Demonetisation and Its Impact on the Indian Economy

Dr.K.Bhavana Raj
Assistant Professor – Finance & Banking, Department of Management Studies,
KL University Hyderabad (KLUH), RVS Nagar, Aziz Nagar (PO), Moinabad Road,
Hyderabad, R.R. Dist. – 500 075, Telangana, India. Ph: +91-9959509996
Corresponding author: E-mail: bhavana_raj_83@yahoo.com, bhavanaraj_612@yahoo.com

Abstract: This research paper tries to gauge the impact of Demonetisation on the Indian Economy. It is basically the art of stripping a currency unit of its status as a legal tender. This is not a novel concept, neither to India nor to the World. In U.S (United States), The Coinage Act of 1873 demonetised silver as a legal tender to create a favourable environment for adopting The Gold Standard. In India, It happened first in 1946 when all the Rs 1,000 and Rs 10,000 notes were recalled for and then again in 1978 when all the Rs 1,000, Rs 5,000 and Rs 10,000 notes were demonetized. The current denominations are pulled from the circulation, retired and often replaced with new currency denominations. The reason behind a nation doing away with the local units of currency could be for trade facilitations, to curb inflation, to fight against corruption, crime, counterfeiting and tax evasions, and finally persuade for a cash-independent economy, if possible for a ‘cashless economy’ keeping in mind the geo-physical, socio-economic and techno-political constraints. Post demonetisation the BSE SENSEX and NIFTY 50 stock indices fell over 6 (six) percent. The following days, India faced acute cash crunch with detrimental effects on the Economy. Surprisingly, the Indian Economy grew by 7% in Q4 (Fourth Quarter) of 2016 despite the unexpected currency ban on 8th November, 2016 which affected 86% of all the currency in circulation, 99% of the banned currency had been deposited back in the Banks and only Rs 14,000 crores of the total demonetised currency has not been accounted for. The immediate effect of this operation didn’t affect the GDP (Gross Domestic Product) but has greatly influenced some of the indicators like economic fluctuations, investor’s sentiment, and sale of goods or services. This paper tries to provide the impending impact of Demonetisation on various sectors.

Keywords: Demonetisation, currency ban, legal tender, cash crunch, denomination, Indian Economy.

JEL Classification: E00,E50,E60,G02,G30,H30,M10,M20,N10,N20.

I. Introduction

The banning of Rs 1000 and Rs 500 currency notes on 8th November 2016 was the result of finding 1.25 lakh crores black money in the system. Within 3 (three) days of that striking decision Rs 35,000 crores were deposited in the Banks and approximately Rs 1500 crores of black money has been destroyed. The currency notes valued to Rs 16.42 trn by 31st March 2016 as per RBI’s (Reserve Bank of India) Annual Report of April 2015 – March 2016. The banned currency, by value amounted to 86.4% of the currency in circulation and by volume formed to 24.4% of total 90.27 bn. As of March 2016, RBI data disclosed that 6, 32,926 currency notes were counterfeit which were termed as FICN (Fake Indian Currency Note). The proportion of NIC (Notes in Circulation), of Rs 1,000 and Rs 500 notes were the highest thereby nullifying the FICNs was also a part of the Demonetisation stir. The Indian Economy can be broadly categorised in to three segments such as the Agriculture Sector, the Manufacturing Sector and the Services sector where in all these sectors have a massive contribution to the Indian GDP (Gross Domestic Product). The Agriculture Sector contributes to 17% of GDP, the Manufacturing Sector contributes to 30% of GDP and the Services Sector contributes to 53% of GDP.

Post Demonetization all these three sectors faced negative impact but surprisingly the Indian Economy grew by 7% in Q4 (the Fourth Quarter) of 2016. Indicators like economic sentiments and vehicles sales showed as rebound post the Demonetisation process but the initial slump was not evident in the GDP headline figure. One more evidence was the informal sector which suffered trauma of the Demonetisation operation as they were highly dependent on cash and were under-represented in the nation’s accounts. There is still a huge gap between the former and the current liquidity levels and the negative effects may reveal in further revisions of GDP or when more reliable data on informal sector shall be released coming year. As of now, based on the forecasts the Indian Economy is expected to grow by 5.5% in the FY 2016-2017 and 8.1% in the FY 2017-2018.
Demonetisation and Its Impact on the Indian Economy

China and India’s ratings have been very inconsistent since there was uncertainty and anxiety in the economy due to surge in job growth. There has been a dramatic reduction in the cash supply but there was also a tremendous increase in the amount of bank deposits there by reducing the lending rates and G-sec (Government Securities) rates.

