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IMPACTS OF DEMONETISATION ON INDIAN ECONOMY

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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 Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it.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. The recently released Annual Report of the Reserve Bank of India for 2017-18 has revealed that 99.3 per cent of the high denomination notes were returned to the banking system. In other words, only about 0.7 per cent of the value may have been "extinguished" — this is the fraction that was being attributed to unaccounted incomes, if at all. This number should be taken with a pinch of salt, since for one, countries like Nepal and Bhutan where Indian currency has served as a proxy currency, are reportedly requesting for a facility to exchange notes held by their citizens.

Key Words: Demonetization, Counted Income, Efficiency, Welfare Loss.

INTRODUCTION

DeMo does not seem to have impacted black money hoards. It may, however, lead to improved tax compliance in the long run. Further, anecdotal evidence seems to suggest that citizens within the country could be holding some balances as well since they couldn't exchange the said amounts for a variety of reasons. Since the latter cannot be considered to be manifestation of unaccounted incomes, clearly, demonetization as a means to dry up unaccounted wealth held in stocks of currency cannot be said to have yielded immediate results.

There has been considerable discussion on the likely impact of demonetization on a range of parameters such as growth in the economy, compliance with tax regimes, and impact on the informal economy, to take only the economic factors. It is possible to argue that while the direct impact of demonetization through currency not returning to the banking system did not play itself out, the measure could have had some indirect impact through improvement in compliance for income tax.

The government move to demonetize 86 per cent of the total currency in circulation has been the biggest currency replacement in the history of Indian monetary system. The merits and demerits of demonetization with regard to desirable objectives of the government such as reduction of black money, corruption, and fake currency notes are still debated.

Demonetization is like a bad dream etched in our memories. Weddings were postponed and medical treatment was curtailed for lack of money. Long queues formed outside banks. Small businesses closed due to lack of working capital and their workers returned to their villages. Indians who never generated black money was the worst affected. Yet, the narrative that demonetisation would destroy the wealth of the corrupt was widely accepted.

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.

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.

1.Liquidity crunch: 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 presses 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 was 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.

2. Welfare loss for the currency using population: Most active segments of the population who constitute 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 stringency will compel firms to reduce labor 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.

3. 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 ↓

4. 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.

5. **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 takes 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.

6. **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 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.

7. **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 immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

GROWTH IMPACT:
Growth rate for the first quarter of the financial year 2017-18 dropped to 5.4 per cent. It is interesting to see what the expenditure side of GDP reveals. There appears to have been considerable increase in the expenditure on valuables during this period.

Such spending does not contribute to expansion in productive capacities in the economy, nor does it result in expansion in demand for other sectors in the economy. If one excludes expenditure on valuables from the calculations, the rate of growth of rest of GDP falls further to 4.1 per cent. Even in the next quarter, the rate of growth without valuables is lower at 5.7 per cent as compared to 6.3 per cent with valuables. In other words, the immediate impact is a reduction in growth with the recovery led by government expenditure.

The second expected economic impact was a boost to the use of financial substitutes of currency as well as a shift from physical savings to financial savings. The Annual Report of the RBI for 2017-18 suggests that net financial savings of households as a percentage of gross national disposable income had declined in 2016-17 to 6.7 per cent when compared to 8.1 per cent in the previous year. For 2017-18, it has increased to 7.1 per cent which is barely on par with the levels reached in the earlier years of this decade. The surge in the use of cash to exceed pre-demonetisation levels suggests that comfort in cash based transactions continues to persist.

FORMALISATION PUSH

Second, formalisation of the economy as measured by the share of transactions on which taxes are paid should have received a boost. Unfortunately, we do not have evidence on this aspect of the economy, since the methodology of measurement of GDP only measures the formal sector and attributes the same growth to the informal component of the economy. Formalisation should have led to an expansion in the formal component at a cost to the informal component.

