Recent Currency Demonetization and Its Probable Impact on Indian Economy

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Abstract:
The BJP led government in India has made a surgical strike on black money on November 8, 2016 to wipe out black money, counter tax evasion and destroy counterfeit currency. Demonetization as a clean-up exercise may turn out several excellent changes in the economy. At the same time, it generates inescapable income and welfare losses to the poor sections of the society. The demonetization exercise may produce following short term or long term, consumption, investment, welfare, growth impact on Indian economy. The object of the article is to assess the probable effect of demonetization on Indian economy.

Keywords: Demonetization, India, GDP, inflation, interest, repo, reverse republic money, counterfeit currency etc.

1. Introduction
The BJP led government in India has made a surgical strike on black money on November 8, 2016 when the entire world was waiting for the upshot of US presidential elections. Prime Minister of India, Narendra Modi appeared on TV screen with his master stroke on corruption, counterfeit currency, terrorism and black money by announcing demonetisation and ceasing Rs 500 and Rs. 1000 notes as a part of legal tender in India. The aspiration is to wipe out black money, counter tax evasion and destroy counterfeit currency. With the new demonetization policy, the liquidity side of the Indian market has been affected. About nearly 86% of currency value in circulation was withdrawn without replacing bulk of it.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, an enormous gap in the currency composition was created as after Rs 100, Rs 2000 was the only denomination. While the pros and cons of the measure still continue to be debated, the consensus of opinion appears to be that while the advocates of demonetization may have had fine intentions, the distress it has caused to millions of Indians is unjustifiable. Since Rs500 and Rs1000 notes make up some 86% of the total currency in circulation in India, especially in the vast rural areas, one economist compared the pain to what individuals might experience if 86% of their blood was removed from their bodies.

Kartik Hosanagar, a professor in Wharton’s department of operations, information and decisions, views demonetization against the backdrop of other economic gains: “The biggest wild card in all of this, of course, is demonetization”. Hosanagar notes: “It’s unclear how it will all play out.” He hopes that “any impact on economic activity and GDP will be temporary, and the long-term benefits such as an increase in cashless activity will be more permanent.” By withdrawing 86 percent of circulating currency when 70 to 80 percent of transactions are cash-based, the India government perhaps has burned down its economic house in order to eradicate the pest of corruption.

The term demonetization is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But, these notes were demonetized in January 1946 and again in January 1978. According to Investopedia, demonetization is an act of stripping a currency unit of its status into legal tender. Demonetization theoretically is a liquidity shock, an unexpected impediment in terms of currency availability. It generates a circumstance where lack of currencies blocks consumption, investment, production, employment etc. Demonetization as a clean-up exercise may turn out several excellent changes in the economy. At the same time, it generates inescapable 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 activities will be diminished in the short term. But, the immense benefits of having more transparency and reduced volume of black money activities may probably be construed as long term benefits.

2. Notes in circulation in Indian economy before demonetization:
As a result of demonetization, major share of currency put out of circulation. According to the RBI’s (Reserve Bank of India) Annual Report for April 2015 to March 2016, the value of the currency notes at the end of March 2016 was 16.42 trillion Indian rupees. The 500 rupee and 1,000 rupee currency notes formed 86.4% of the value. In one stroke, the government removed 86.4% of the currency in circulation by value. Demonetisation has invalidated approximately Rs 14,180 billion worth of high value currency, which is almost 86 percent of the total currency in circulation (total currency in circulation Rs 16,454 billion as on 31 March 2016). In terms of volume,
the currency notes of these two denominations formed 24.4% of a total 90.27 billion pieces.

Source: Adapted from Market Realist.

In addition, RBI data showed that as of March 2016, 632,926 currency notes were counterfeit-known as an FICN (Fake Indian Currency Note). As a proportion of NIC (Notes in Circulation), the 1,000 rupee and 500 rupee notes were the highest. Nullifying these, FICNs was also part of the demonetization move.

