

Demonetisation: Impact on the Economy

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Abstract: *The argument posited in favour of demonetisation 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 remonetise. This paper elucidates the impact of such a move on the availability of credit, spending, level of activity and government finances.*

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

I. Introduction

The government has implemented a major change in the economic environment by demonetising 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 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 limits placed on the amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat. The reasons offered for demonetisation are two-fold: 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”.

II. 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 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.

Alternatively, to keep the flows going, people might take recourse to credit - both the retailers and other agents in the economy might make supplies on credit in the hope that when the liquidity status is corrected, the payments can be realised. In these cases, the price of commodities might rise instead of falling. 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.

Short-term effect with complete replacement:

The short-term effect on the economy would depend on the speed with which and the extent to which the cash is replaced by the authorities. If the entire cash is replaced within a short duration of time, the effects beyond the very short term of 1-2 months might be little. But a few sectors are likely to be seriously affected. To give an example from two sectors which are supposed to have large employment effect on the economy, we can talk about agriculture, automobiles and construction.

This is the sowing season for the Rabi crop in some parts of the country and the harvesting season for the Kharif crop. Most of the purchases and sales in this segment of the economy are carried out through cash. With the elimination of cash from the economy, sale of kharif crop would be difficult unless the crop is sold on the promise of payment in future. Given the limited bargaining power of the farmer, the price they can realise for the crop can be adversely affected. On the other hand, in the sowing activity, people would not get access to the inputs required since most of the inputs are now purchased from the market unless they seek access to credit from the supplier. In other words, with demonetisation, there would be a significant strengthening of the informal sector credit market in the rural economy. Further, if there are agents who do not get access to credit from the informal sector agents, their sowing activity and hence their incomes in the next season would be adversely affected. Thus, in spite of a good monsoon in large parts of the country, the farmer might not get the benefits.

The second sector which could be adversely affected would be the construction sector. The sector, it is often argued, works with a significant amount of cash. Payments to workers as well as a variety of purchases might be carried out in cash. So, on the supply side, this sector can be adversely affected.

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.

III. Transition Issues

There are a number of transition issues that need to be managed for this transition to be effective:

1. **Infrastructure Issues:** There is need for a significant upgrade of the banking system as well as in the telecom infrastructure that would provide the backbone for digital transactions. For people to be able to transact at any time and place as well as for them to consider it a reliable medium of exchange, it is important that not only the banking system is upgraded to ensure that transactions can be completed without a hitch, but the supporting infrastructure too is up to the mark.
2. **Consumer behaviour Issues:** Apart from the technological issues, there is a behavioural change that is being expected in people from using cash as a medium of exchange to using other cash substitutes both for making payments and receiving payments. This transition requires individuals to make two changes in their behaviour: one, agents need to move from tangible means which can be seen and felt to forms which are less tangible or not tangible, and second, they have to learn to rely on technologically advanced tools to undertake regular day to day operations.
3. **Accessibility in language:** In addition to all of the above, most of the banks and the mobile instruments for transaction are currently adapted to a single to two languages. If the bulk of the population of this country needs to come on board, it might be important to make these facilities available in a myriad of Indian languages to ensure that the user can comprehend the transaction that they are entering into.
4. **Transition issues for banking sector:** There are multiple issues here.
 - a. The banks too might have a transition issue to deal with. Banks would have a model of the fraction of deposits that they can safely lend without an excessive risk of withdrawal of the amount. This is important since, while banks can borrow money from the call money market, the costs of such borrowings can be large. These models, however, might need to be altered in the new regime since the character of the new deposits that come into the bank would be different from the pre-existing deposits.
 - b. Second, while 1/reserve ratio defines the potential maximum amount of credit that can be generated in the economy, the actual credit generation would be defined both by the demand for credit and the extent to which cash intervenes in the functioning of the economy. For instance, if people who receive credit from the bank make payments through cheques alone and they in turn make payments through cheques, then the potential credit creation can be realised. However, if on receipt of payment, the agent

withdraws the money to cash and makes payments, only a fraction of the credit/deposit will return to the banking system.

- c. A third issue that might arise as a transition issue is because of the mismatch between people's preferences for cash and the availability of cash. In the interim, until people adjust to the use of non-cash instruments, there would be an increased demand for the cash that is available and that might generate a situation where the agents have to pay a premium to access legal tender. In periods of scarcity of coins for instance, it is commonly known that people pay a premium to get the change.

IV. Mode of payment and spending behaviour

There is growing literature that points out to the possibility of changes in spending behaviour as a result of moving to instruments other than cash. There are many substitutes for cash in the modern economy ranging from cheques, debit cards, pre-paid cards, credit cards and mobile wallets. We summarise the results of some of these studies which compare the behaviour of consumers using alternative instruments as follows:

- a. In a comparison of debit cards with cash, studies suggest that with the use of debit cards, the level of consumption tends to be higher.
- b. In a comparison of credit cards with cash, this effect is more pronounced.
- c. Credit cards often are associated with more spending resulting in an increase in debt as well.
- d. Further, spending with cards seems to encourage spending on non-essentials.

These changes in consumer behaviour can have long-term consequences on the economy as well as on the budgets and lifestyles and priorities of agents in the economy.

V. 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. 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. With increase in GDP, since imports are supposed to be related to the size of the economy, it is expected that imports will rise, but the same cannot be said about exports. In other words, the balance of trade could worsen. This could result in pressures on the rupee towards depreciation. Any increase in inflationary pressures too could augment these pressures.

Alternatives to currency: would they evolve in the face of demonetisation?

A number of agents in the economy would be required to move from the informal sector to the formal sector. For these agents as well as for agents who have been operating through the medium of cash and find the transition difficult, certain informal cash substitutes might emerge. For instance, even at present, there are coupons like the SODEXO coupons which are used for paying for certain purchases. These are accepted by a range of establishments in place of formal currency. It is, therefore, possible to see an expanded use of these coupons. The change might induce the generation of other tokens as substitutes for money as well - the agency collecting MCD's green tax has started issuing tokens in place of change. Similarly, for high value transactions one can think of bitcoins and other such crypto currencies on one side and foreign exchange on the other as a mechanism for settling transactions. Perhaps these would not take on a dimension large enough to challenge the official currency, but it can disturb the expectation that the unaccounted economy would be brought into the formal sector since there might exist alternatives to the formal currency. Here it is important to explore the possibility and acceptability of peer to peer payment instruments – a category which has been evolving in recent times.

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 seigniorage 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 seigniorage to the RBI once again when released into circulation. 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.

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.

VI. Conclusions

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. 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.

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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