The effect on credit implied a decline of 2 percentage points or more in the fourth quarter of 2016, the paper said. “The slow replacement of notes led to a decline in currency, it did not affect the overall size of the RBI’s balance sheet or market interest rates,” the study noted. Recently last month, India’s GDP (gross domestic product) grew at a rate of 7.1 per cent for the second-quarter (July-September) of the financial year 2018-2019. The GDP growth rate in the second quarter was higher as compared to Q2 FY18 GDP growth rate of 6.3 per cent but was lower on sequential basis as in the Q1 FY19, Indian GDP grew at 8.2 per cent.

This was because of the misperception that ‘black means cash’. If cash was squeezed out, the black economy would disappear at one stroke – justice being meted out to the corrupt. The Prime Minister said that for long-term gain one had to bear short-term pain. He likened it to ‘*ahuti*’ in a ‘*yagya*’. If the pain does not end in 50 days, Modi said, the public could give him any punishment and he would accept it.

Two years later, the pain persists but the government only continues to justify its error. It has refused to admit to the long-term damage to the economy, especially to marginalized Indians in the unorganized sectors. Instead, data from the organized sector is used to claim that the economy has recovered to a 7-8% rate of growth. This is treated as evidence that the pain was temporary.

The government did not survey the unorganized sectors to find out what was happening there. The underlying assumption is that the shock to the economy did not require a change in the old methodology for calculating growth. In that methodology, the organized sector is more or less the proxy for the unorganized sector. But the shock to the economy changed the ratio between the organized and the unorganized sectors. So, the ratio used prior to November 7, 2016, was no more valid after November 8, 2016.

METHODOLOGY

Data from private surveys showed that the unorganized sector was hit hard. Surveys were conducted by Punjab Haryana Delhi Chamber of Commerce and Industry (PHDCCI), All India Manufacturers Organization (AIMO), State Bank of India (SBI) and many others including NGOs. The RBI survey released in March 2017 showed a sharp decline in deremand for consumer durables and so on.
Agriculture faced a crisis due to notes shortage. Produce could not be sold, the sowing of crops was delayed and the demand for the perishables like vegetables collapsed. Prices fell sharply, thereby impacting incomes of farmers. Banking also went into a crisis since normal banking operations stopped for months. With industry, trade and agriculture facing a crisis, the problem of NPAs only increased.

According to the Centre for Monitoring of Indian Economy (CMIE), investment fell sharply during that quarter. In effect, output, employment and investment declined, sending the economy into a tailspin from which it has not yet recovered. The impact of the goods and services tax (GST) from June-July 2017 again impacted the unorganized sectors and deepened the crisis. So, now the twin impact of demonetization and GST is being felt in the economy. If the method of measuring quarterly growth of the economy is modified to take into account the decline in the unorganized sector (about 45% of GDP), the rate of growth would turn out to be less than 1% – what a crisis in an economy that was running well till October 2016.

Institutions like the RBI were damaged. Farmers, traders, workers and the young have been agitating. The government, sensing failure, has turned more authoritarian. The roots of the current problems with RBI are also contained in the impact of demonetization. It was believed that Rs 3 to 4 lakh crore would not return and would become available to the government to give to the poor. Since this did not happen, now a dividend is sought from RBI out of its reserves.

Many identified the impact of demonetization with a note shortage only. By the end of April 2017, 80% of the currency had come back into circulation and now it exceeds the amount on November 8, 2016. The impact was not just the shortage of currency in circulation, but via difficulties in transactions on the economy as a whole. It hit output, employment and investment, which will all have a long lasting impact.

All the demonetized notes were returned so little black money was squeezed out of the system. Black wealth held in the form of currency has got converted to new notes. People were being caught with lots of new currency. No one saw any rich people standing in the queues. They used various devices like Jan Dhan accounts, money mules and cash in hand to convert money.

Many saw demonetization as a political move to eliminate the black money hoard held by the opposition before the Uttar Pradesh assembly elections. But the main reason was the constant attack by the opposition that the promised Rs 15 lakh per family had not materialized and it was just a '*chunavi jumla*'. The government's steps to tackle the black economy such as the setting up of a SIT, the foreign money bill, Benami bill, etc., had yielded little results. The party in power needed a big bang and demonetization was that step.

There are many misconceptions about the black economy. For instance, the promise to give every family Rs 15 lakh was based on the idea that all the black money is outside and can be easily brought back (within a month). If this was correct, demonetization could not have worked because it has no impact on the black money held abroad. Further, only 10% of the black incomes generated annually go abroad and are partly round-tripped back. So, the bulk of it is here.