In most large economies, cash is around 5 percent of GDP; in India it is 12 to 14 percent. Less than one-third of Indians have access to financial institutions. While most banks are concentrated in cities, most Indians live in villages. Only 5 percent of Indian workers pay income tax, just 15 percent of the economy is inside the tax net and India’s tax to GDP ratio at 17 percent is 5 points lower than comparable countries. Because of high property taxes, buyers conspire with sellers to minimize the sale value and split the tax difference. This explains why the policy is an attack on the Indian way of doing business. Much of India’s cash-based consumer transactions have ground to a close down. Forcing businesses to use banks and digital payments will help to bring them inside tax net. On the other hand, the poor keep their money in cash and the rich keep illegal wealth in Indian and overseas real estate, shell companies, shares, gold and overseas bank accounts. Only 5 to 6 percent of India’s illegal wealth is expected to be held in cash components. Demonetization attacks the stock without touching the flow of black money. Cumulative illegal outflows from developing to developed countries increased from $369 billion in 2000 to $1.26 trillion in 2008. In the 10-year period from 2004 to 2013, the developing world as a whole lost $7.8 trillion. India has experienced the third-highest illegal capital outflow ($83 billion in 2013) after China ($259 billion) and Russia ($120 billion).

In view of the above perspective, the object of the article is to assess the probable effect of demonetization on Indian economy.

3. Probable effect of recent demonetization
Demonetization may cause some difficulties for the common people at this particular time but in the long run, it seems that it will be beneficial for the country’s growth. Consequently, demonetization has its proponents as well as critics. While industrialists and corporate chiefs like Ratan Tata, Mukesh Ambani, K.V. Kamath and Deepak Parekh favour the move of demonetization as initiated by honorable India’s prime minister, Narendra Modi but economists including Nobel laureates Amartya Sen and Paul Krugman, among others, are critical. Truly, the unexpected and sudden demonetization has had a ‘knee jerk’ reaction on the level of economic activity. All the cash dependent consumption-led sectors such as retail, wholesale, jewellery, hospitals, healthcare, diagnostics, trading, restaurants, transport, logistics are severely affected.

In this perspective, the demonetization exercise may produce following short term or long term, consumption, investment, welfare, growth impact on Indian economy. The intensity of demonetization effects obviously depend upon the duration of the liquidity shocks. Following are the probable impacts of demonetization on Indian economy.

Probable decline in GDP growth:
Demonetization is not a gigantic catastrophe like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that upsets economic activities. The demonetization of the 500 rupee note and the 1,000 rupee note—the two highest currency denominations available in India—will probable hit the economy hard in the short term. Some economists opine that demonetization will unfavorably impact India’s economic growth even as others consider the disruption is unlikely to be significant. Some economists suspect that the government’s move to suck out 86% value of money in circulation by demonetizing Rs.500 and Rs.1,000 currency notes will unfavorably impact India’s economic growth, at least in the short run. Some others, however,
expect that the demonetization move, taken to weed out black money and counterfeit notes in circulation, will have modest effect on the economy.

Former chief statistician of India Pronab Sen said that with 86% of value of money in circulation, the economy will have to make do with only 14% of money in circulation at least for two weeks, until when there are restrictions on withdrawing money. The surprise move is expected to crush the consumption activity in the Indian economy to a virtual halt. The service sector, which dominates economic activity and involves a sizable chunk of cash transactions, will likely be hit the hardest. Growth in the Indian economy remained solid in the quarter from April to June 2016. In India, a financial year begins in April and ends in March of the following year. The previously mentioned quarter is the first quarter of fiscal 2016–2017. During that period, the GDP (gross domestic product) rose 7.1%, while the GVA (gross value added) rose 7.3%. GDP growth in the first quarter (April-June) slowed down to 7.1% from 7.5% during the same quarter a year ago and the slowdown is attributed to increase in subsidy payments by 53% which resulted in lower growth in indirect taxes. The government expects the GDP to grow at 8% in 2016-17 on the back of a bumper farm production due to normal monsoon. The informal sector accounting for around 40% of the economy which will be impacted the most, especially in rural India. This is expected to reduce GDP growth by one percentage point this year (2016-17).

Goldman Sachs slashed its forecast for India’s GDP growth to 6.8% for the current fiscal. Mumbai-based Ambit Capital was even more pessimistic, forecasting that India’s GDP would grow only by a meager 3.5% in the current fiscal. Deutsche Bank, too, cut its GDP growth forecast for India by 100 basis points to 6.5% in the current fiscal.

Impact on inflation in India:
Former chief statistician of India, Pronab Sen and N.R. Bhanumurthy, professor at the National Institute of Public Finance and Policy opine that demonetization will bring down inflation in the economy, though for different reasons. Sen is of the arguments that lower money supply will lead to a deflationary situation with too little money chasing too many goods. Bhanumurthy, on the other hand, explained that demonetization will play a positive role in curbing inflation in the medium term due to lower money supply as unaccounted money used in sectors like real estate and higher education will be taken out of the system.