Figure 1: DEMONETISATION: Unusual. Currency declined sharply BUT deposits too increased sharply hence hard to estimate impact.  Source: RBI

Figure 2: Credit/GDP and GDP growth for China and India and their S&P (Standard & Poor) ratings  Source: RBI
Table 1: Long-term and short-term impact on various sectors

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Sector</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Effect as on 31st December 2016</td>
</tr>
<tr>
<td>1</td>
<td>Money rates</td>
<td>Cash declined whereas Bank deposits increased sharply.</td>
</tr>
<tr>
<td>2</td>
<td>Interest rates</td>
<td>Interest rates on deposits, loans and government securities declined; implicit rate on cash increased.</td>
</tr>
<tr>
<td>3</td>
<td>Unaccounted income / black money</td>
<td>Stock of black money fell, as some holders came into the tax net.</td>
</tr>
<tr>
<td>4</td>
<td>Formalization / digitalization</td>
<td>Digital transactions amongst new users (RuPay/AEPS) increased sharply; existing user’s transactions increased in line with horizontal trend.</td>
</tr>
<tr>
<td>5</td>
<td>Real estate</td>
<td>Prices declined, as wealth fell while cash shortages impended transactions.</td>
</tr>
<tr>
<td>6</td>
<td>Broader economy</td>
<td>Job losses, decline in farm incomes, social disruption, especially in cash intensive sectors.</td>
</tr>
<tr>
<td>7</td>
<td>GDP</td>
<td>Growth slowed, as Demonetisation reduced demand (cash, private wealth), supply (reduced liquidity and working capital), and disrupted supply chains, and increased uncertainty.</td>
</tr>
<tr>
<td>8</td>
<td>Tax collection</td>
<td>Income taxes rose because of increased disclosures. Payments to local bodies increased because demonetised notes remained legal tender for tax payments / clearance of arrears.</td>
</tr>
<tr>
<td>9</td>
<td>Uncertainty/ Credibility</td>
<td>Uncertainty increased, as firms and households were unsure of the economic impact and implications for future policy. Investment decisions and durable goods purchases postponed.</td>
</tr>
</tbody>
</table>

Source: RBI, World Bank, IMF

II. The Demonetisation Riddle

On 28th February 2017, the CSO (Central Statistical Office) released data on GDP wherein India’s economy showed 7% growth in the last quarter. This came as a surprise given the fact that the demonetisation manoeuvre came as a shock to most of the people in the country. A lot of analysts predicted that there would be a huge negative impact on private consumption and investment but seems that the economy is holding up well. The demonetization plan wherein 86% of the currency in circulation was replaced which resulted in a huge monetary squeeze (Figure 4). It was Government of India’s (GoI) attempt to clean-up the accumulated counterfeit money that has been allegedly used to finance criminal activities like terrorism, drug trafficking etc and also this scheme was aimed to withdraw a huge part of the black money. This plan could be of benefit for India in the long run as it will help in boosting the revenues and with the usage of online transactions, the Indian economy shall become more cash independent thereby improving the efficacy.

![Figure 3: Monetary base declines from INR 22.5trn to INR 13.7trn](source: Macro bond, Rabobank)
Demonetisation and Its Impact on the Indian Economy

III. Is It The End Of An ERA???

The cash crunch will have significant negative impact in the short run. As per ILO (INTERNATIONAL LABOUR OFFICE) 2013, India’s substantial growth in informal economy contributes to 46% in non-agricultural GDP and encompasses 84% of the non-agricultural jobs. The informal sector is very cash reliant and the liquidity crunch greatly affected the cash dependent sectors like agriculture, retail, commodities etc. Most of the entrepreneurs in the agricultural sector and the retail sector didn’t have access to the bank accounts, they don’t pay taxes and they run their daily business exclusively on a cash basis. In the period of note ban, they were unable to pay wages to the workers in cash, buy intermediary goods in cash or sell the products for cash or render any cash-based services. Moreover, the clean-up of black money that hoarded in the real estate would most likely result in house prices being lowered thereby having negative wealth effects which were also detrimental for investments in the housing arena, private consumption etc. To solve the demonetisation riddle, many analysts revised the growth expectations for the FY 2016/2017 (April 2016-March 2017) (Table2).