Another mistaken belief is that black incomes are generated in the informal sector. In a change of goal posts, it was argued that demonetization will lead to the digitalization of the economy and to formalization which would check the black economy.

But most incomes of this sector are way below the taxable limit. Black incomes are generated by only a few in this sector, like a well-off *dhabawallah* or a trader. Most black incomes are generated in the organized and formalized sectors, using under- and over-invoicing. If some from the informal sectors get formalized they would also resort to the same devices to generate black incomes.

Since all the money has come back into the banks, in another spin, the government has argued that a paper trail is now available to track those generating black incomes. To support this argument, data is cited on the increase in direct tax collection and the number of taxpayers. Given the expansion of the organized sectors at the expense of the unorganized and the rising disparities, this is to be expected. Further, the number of direct tax payers has increased due to the implementation of the Seventh Pay Commission award.

However, the rise in tax collection is not commensurate with the increase in numbers. But this is nothing new. In the past also, a large number of those filing returns have either declared nil income or declared very low incomes. It is reported that tax officers have been given targets and they are forcing businesses to declare incomes. This will not last and there are complaints of selective tax terrorism. Possibly this is the reason that the number of millionaires leaving the country is rising rapidly.

In brief, the shortage of notes was painful and faded away slowly but its long term implications are playing out. Inadequate demand from the unorganized sectors which were hit hard, deterioration of the investment climate and the inadequate employment generation has meant that the crisis continues even today.

IMPACT OF CURRENCY DEMONETISATION ON THE INDIAN ECONOMY

India's GDP which grew at 7.6% in FY 2015-16 is likely to **slow down by 0.5% to 1.5%** as per reports of various agencies. This is is due to less availability of cash in **cash-intensive sectors like manufacturing and real estate**. Even the automobile industry which was growing rapidly earlier has seen a contraction in the October-December quarter of 2016. Purchasing power of consumers has been negatively affected due to cash not being readily available.

Banks have also been focusing on the single task of deposit and withdrawals with the result that their **core function of issuing loans has been adversely affected**. Also current account customers, who are largely business owners, need large amounts of cash at short notice have not been able to access cash and credit owing to restrictions on withdrawals and inability of banks to focus on the task of issuing loans.

On Tax Compliance

India's **tax-to-GDP ratio is quite low at 16.6%** compared to other emerging economies. It is estimated that since more money, including black money, gets accounted for this will lead to **better tax compliance** owing to better targeting of income. The positive impact could be **lower tax rates as the tax base widens** and more people start paying taxes. The digital push of the government will also result in **higher indirect tax revenue** for the govt. in the form of service tax. Moreover businesses that under-reported their revenue earlier, will have to make proper disclosure, especially, of revenue received through digital or cashless means.

ON SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs)

The small and medium-sized enterprise (SME) sector, as we understand, is a big chunk of the economy, contributing to eight percent of the GDP whilst employing more than 80 million people year on year. The labour wages in this sector are largely paid in cash and **wages have been adversely affected** by the demonetization move. Unemployment has also been reported owing to decline in demand of SME goods as the purchasing power of the consumers has contracted in the short term. Other sectors within the SME space like **restaurants and transport operators have also been negatively impacted** since economic activity has declined and also due to the fact that there is high tendency in this segment to accept payments through cash only.

ON AGRICULTURE

This is one sector where all transactions are in cash and, given the values involved, involve the higher denomination notes. The withdrawal of the old currency notes has put **pressure on the mandis**; farmers are having problems in selling their produce as both the parties have to agree on the mode of payment. Also since there is acute shortage of Rs 500 denomination notes presently, **change for the high denomination Rs 2000 notes is not readily** available with the vegetable and fruit vendors. This is also taking the buyers away from these vendors to big retail markets thus impacting the livelihood of the unorganized sector.

ON EMPLOYMENT GENERATION

Since consumer demand has slowed and consequently industrial production has declined, **employment generation has been adversely impacted** by the currency demonetization drive. Since the manufacturing sector which accounts for the highest employment of skilled and semi-skilled labourers, is witnessing slowdown in production; not only less jobs are being created but lay-offs are also taking place at a higher rate.

