

The Impacts of Demonetisation on Indian Economy

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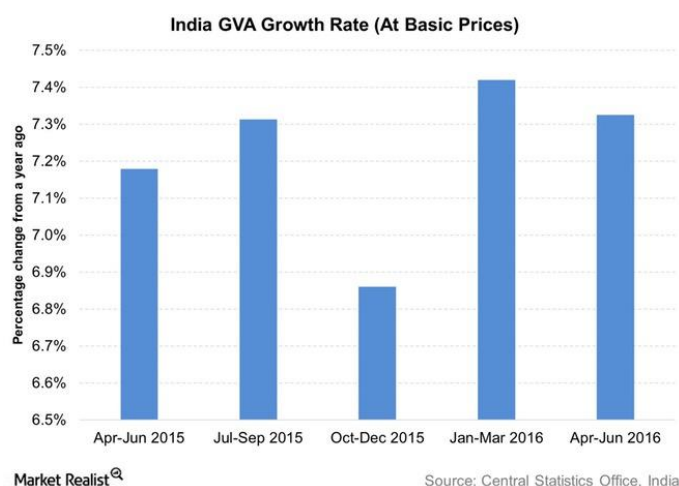
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Abstract: Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it.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 after Rs 100; 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. To begin with, demonetization has often been used a tool to cut down **hyper inflation**. We, on the contrary, were running smooth on Inflation and for that matter, were the fastest growing economy in the world. In last few days there has been quite a lot of debate on demonetization- one of the biggest criticisms being that the implementation has been quite poor and has caused a lot of inconvenience to the common man. While it is hard to say what exactly transpired in the corridors of power in the run up to demonitization, sure certain tradeoffs had to be made between keeping the secrecy of the mission vs. consulting all stakeholders and creating a full proof implementation plan.

(Key words: India's economic growth, Black Money, Counterfeit Currency, Sectoral Impacts, Cashless Economy)

I. Demonetization will hit the economy

The demonetization of the 500 rupee note and the 1,000 rupee note—the two highest currency denominations available in India—will likely hit the economy hard in the short term. The surprise move is expected to grind 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.



India's economic growth

Growth in the Indian economy remained solid in the quarter from April to June 2016 (the latest available). 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%.

The relationship between the GDP and GVA is:

$$\text{GDP} = \text{GVA} + \text{taxes on products} - \text{subsidies on products}$$

The base year for calculating the GVA is 2011–2012.

The fall in economic activity due to demonetization could last from two to three quarters. As a result, GDP and GVA growth in the quarters from September to December 2016 and January to March 2017 could be significantly lower than previous years. Some bounce back should be seen in the first quarter of fiscal 2017–2018. In the medium term, the Indian economy can grow considerably after curbing the debilitation caused by counterfeit money and an increase in economic activity.

II. The Impacts Of Demonetisation On Indian Economy

Demonetization 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.

Black money stored in the form of Rs 500 and Rs 1000 notes will be taken out of our system. As predicted by ICICI Securities Primary Dealership the government's plan to scrap ₹ 500 and ₹ 1,000 notes will uncover upto ₹ 4.6 lakh crore in black money.

There are three major types of Black money :-

1. **Money that is stashed in abroad** i.e tax havens like Panama
2. Money that is in the country but in **higher value currencies** i.e Dollar, pounds etc (Less in volume So easier to hide. Also, once you would sell them off you get inflation indexed prices). New 2000 currency will, on the contrary, help this lot because they will have to carry lesser volume of currency once they exchange.
3. Unaccounted money stashed under mattress or elsewhere to evade tax.
 - **1 and 2 are off course out of the ambit** of this move. Different sources claim that they are as much as 90% of the total black money. For a fair argument, let's just assume it to be somewhere around 85%. **So 15% of the total black money is in question here.**
 - Given the different unfair means prevalent, do you really think that the 15% of the total black money has been dumped in the garbage. ? Bank managers, gold sellers, etc are all involved in it. **This news for example will give you an idea.**
 - Calculate it all and you would reach to a conclusion that only a meagre percentage of the total black money has gone inoperative; possibly.