The RBI (Reserve Bank of India) considers the CPI (consumer price index) as its primary gauge of measuring inflation. Prior to the RBI adopting the CPI in India, another measure of inflation—the WPI (wholesale price index)—was the key measure of inflation and it’s still considered for reference. The RBI has CPI growth targets to adhere to while deciding its monetary policy stance. By January 2016, it was supposed to keep inflation below a target of 6%, which it was able to do. Its next target is to keep inflation at or below the 5% mark by March 2017.

The demonetization that has been in effect since November 9 is expected to have a negative impact on inflation. Consumer spending activity fell to a near halt. Consumers are refraining from making any purchases...
except essential items from the consumer staples, healthcare, and energy segments. Activity in the real estate sector, which includes a lot of cash and undocumented transactions, slowed down significantly, Metropolitan and Tier 1 cities reported up to a 30% fall in house prices.

Food item inflation, measured by changes in the Consumer Food Price Index, accounts for 47.3% of the overall CPI. Due to 86.4% of the value of the currency notes in circulation going out of the financial system and re-monetization being slow, the supply and demand of food items fell. It will put forth more downward pressure on inflation.

Investors in India-focused funds should continue to monitor CPI inflation. It will determine future rate cuts by the RBI. A change in the repo rate will impact interest rate-sensitive sectors and industries like financials and automobiles, among other sectors like the tech sector.

Cut in the Repo Rate by RBI:
In its last policy meeting on October 4, 2016, the RBI’s (Reserve Bank of India) Monetary Policy Committee reduced the country’s repo rate by 25 basis points on October 4, 2016. The rate reduced 6.3% from the said date. The October meeting marked the second rate cut in 2016. The combined quantum of the cuts for the year stands at 50 basis. The repo rate, or repurchase option rate, is the key monetary policy rate for the RBI. It’s the rate at which the RBI lends to commercial banks. The reverse of the repo rate—the rate at which banks park money with the central bank—is known as the “reverse repo rate.” A change in the repo rate signals an increase or decrease in rates to commercial banks. Other rates, like the reverse repo rate and the MSF (marginal standing facility), are fixed against the repo rate. The rate impacts the movement of the rupee, which impacts the revenue of exporters and tech companies. It feeds into India-focused funds as well. With the announcement of demonetization and the subsequent impact on cash transactions and consumption, inflation will likely fall. Banks already started reducing their deposit rates. Lending rates are expected to fall as well. Due to the expected fall in inflation, the RBI will likely undertake more cuts in the repo rate. These rate cuts will aim to boost consumption. They will work to get the temporarily derailed economic growth back on track. A cut in interest rates boosts economic activity and raises hopes that after a lull for two to three quarters, economic growth will rise.

Decrease in Loan burden
After the demonetization announcement on November 8, 2016, Indian banks witnessed a mount in deposits. According to data from the Reserve Bank of India released on November 21, deposits crossed the 5 trillion rupee mark from November 10 until November 18. At 68.2 rupees to one US dollar, it translates to $75 billion in deposits in just eight banking days. Banks also saw a rise in term deposit accounts since the demonetization. Due to these factors, commercial banks like State Bank of India, ICICI Bank, HDFC Bank, and Punjab National Bank, among a host of others, sharply reduced their deposit rates.

Source: Adapted from Market Realist

Apart from cutting deposit rates, banks reduced their lending rates as well. In India, loans sanctioned from April 1 are with reference to the MCLR (Margin Cost of funds-based Lending Rate), instead of the Base Rate, which was used earlier. It will translate into lower interest rates on existing floating rate loans and new loans. The reduction in lending rates is expected to stoke lending by tempting consumers to take out loans for purchasing expensive consumer discretionary items like vehicles and houses.

India’s Financial Markets Fell due to Demonetization
Indian equity markets have shown falling trend since the government demonetized the 500 rupee and 1,000 rupee currency notes after midnight on November 8, 2016. 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 10 and November 22. While the Nifty 50 fell 6.3% from November 8 until November 22, the S&P BSE Sensex fell 5.9% during
the same period. Due to the rise in the US dollar, the dollar equivalents of the Sensex and the Nifty fell more than 8% each. The S&P BSE 100 Index, which is comprised of 100 stocks compared to the Sensex’s 30, fell 6.6% during this period. Mid and small-cap indices have been hit much harder than broader market indices. Even after a rise on November 22, the S&P BSE MidCap and the S&P BSE SmallCap indices fell 8.2% and 10.9%, respectively, in the previously mentioned period.

