Effect of Demonetization in India (An Analytical Review)

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Abstract - The Government of India declared on 8 Nov.2016 that the five hundred and one thousand rupee notes would no longer be legal tender from midnight, 8th November 2016. The RBI issued Two thousand rupee notes and new notes of Five hundred rupees which would be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. This measure has been taken by the PM is an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. This paper is giving an analytical review over demonetization and studying the effects of it in India with indication some valuable suggestions.

Keywords: ***Demonetization, Legal Tender, black money, 8 Nov.2016.***

I. INTRODUCTION

The move by the government to demonetize Rs.500 and Rs.1000 notes by replacing them with new Rs.500 and Rs.2000 notes has taken the country with surprise. The move by the government is to tackle the menace of black money, corruption, terror funding and fake currency. From a market perspective, we think that this is a very welcome move by the government and which has taken the black money hoarders with surprise.

The total value of old Rs.500 and Rs.1000 notes in the circulation is to the tune of Rs.14.2 trillion, which is about 85% of the total value of currency in circulation. This means that the total cash has to now pass though the formal banking channels to get legitimacy. The World Bank in July, 2010 estimated the size of the shadow economy for India at 20.7% of the Gross Domestic Product (GDP) in 1999 and rising to 23.2% in 2007. Assuming that this figure has not risen since then (quite unlikely though) and that the cash component of the shadow economy is also proportional (it could be higher), the estimated unaccounted value of the currency could be to the tune of Rs.3.3 trillion.

Now, post the announcement of demonetization by the government this money would have to either accounted for by paying the relevant tax and penalties or would get extinguished. There are higher chances of larger proportion of this unaccounted currency getting extinguished as the tax rate and subsequent legal issues could be prohibitively high for such money.

In an important move, the Government of India declared on 8 Nov.2016 that the five hundred and one thousand rupee notes would no longer be legal tender from midnight, 8th November 2016. The RBI issued Two thousand rupee notes and new notes of Five hundred rupees which would be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. This measure has been taken by the PM is an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same.

II. VARIOUS EFFECT OF DEMONETIZATION

In this report the effects of demonetization have been highlighted the probable consequences of this decision on various economic variables and entities.

(1) Effect on parallel economy

The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee Notes is expected to

- remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks,

- Temporarily stall the circulation of large volume of counterfeit currency and

- curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

(2) Effect on Money Supply

With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to reduce in the short run. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money and hence money supply will decrease permanently. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.

(3) Effect on Demand

The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly:

- Consumer goods
- Real Estate and Property
- Gold and luxury goods
- Automobiles (only to a certain limit)

All these mentioned sectors are expected to face certain moderation in demand from the consumer side, owing to the significant amount of cash transactions involved in these sectors.

(4) Effect on Prices

Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

- Consumer goods: Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
- Real Estate and Property: Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheque transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices (probably charging more on cheque payment).

(5) Effect on various economic entities

With cash transaction lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- Agriculture and related sector
- Small traders
- SME
- Services Sector
- Households
- Political Parties
- Professionals like doctor, carpenter, utility service providers, etc.
- Retail outlets

The nature, frequency and amounts of the commercial transactions involved with these sections of the economy necessitate cash transactions on more frequent basis. Thus, these segments are expected to have the most significant impact post this demonetization process and the introduction of new notes in circulation.

(6) Effect on GDP

The GDP formation could be impacted by this measure, with reduction in the consumption demand. However with the recent rise in festival demand is expected to offset this fall in overall impact. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and re-enter the stream once the cash situation becomes normal.

(7) Effect on Banks

As directed by the Government, the 500 and 1000 Rupee notes which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there would be withdrawals at the second stage.

8) Effect on Online Transactions and alternative modes of payment:

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increase in demand. This should eventually lead to strengthening of such systems and the infrastructure required.