Table 2: Many institutes revised FY 2016/2017

<table>
<thead>
<tr>
<th></th>
<th>Original 2017</th>
<th>Revised 2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>RBI</td>
<td>7.6%</td>
<td>7.1%</td>
<td>-</td>
</tr>
<tr>
<td>World Bank</td>
<td>7.6%</td>
<td>7.0%</td>
<td>7.6%</td>
</tr>
<tr>
<td>IMF</td>
<td>7.6%</td>
<td>6.6%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Rabobank</td>
<td>7.0%</td>
<td>5.5%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>

Source: IMF (International Monetary Fund), World Bank, RBI, Rabobank

IV. Latest Readings Are Way Too Positive

The recent data depicts the picture of Indian economy growing by 7% year on year basis in the Q4 (fourth quarter) 2017 which was in total contradiction to the expectations. Private consumption grew strongly by 5.7% (Figure 5) and the other drivers being government consumption and government investments contributing to additional 3%. At the macro level, the real estate sector contribution has been hit badly in the fourth quarter; however, it was counterbalanced by a stronger contribution by the agricultural sector and the manufacturing sector (Figure 6).

Figure 5: Indian economy didn’t budge in Q4

Source: Macro bond, Rabobank

Figure 6: Q4: demonetisation

Source: Macro bond, Rabobank
Demonetisation and Its Impact on the Indian Economy

Further, the PMI (Purchasing Managers' Index) showed a rebound (Figure 7) giving an indication that the worst effect of demonetisation is yet to occur. Especially, the sale of two-wheelers increased tremendously by 12% on a month on month basis in November 2016, 20% in December 2016 and 23% in January 2017. But the number of sales is far below the sales figure occurred in August 2016 and September 2016 which leads to a conclusion that either the sales have been delayed rather than the sales being cancelled.

![Figure 6: Lower real estate activity has been counterbalanced by higher manufacturing and agricultural activity](source: Macro bond, Rabobank)

![Figure 7: PMI points to a rebound](source: Macro bond, Rabobank)

![Figure 8: Vehicle sales show a sharp V-shape rebound](source: Macro bond, Rabobank)

V. Issues In Measurement

Nagaraj and Srinivasan (2016) indicated the reason that the cash crunch did not create a big plunge in the Q4 (the Fourth Quarter) GDP data as given by the CSO (Central Statistics Office) overstates the private sector’s contribution. In 2015, the CSO refined the methodology to measure the GDP but prior to this refinement, only a few companies have actually submitted their BS (Balance Sheets). The firms that actually registered themselves were only used for the sample data analysis and the final outcome was scaled up, however, this method was not reliable since the number of registration increased drastically but the submission
of balance sheet data was very low. Most of the new registrations were the so-called shell companies that were used to inject the black money into the economy. In 2015, the MCA (Ministry Of Corporate Affairs) has improvised their database which was further incorporated by the CSO in their database to generate many reliable data on national accounts. The indicators of industrial production, the IIP (Industrial Production Index) indicated a high contribution to the GDP as stated by the CSO report (Figure 9). The sub-committee report published by the CSO differs significantly from the original report finalized by the sub-committee in September 2014 (R. Nagaraj, 2017). The difference between the gross value added in the manufacturing sector in between the 2 versions of the sub-committee report is 108% and the differences in the estimation of non-financial private corporate sector difference in the savings is 257% higher (Table 3).

<table>
<thead>
<tr>
<th>Table 3: Striking differences between the 2 versions of the same report (Rs in Crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimates of the corporate sector for the year 2012-13</td>
</tr>
<tr>
<td>Sub-committee version I (2014)</td>
</tr>
<tr>
<td>Sub-committee version II (2015)</td>
</tr>
<tr>
<td>Difference in (%)</td>
</tr>
<tr>
<td>Gross value added in manufacturing</td>
</tr>
<tr>
<td>Gross value added in total non-financial sector</td>
</tr>
<tr>
<td>Savings in non-financial private corporate sector</td>
</tr>
<tr>
<td>Investments in non-financial private corporate sector</td>
</tr>
</tbody>
</table>

Source: R. Nagaraj, EPW (Economic & Political Weekly)

VI. Is It Calm Before The Storm?

Though the demonetisation effect has not caused an economic cyclone as expected by most of the analysts but the slight gust has created some pit holes and hindrances to both the administrators and the common man. Finally, the negative effects were fuelled in the period wherein the economic liquidity has returned back to the pre-demonetisation stage (Figure 4) which further paved way for the remonetisation process. The forecast on Indian economy suggests the growth rate of 5.5% in the F.Y 2016/2017 and 8.2% in the F.Y 2017/2018, further the economy’s growth might increase after the effective implementation of the GST (Goods and Service Tax) that hopes to bring consistency in India’s complex tax structure.