Since Nov. 08, the Sensex has fallen by around 5% while foreign portfolio investors (FPIs) withdrew some Rs37,300 crore in November, the highest since June 2013. FPIs had withdrawn Rs12,140 crore in October. “Foreign investors have pulled out funds from capital markets due to fears of (a) rate hike by the US Federal Reserve in December, uncertainty over US ties with emerging markets post (the) Donald Trump victory, and concerns over the the impact of demonetisation and GST on economic growth & corporate earnings,” the Centre for Monitoring Indian Economy (CMIE), a think tank which tracks business and economic data, said on Dec. 02.

Apart from concerns about demonetization, Donald Trump’s victory and concerns about his restrictive trade philosophy led to foreign investors pulling out of Indian equities. According to Bloomberg, foreign investors have net sold Indian equities worth $1.4 billion from November 9–17. 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. In general, Equities fall, but prospects are better.

**Short term liquidity crisis:**

Liquidity shock means people are not able to get adequate volume of popular denomination especially Rs 500. This currency shock is the favourite denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. The higher the amount 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 1600 mn Rs 500 notes were in circulation as on end March 2016. Some portion of this was filled by the new Rs 2000 notes. Towards end of March approximately 10000 million units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

But, the banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial inclusion. The existing white money of people will be known to the government and it will remain with banks so that it can be put on loan, and interest can be generated from it (though interest rates would fall) with a corresponding fall in Inflation. Further Banking System will get a boost up, as more than Rs 7-8 lac crore base money (new legal money) will enter the system. However, it needs to be seen how much money, in fact, remains in the system, once the cash withdrawal limits are eased.

**Welfare loss for the population using currency:**

Most active segments of the population who comprise the ‘base of the pyramid’ use 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 strictness will induce firms to diminish labour cost and thus reduces income to the poor working class. There will be a trickle up effect of the liquidity disorder to the higher income people with time.

**Consumption will expected to be affected:**

When liquidity deficiency strikes, it is consumption that is going to be unfavorably affected first.

Consumption ↓→ Production ↓→ Employment ↓→ Growth ↓→ Tax revenue ↓

**Effect expected 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 tricky 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 big 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. Major public sector banks like SBI, BOI etc as well as some private sector banks like Axis bank, HDFC bank have cut interest rate to the extent of 0.75% to 1% on loan and deposit.
Effect expected on hoarding of black money:  
It is a reality that black money is a parallel economy and almost everyone knows that real estate deals were highly shady before this move. One of the biggest benefits of this demonetization move is that it is going to significantly affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalized and prosecuted by the authorities. Black money stored in the form of Rs 500 and Rs 1000 notes will be taken out of the system. As predicted by ICICI Securities Primary Dealership, the government's plan to scrap Rs500 and Rs 1,000 notes will uncover up to Rs 4.6 lakh crore in black money. But, 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 depends 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 support will encourage government to come out with even strong measures.

Effect anticipated on counterfeit currency and Terror funding:
The actual impact will be on counterfeit/fake currency as its circulation will be checked after this exercise. Enemies of the country which are involved in counterfeit currency and terrorism will not be able to continue it further for quite some time at least. The smuggling of arms and dealing with the terrorist will not sustain further as all of the money will be on record now. Fake Indian Currency Notes (FICN) network will be dismantled by the demonetisation measures. Taking out 500 and 100 rupee notes out of circulation will have a lasting impact on the syndicates producing FICN's, thus affecting the funding of terror networks in Jammu and Kashmir, North-eastern states and maoist and naxalite hit states.

Reduction in tax avoidance in the long run:
Demonetisation measures will also reduce tax avoidance. Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this period. Dealing in this period in sectors like jewellery and real estate will be on radar and those entering into loan transactions may also undergo tax scrutiny. Search and Seizure activities of the IT department will also rise to restrain such malpractices. Limits have already been prescribed for reporting to the IT department those bank accounts in which excess cash deposits are being made in this 50-day window (Rs 2.5 lac in case of individuals and Rs 12.5 lac in case of firms).