III. CONCLUSION

Although the motives behind the demonetization were framed and claimed by the Government as:

- In spite of the initial hiccups and disruptions in the system, eventually this change will be well assimilated and will prove positive for the economy in the long run.
- Black money hoarders will definitely lose out, eventually boosting the formal economy in the long run.
- Short term fall in real estate prices might benefit middle class citizens.
- This move by the Government along with the implementation of the GST will eventually make the system more accountable and efficient.

Some ground reality effects of the demonetization measure may be concluded as :

(a) The total currency in circulation as on Oct 28, 2016 was INR 17.54 lakh crores. According to the Reserve Bank of India (RBI), 86% of this component is in currency notes of INR 500 and INR 1000 denomination. Therefore, the currency that is being attempted to be demonetized is around Rs. 15 lakh crores. It is being estimated (internal estimates) that around 20% of this currency is in black. It may be believed that this money either will not come back into the system for exchange for new notes or will be surrendered as black money and taxes thereon will be paid.

(b) The deposit of these notes with the Commercial Banks ends on December 30th, 2016. Thereafter, currency notes will have to be deposited with RBI till Mar 31st, 2017. It may be believed that after this date, the RBI will reduce Notes in Circulation to the extent of the money not deposited. To match its liability, it will have to reduce it asset or increase its liability. Increasing its liability would mean increase in its Net Non- Monetary Liabilities (or reserves) and declare special dividend (just an accounting entry) to the Government. The Government, in turn can reduce its bonds on the RBI's balance sheet by buying its bonds back from the reserves transferred by the RBI. The government will have multiple options about what it could to do with this special dividend. It may reduce domestic outstanding debt, prepay external debt, reduce fiscal deficit as interest cost drops, and reduce its borrowing for following years. Improvement in debt/Gross Domestic Product (GDP) ratio should also help improve the country's sovereign rating by the International Agencies. RBI's balance sheet also frees up for supporting liquidity requirements of the banking system**.**

(c) On the other hand, the banking sector is going to see a surge of liquidity as deposits get collected. Based on our assumption (internal estimates) that (20% of currency will not be tendered back), there is going to be tendering of currency from the public to the tune of Rs. 12 lakh crores (80% of Rs. 15 lakh crores). Due to the temporary restrictions on withdrawing cash, our internal estimate is that at least 50% of the cash will remain within the banking system, i.e. of Rs. 6 lakh crores. This sudden surge in deposit of 6% of current aggregate deposits will help in improvement of liquidity. This will lead to demand for fixed income securities, particularly government securities.

(d) According to a World Bank estimate in 2007, around 20-25 % of India's GDP is the size of the parallel black economy. The steps taken by the Indian Government has led to a scare in the parallel black economy and should lead to better tax compliance going ahead. This will have a telling effect on the other heavens of black money i.e. real estate and gold. Both these sectors are going to witness reduced demand. Lower demand for gold resulting ultimately in lower import of gold is expected to improve the current account balances. The Indian rupee should remain stable and display appreciating bias against hard currencies, as the current account improves and may

also move into surplus.

(e) The sudden change due to reduced cash transaction will lead to reduction in economic activity. We believe that the services sector growth will be majorly affected. This will lead to lowering of inflation expectation and moderation of headline inflation too. However, the effect on inflation would depend on the moderation in economic activity in those sectors that have heavy cash transactions. RBI will find larger room to reduce repo rates with moderation in inflation.

(f) There are some other positives expected over the medium to long term. A more compliant economy should increase tax collections and tax to GDP ratio should improve from both direct and indirect tax. In future, an increase in use of plastic money rather than hard currency would also lead to higher money multiplier which will be more productive. To sum up, the fight against corruption, terror funding, counterfeit currency and the black economy should result in positive way and some other effects may be:

- Increased systemic liquidity leading to higher demand for bonds
- Rate reductions due to lower inflation and inflationary expectations
- Stable to appreciating INR as Current account deficit improves due to lower demand for gold
- Higher tax would help GDP by other ways.
- RBI freeing up balance sheet as liability declines
- Government would be able to bring down its outstanding debt liability and improve fiscal deficit
- Immediate near term impact – decline in cash transactions may lead to reduction in consumption demand leading to some decline in the GDP growth.

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