As per this report, Industry is staring at temporary job losses due to demonetization, as production gets hit, especially in labour-intensive sectors like textiles, garments, leather and jewellery. As many as 4 lakh people, mostly daily wagers, may have either lost their jobs or shunned work temporarily due to the lack of payment so far, and the number is only going to grow if the cash crunch persists.

However there have also been some positive impacts like one time **removal of counterfeit or fake currency from the economic system**. Some people argue that since black money has reduced, prices of black money intensive sectors like real estate and gold jewellery will go down. This remains to be seen. But demonetization cannot and will not prevent future generation of black money since black money problem is more of a cultural mindset in India than a legal problem. A total of **Rs 3185 crores in black money of which Rs 86 crores in new notes** has been seized by the Income Tax authorities since the launch of the demonetization drive on 8th November. This implies that on the one hand black money is getting unearthed and on the other **leakage of new currency notes is taking place**; most probably through the banking system itself.

COUNTERFEIT NOTES

The menace of counterfeit notes was one of the reasons for the demonetisation exercise in 2016. It was stated by the govt. that demonetization will solve or at least drastically reduce the number of counterfeit notes in circulation. As per RBI data, 5,22,783 fake notes were detected in 2016-17. This decreased to 522,783 in 2017-18, a fall of 31%. So surely there has been some reduction in counterfeit currency in circulation. But the very fact that demonetisation could only reduce fake notes by 31% and not wipe it entirely and also the fact that as total currency in circulation increases, more counterfeit currency is likely to be detected in the coming years, **fake currency is a menace which cannot be tackled by demonetization alone**.

There is no doubt that **demonetization, along with GST, has helped in the formalization of the economy**. The Finance Ministry has said the there has been an increase of 24.5% in the number of tax returns filed till August 2018 as compared to the previous year. The Tax-to-GDP ratio (which measures the tax revenue relative to the GDP) has also increased from 10.6% in 2015-16 to 11.6% in 2017-18. But a mere increase in the number of taxpayers does not translate into increased taxes since the majority of the citizens filing their returns for the first time have filed Nil returns.

DIGITAL TRANSACTIONS

As mentioned earlier in this article adoption of digital transactions was not one of the original objectives of demonetization. It was added only later as an afterthought. Let us analyse the growth in digital transactions in India before and after demonetization from the following RBI data. As can be seen from the above chart digital transactions were already growing at a very high pace of 200-300% year on year before November 2016. Demonetization helped to temporarily increase the growth of card PoS (debit and credit card point of sale) transactions from 50% to 150% in a very short period. But this growth in 2018 is now backing to its average growth rate. In fact, the growth in mobile wallet and mobile banking transactions even turned negative at the end of 2017 and have only recently picked up the pace again. So it can be safely summarized that digital transactions have been steadily increasing much earlier than demonetization of November 2016 and there has been almost negligible impact on its growth owing to demonetization exclusively.

CONCLUSION

Demonetization of old currency notes surely has had **some positive impact** like reducing the cash flow to terror organizations, dismantling of counterfeit currency infrastructure to some extent, better income tax and indirect taxation, boost to digital economy. However, it has come at a huge social and economic cost. Demonetization costs are estimated at Rs 1.28 lakh crore to the economy for the 50-day time period till the end of depositing period of old currency. This includes a cost of Rs 17,000 crore towards the government and the RBI for implementing the demonetization process in India.

Demonetization was a one-time event and after two years, it can be said, its effect has been transitory**. It alone is not sufficient to counter black money and corruption in the** country; rather other measures are more crucial like bringing the offshore tax evaders to book whose names figure in the Panama papers, raid on benami properties, making donations to political parties open to public scrutiny and making it mandatory for all donations above Rs 2000 to political parties and religious places to be through digital means only.

This entire exercise seemed more like a **carpet bombing than a surgical strike** where the vast majority of honest and law abiding citizens had to undergo terrible hardships in order to catch the few black sheep who have hoarded black money and who also managed to convert their black income into white.

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