy economic transactions. Demonetization could remove the problem of counterfeit currency from the economy.
5. To digitalize the Indian economy.

Impacts of demonetization

In order to understand the impacts of demonetization which reduced the amount of currency in circulation in the economy, we need to understand the type of cash transactions in the economy. This step affected the economic agents who were holding cash and did not deposit in the banks. On the other hand currency has been used by those agents whose transactions were recorded for tax purposes or there exist no tax liabilities for them.

According to the Nikkei Markit India Manufacturing Purchasing Managers' Index (PMI) -- a composite indicator of manufacturing performance -- the withdrawal of high-value banknotes has reportedly hit new business orders and factory output in December, with companies signalling fewer numbers of new orders, buying levels and output.

The index fell to 49.6 in December, from 52.3 in November, which marked the biggest month-on-month decline in the index since November 2008

Due to the hardship faced by people, during demonetization households opened bank account. Jan Dhan accounts increased by 23.3 million post demonetisation, while deposits under Jan Dhan.

Table 1

(in million)

Bank-Group	As on November 9, 2016			As on March 1, 2017			Variation (March 1, 2017 over November 9, 2016)		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total
	Public Sector Banks	114.3	89.3	203.6	122.1	100.8	222.9	7.8	11.5
							(6.8)	(12.9)	(9.5)
Regional Rural Banks	37.1	6.0	43.1	40.0	6.4	46.4	2.9	0.4	3.3
							(7.8)	(6.8)	(7.7)
Private Sector Banks	5.3	3.1	8.4	5.4	3.6	9.0	0.1	0.5	0.6
							(1.3)	(16.8)	(7.0)
Scheduled Commercial Banks	156.7	98.4	255.1	167.5	110.9	278.4	10.8	12.5	23.3
							(6.9)	(12.7)	(9.1)

Note: Figures in parentheses are percentage variations.

Source: Pradhan Mantri Jan Dhan Yojana website.

Accounts increased by ` 187 billion (41 per cent).

Amount deposited under Jan Dhan

Table 2

(₹ billion)

Bank Group	As on November 9, 2016	As on March 1, 2017	Variation (Col. 3 over Col. 2)	Variation in aggregate deposits of scheduled commercial banks (February 17, 2017 over November 11, 2016)	Accretion in PMJDY deposits as percentage of accretion in Aggregate deposits#
1	2	3	4	5	6
Public Sector Banks	364.0	502.5	138.5 (38.0)	2733.0 (3.9)	5.1
Regional Rural Banks	76.3	118.1	41.8 (55.0)	616.0 (18.0)	6.8
Private Sector Banks	16.0	22.3	6.3 (39.0)	778.0 (3.5)	0.8
Scheduled Commercial Banks	456.4	642.9	186.5 (41.0)	4098.0 (4.1)	4.6

Note: Figures in parentheses are percentage variations.

#: The ratio pertains to Jan Dhan deposits as on February 15, 2017, as data on aggregate deposits of SCBs as on March 3, 2017 are not available yet.

Source: Pradhan Mantri Jan Dhan Yojana website.

Increase in the electronic mode of payments has been witnessed, although the country does not have the digital transaction culture.

Table 3

Category		Oct-2016	Nov-2016	Dec-2016	Jan-2017	Feb-2017
NEFT	Volume	16.2	23.3	39.0	38.0	34.5
	Value	37.6	38.3	40.8	60.2	49.5
CTS	Volume	-1.1	23.0	58.4	52.7	20.2
	Value	2.9	8.6	13.0	19.3	0.8
IMPS	Volume	116.7	89.6	157.2	177.7	150.4
	Value	150.7	135.9	186.6	196.7	184.2
NACH	Volume	53.0	30.8	58.3	19.8	-0.9
	Value	89.8	76.3	116.7	22.8	54.2

Source: RBI Bulletins and Press Releases on Electronic Payment Systems - Representative Data

Various agencies estimated GDP growth as

Table 4

Agency	2016-17		2017-18	
	Pre-demonetisation	Post-demonetisation	Pre-demonetisation	Post-demonetisation
IMF	7.6	6.6	7.6	7.2
World Bank	7.6	7.0	7.7	7.6
ADB	7.4	7.0	7.8	7.8
Economic Survey, Government of India	7.0 to 7.75	6.5 to 6.75		6.75 to 7.5
Morgan Stanley	7.7	7.3	7.8	7.7
HSBC	7.4	6.3	7.2	7.1
Nomura*	7.8	7.1	7.6	7.1
Goldman Sachs	7.6	6.3	-	-
ICRA	7.9	6.8	-	-
CARE Ratings	7.8	6.8	-	-
CRISIL	-	6.9	-	-
FITCH	7.4	6.9	8.0	7.7
BofA-ML	7.4	6.9	7.6	7.2

*: Pertains to calendar year.