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 activities 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.

9. Terror funding

Fake Indian Currency Notes (FICN) network will be dismantled by the demonetisation measures. Taking out 500 and 1000 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 Naxalite hit states.

10. Real estate may see significant course correction

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.

11. Political parties in crisis 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 hamstrung as cash hoards are often undeclared money. Parties will have to completely rejig campaign strategies in light of expected cash crunch.

12. Moving towards digital payments

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.

13. Temporary chaos and confusion

Public will face minor problem for a few days owing to the scarcity of lower denomination notes in the system.

14. Economic Impact and Social Impact

There would be a big social inclusion in banking system, enabling them to avail banking services. The technology will simplify the banking transactions and bring banks to homes. Minimum wages would be paid. Currently unorganized sector including labors, and house maid are not paid minimum wages. The compulsory payment through banks would ensure that they are paid minimum wages.

15. Some of the sectoral impacts

While sectors with linkages to the unorganised economy are likely to be affected, technology and financial services are expected to gain in the medium to long term. On a sectoral basis, the commodities and agricultural sector, including the market for consumer durables and non-durables is expected to feel the heat. In the short to

medium-term, large denomination purchases will likely be made via electronic purchases rather than through brick and mortar outlets. This will impact the retail sector adversely.

The real estate sector is likely to see a significant negative impact in the medium- to long-term, particularly in the repurchase market. There are expectations of a revaluation of current real estate transactions across the board representing possible losses to players in the sector. The luxury goods market is also likely to get affected as this move represents an erosion of real wealth to a large number of people. Areas of sub-sectoral impact will be felt in luxury cars, SUVs, gems, jewellery, gold and high-end branded products.

On the positive side, there is likely to a reset of spending patterns as this move represents indirectly a significant push towards a cashless economy. Businesses in the fin-tech sector, including payment banks, mobile wallets, electronic transfer providers, etc., are expected to see gains.

Positives

E-commerce and Fintech

1. Payment gateways
2. Cards
3. Mobile wallets
4. Online retail
5. Net and payment banks
6. e-marketplace

Negatives

1. Agriculture
 2. Luxury goods
 3. Real Estate
 4. Commodities
 5. Traditional Retail
- 1) Consumer durables
 - 2) Consumer non-durables

III. Aside From Eliminating Black Money And Counterfeit Currency, One Of The Most Significant And Welcome Impacts Would Be This:

Cashless Economy

The gradual transition towards digitization and a cashless economy will definitely help curb corruption in the long run. The increased transparency and record of transactions will make it considerably difficult to hold black money and carry out under-the-table deals. The added convenience of using digital payment solutions and virtual wallets can't be ignored either. While virtual wallet firms like Paytm are going the extra mile to make things easy for everyday consumers and small vendors, solutions like Happay are working their way towards making business transactions go cashless. Automated expense reporting solutions, coupled with their Visa and MasterCard integrated credit cards, have gained significant traction over the past few days for their complete-food, travel, medical and ad-hoc, cashfree solutions. When the government is doing its part to curb corruption, switching to these cashless solutions is the least of the contributions we can make.

As most of the unaccounted wealth is particularly widespread in real estate sector, the central government's latest decision on note ban is expected to cause problems for developers. As there will be the liquidity stress on them, they may slow down the construction works and it would eventually increase the number of residential projects getting delayed on its completion. The government has pulled off arguably the most significant reform measure in its tenure. While this expeditious move to boldly counter the black money and parallel economy threat is likely to have significant repercussions, importantly, this effort will have a visible impact on how the current government's policies are perceived in international circles of economic power. Most of the macroeconomic impact will be felt in the short-term, though there are larger implications in the medium- to long-term.

IV. Conclusions

In last few days there has been quite a lot of debate on demonetization- one of the biggest criticisms being that the implementation has been quite poor and has caused a lot of inconvenience to the common man. While it is hard to say what exactly transpired in the corridors of power in the run up to demonitization, sure certain tradeoffs had to be made between keeping the secrecy of the mission vs. consulting all stakeholders and creating a full proof implementation plan.