VII. Fact Finding

7.1 Impact of Demonetization on Agriculture Sector: - The Agricultural growth in India was 0.2% in 2014-15 and grew to 1.2% in 2015-16 and was expected to grow to 4% as per the CRISIL Research Agriculture Report but due to the demonetisation process the prediction became incorrect as the farmers ran out of cash to buy the seeds, fertilizers, equipments, payment of wages to the workers has been delayed and delay in paying commission to the agents etc. The cash shortage resulted in 25% to 50% sales reduction. 78% of the population don’t have access to the internet, in those 80 to 85% are farmers who aren’t educated and are not aware of the E-payments system (RBI report on Agricultural Trends 2017).
7.2 Impact of Demonetization on Business sector:- As per IPP (Independent Power Producer) report, the growth in business sector was 0.7% in October 2016 but after November 2016 the labour turnover increased due to lack of production since the demand for the products has drastically reduced, the reason being people purchased products only based on their necessities post demonetisation policy.

7.2.1 Textile industry :- Almost all the brands and the retailers reported 40 to 60 % drop in sales post the demonetization in first few weeks and from December onwards this drop has slightly decreased but still we can say that the impact of this decision has affected the industry in 2017 for at least 3 to 4 months.

7.2.2 Real Estate: - The demonetisation shattered the real estate market thereby resulting in 50% drop in investments and this trend continued for the next 6 months. The impact is negative in the short run but the experts opine that the reduction in interest rates would boost up the sales.

7.2.3 FMCG Products: - The production process has also been affected as the consumers were spending only on the necessities that too on a day to day basis and small business like kirana stores do their daily transactions purely on cash basis thereby resulting in trading sales slump to 20-30%.

7.3 Impact of Demonetization on Service Sector: - The Services Sector was one of the worst hit posts the demonetisation plan when compared to the last 3 years. The Nikkei India Services PMI that tracks the companies on a month on month basis showed 46.7 in November which further came down to 54.5 in the month of October.

The only sector which possibly gained from this decision was the Banking Sector where a huge segment of first time customers would approach the bank for opening their accounts, saving the money, some people who will have to approach the bank at least once so as to exchange their old currency in the place of a new one. A survey conducted by Moody’s indicated that most of the people continue their banking services once they have crossed their ‘first-time user’ step. This development hopes to increase the bank deposits by 1-2% compared to the pre-demonetisation figure.

VIII. Conclusion

The impact of Demonetisation on the Indian Economy pertaining to various sectors has been indicated but this one-time intervention of exhausting the current stock of black money had a considerable impact on the common man but until and unless the disease of corruption isn’t treated along with its root cause, there might not be any end to the corruption demon.

Expert Review

Arun Jaitley, Minister of Finance, Defence and Corporate Affairs said that the goal of demonetisation is to have clean transactions and clean money. Girish Vanvari, Partner and Head, Tax of KPMG in India opined that the demonetisation process is the most significant change made by the GoI. CRISIL: A global analytical company providing Ratings, Research and Risk & Policy Advisory services informed that the impact of demonetisation was bigger than the implementation of GST (Goods and Services Tax). Rajesh Chakrabarti, a Leading Columnist in The Indian Express and Professor and Executive Vice Dean, Jindal Global Business School, Jindal Global University pointed out that only a petite percentage of the unaccounted wealth is held in the form of cash only 6%. Pronab Sen , Country Director for the IGC’s (International Growth Centre) India Central Programme opined that the demonetisation perhaps has penalized the informal sector in totality and has further dented it permanently, the informal sector contributed to around 26% of the GDP.

References

Demonetisation and Its Impact on the Indian Economy


[33] Simon Clarke, The Financial System and Demonetisation of the Economy, University of Warwick, UK


[37] https://www.concertedaction.com/2016/11/14/demonetisation/


[41] [41] https://thehindu.com/print/84328/demonetisation-costs-benefits-analysis/


Name of Conference: International Conference on “Paradigm Shift in Taxation, Accounting, Finance and Insurance”