Significant course correction in Real estate business:
The demonetization decision is expected to have far reaching effects on real estate. Resale transactions in the real estate sector often have a significant cash component as it reduces incidence of capital gains tax. Black money was responsible for sharp appreciation of properties in metros; real estate prices may now see a sharp drop up to 25-30% as is expected.

Political parties in catastrophe ahead of polls:
With nearly five state elections in 2017, demonetization has stunned political parties. Especially, in large states like Punjab and Uttar Pradesh, cash donations are a huge part of "election management". In one stroke, big parties will find themselves confined as cash hoards are often undeclared money. Parties will have to completely redesign campaign strategies in light of expected cash crunch.

Moving towards digital payments and new road to a new Digital India:
With this new policy people have started going cashless. Paytm and other similar apps are on the rise. Digital India has actually started working with people using such apps. It has reduced the risk and cost of cash handling as soft money is safer than hard money. The banking system will also improve rapidly with this. Therefore, demonetization will likely result in people adopting virtual wallets such as Paytm, Ola Money etc.: This behavioural change could be a game changer for India.

Temporary disorder and bewilderment:
Part of the problem with demonetization was that it came as a bolt from the blue; the government claimed that giving advance notice would have defeated its purpose. But not everyone agrees with that view. “There was no need for secrecy,” counters Jayati Ghosh, a professor of social sciences at Jawaharlal Nehru University. “All demonetizations through history have been done with some advance warning. This reduces the damage to innocent people. The government could monitor suspicious transactions after the announcement, just as it is doing now.

In true sense, public have faced temporary severe problems owing to the scarcity of lower denomination
notes in the system. The distributional system has not been working properly. The ATM networks have been hit by total disorder, while the central bank struggles to print replacement currency. Almost 60 deaths have been reported among people forming long lines at banks. Foreign tourists were caught unawares and basically do not have the time or patience to stand in line for long hours for minor sums of money. Business of wholesale and retail traders who deal mostly in cash has been horribly upset. The marginal small businesses are suffering the loss of monthly sales and income.

The government has announced that withdrawal through ATMs will be limited to Rs.2,000 per day up to 18 November and Rs.4,000 per day thereafter. Cash withdrawal from one’s bank account is also limited to Rs.10,000 per day and Rs.20,000 per week till 24 November. This will impact a large number of cash transactions which will have a multiplier effect on the economy. The liquidity squeeze caused by demonetisation will be negative across sectors with high level of cash transactions. Real estate, jewellery, retailing, restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space will be facing short term instability. Those companies with high level of debt will face more pressure and can face loan defaults.

Consumer goods sales are reported to have dropped by one-third. Trucks are at a standstill. Farmers have difficulty in buying seeds and fertilizer and selling crops and perishable produce. The fishing industry is close to collapse. Few villages have ATMs and having to walk into cities and wait in line for hours means the loss of daily wages as it does for the rickshaw drivers, street vendors, domestic workers and daily laborers in the cities. The construction industry has been roughly hit with significant wage implications for its casual workforce.

3. Conclusion
Demonetisation is certainly hampering the current Indian economy and will continue to do so in the near term and will also impact India’s growth for the coming two quarters but will have positive long lasting effects. The government will get a boost as a lot of legal money will enter the system. If the money is declared null and void and the corrupt have to deposit a bulky penalty, there is a lot of money being pumped into the system, it will generate heavy liquidity, this will be used to build roads, highways etc. moreover the money will ensure cheap loans for real estate construction. At the same time, a lot of jobs will be generated. Steel and other manufacturing sectors will see heavy growth. In the longer run, tax and interest rates on loans are expected to come down as higher income tax collections arising from better compliance would offer scope to reduce rates over the long term. This, in turn, will drive up disposable income. This can give a positive impact on consumption demand in long term.

Primarily, it is very tricky to build a cashless society as more than 50 percent of Indian population is not well versed with card transactions. Also for these initial months, it will be very difficult to make cash transactions of a higher amount. But the government is taking steps to improve liquidity into the system and reduce nuisance as much as possible. Further, the penal provisions should be heavy enough to ensure that corrupt practices will find it hard to take roots again. Despite certain short term troubles, demonetization is certainly going to give a boost to the Indian economy in the long run and we have to wait for another two to three quarter of the current financial year and witness how much money finally remains in the system.

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