Sources: Growth projections by the Financial Institutions and Rating Agencies were compiled on the basis of media reports published during November and December 2016.

Short term impacts of demonetization

1. Lack of medium of exchange: as demonetization removed 86% of the currency out of the economy. This affected the consumption level in the economy. There was higher effect on that section of society which earns in cash.
2. The sectors in which most of the transactions were carried out in cash or demand was backed by the cash in hand. For example daily wage earners, laborers and small traders etc.
3. It was also a possible outcome that agents start supplying goods and services on credit.
4. In a situation of cash crunch, this adversely affected on demand for non-essential goods. Because agents postponed their purchase of such goods and started utilizing cash for essential commodities. If the economic agents were aware of the digital payment system and such financial infrastructure was available widely then demand remain unaffected.
5. The sectors like agriculture and construction sector adversely affected as in these sectors most of the transactions were cash based, due to which construction sectors reduced labour cost.
6. Most of the unaccounted income was utilized in the real sector.
7. Money inflows in the banks were transitory and not for long term savings. People deposited money into banks just to convert the old notes into new notes.
8. Decrease in cash liquidity caused short term reduction in purchase and trade in securities by the public.
9. Wholesale inflation broke the 3-month declining trend and rose to 3.39 per cent in December 2016, mainly due to rise in prices of manufactured items, even as food articles turned cheaper.
10. The Wholesale Price Index-based inflation, reflecting the annual rate of price rise, in November stood at 3.15 per cent.

11. wholesale price index-based inflation flared up to two-and-a-half years high of 6.55% in February from 5.25% in January mainly due to a spurt in mineral and fuel prices while food prices started rising following rapid remonetisation.
12. The spurt in WPI inflation adds to the worries of a pent up demand after demonetisation which may prompt Reserve Bank of India to keep policy interest rates unchanged for some more months.
13. Reflecting some impact of the government's recent demonetization measure, the output of India's eight infrastructure industries in November 2016 increased by 4.9 per cent, but fell sequentially as compared to the 6.6 per cent growth logged in October

Long term impacts of demonetization

- Total amount extinguished from the economy was replaced by new currency notes it would benefit in medium term and long term.
- Agents are compelled to shift from the cash transactions to digital versions as government of India proposed various benefits for making digital transactions such as Public sector banks are advised that merchant should not be required to pay more than ` 100 per month as monthly rental for PoS terminals/Micro ATMs/mobile POS from the merchants to bring small merchant on board the digital payment eco system, No service tax will be charged on digital transaction charges/MDR for transactions upto ` 2000 per transaction, All railway passengers buying online ticket shall be given free accidental insurance cover of upto ` 10 lakh etc.
- Use of debit and credit cards at point of sale increased from Rs.52,000 crore to Rs.82,000 crore, could benefit the economy if this digital transactions keep pace.
- The World Bank said "note ban will have a positive development impact in the long-term as it accelerates

financial deepening, foster financial inclusion and increase transparency.”

- But India is far from being cashless economy. According to the estimates of watal committee, cash accounts for the 78% of the total consumer payments.
- With a tax net widening after restriction on cash economy, GDP in the long-term likely to get a boost
- Since effect of lower demand can have a lagging impact on inflation, prices may remain flat or fall in the long term

Demonetization lead to the redistribution of resources in the economy. It shifted resources from private sector to government. Government is the main party whose response would decide the long term impact in most cases.

Demonetization impacted the growth through two channels. (A) By reduction in demand due to liquidity shock. (B) Due to disruptions in production.

Due to reduction in currency in circulation economy faced compression of income, employment and consumption. If the demand for credit is large enough in the economy, it may lead to the expansion of investment in the economy and which lead to the growth in GDP and employment. The latest CSO estimates suggest that the impact of demonetisation on GVA growth in Q3 of 2016-17 was felt mostly in real estate and construction, but because of stronger growth in agriculture, manufacturing, electricity, and mining, the overall impact on GVA growth was modest.

Table 5: Impact of Demonetisation

Sector	Impact	
	Effect through end-December	Likely longer-term effect
<i>Money/interest rates</i>	Cash declined sharply	Cash will recover but settle at a lower level
	Bank deposits increased sharply	Deposits will decline, but probably settle at a slightly higher level
	RBI’s balance sheet largely unchanged: return of currency reduced the central bank’s cash liabilities but increased its deposit liabilities to commercial banks	RBI’s balance sheet will shrink, after the deadline for redeeming outstanding notes
	Interest rates on deposits, loans, and government securities declined; implicit rate on cash increased	Loan rates could fall further, if much of the deposit increase proves durable
Financial System Savings	Increased	Increase, to the extent that the cash-deposit ratio falls permanently
<i>Corruption (underlying illicit activities)</i>		Could decline, if incentives for compliance improve
<i>Unaccounted income/ black money (underlying activity may or may not be illicit)</i>	Stock of black money fell, as some holders came into the tax net	Formalization should reduce the flow of unaccounted income
<i>Private Wealth</i>	Private sector wealth declined, since some high denomination notes were not returned and real estate prices fell	Wealth could fall further, if real estate prices continue to decline
<i>Public Sector Wealth</i>	No effect.	Government/RBI’s wealth will increase when unreturned cash is extinguished, reducing liabilities
<i>Formalization/ digitilisation</i>	Digital transactions amongst new users (RuPay/ AEPS) increased sharply; existing users’ transactions increased in line with historical trend	Some return to cash as supply normalises, but the now-launched digital revolution will continue
<i>Real estate</i>	Prices declined, as wealth fell while cash shortages impeded transactions	Prices could fall further as investing undeclared income in real estate becomes more difficult; but tax component could rise, especially if GST imposed on real estate
<i>Broader economy</i>	Job losses, decline in farm incomes, social disruption, especially in cash-intensive sectors	Should gradually stabilize as the economy is remonetized
<i>GDP</i>	Growth slowed, as demonetisation reduced demand (cash, private wealth), supply (reduced liquidity and working capital, and disrupted supply chains), and increased uncertainty	Could be beneficial in the long run if formalization increases and corruption falls

	<p>Cash-intensive sectors (agriculture, real estate, jewellery) were affected more</p> <p>Recorded GDP will understate impact on informal sector because informal manufacturing is estimated using formal sector indicators (Index of Industrial Production). But over time as the economy becomes more formalized the underestimation will decline.</p> <p>Recorded GDP will also be overstated because banking sector value added is based (<i>inter alia</i>) on deposits which have surged temporarily</p>	<p>Informal output could decline but recorded GDP would increase as the economy becomes more formalized</p>
<i>Tax collection</i>	<p>Income taxes rose because of increased disclosure</p> <p>Payments to local bodies and discoms increased because demonetised notes remained legal tender for tax payments/ clearances of arrears</p>	<p>Indirect and corporate taxes could decline, to the extent growth slows</p> <p>Over long run, taxes should increase as formalization expands and compliance improves</p>
<i>Uncertainty/ Credibility</i>	<p>Uncertainty increased, as firms and households were unsure of the economic impact and implications for future policy</p> <p>Investment decisions and durable goods purchases postponed</p>	<p>Credibility will be strengthened if demonetisation is accompanied by complementary measures. Early and full remonetisation essential. Tax arbitrariness and harassment could attenuate credibility</p>

Source: economic survey 2016-17

Indicators of success of demonetization

Following can be seen as signs of success in the long run. (Economic survey, 2016-17)

1. Changes in the use of digital methods through various digital access. The categories of the digital access are defined as smart phone users, simple phone users and phoneless.
2. There should be a fall in cash-GDP ratio because more savings are channeled through financial system and black money moves out of the system.
3. Most important sign of success will be the tax. Total number of tax payers and the magnitude should rise over time.

Conclusion

The demonetization was an unexpected and sudden decision of the government which resulted into a liquidity shock to the country. In India, there is a large section of population who reside out of the formal economy such as daily wagers, roadside traders, hawlkers, rikshawpaddlers and other labourers who uses cash frequently. This section affected adversely as cash stringency left them with no cash and reduced labour cost. The overall impact on GVA growth was modest. With the return of SBNs, currency in circulation declined and deposits with banks surged. Increase in the electronic mode of payments has been witnessed, although the country does not have the digital transaction culture. Demonetization curbed black money for the moment, but can't check generation of black money in future. To check on generation of black money more transparency, digitalization and lower tax rates are required.

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