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"DEMONITISATION AND *INDIAN ECONOMY: ISSUES AND CHALLENGES*"

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Abstract:

Demonetization of high currency notes has a two-fold objective – first, choking the funding channels of militancy and terrorism from across the border. In the last few years large number of counterfeit notes was regularly discovered in states infested with terror activities. Thus, demonetization will certainly paralyze financing channel of terrorist activities. The other objective, to fight corruption, is rather complex and needs to be addressed persistently through different ways. The demonetization of the highest denomination currency notes is part of several measures undertaken by the government to address tax evasion, counterfeit currency and funding of illegal activities. The requirement to deposit currency notes in excess of specified limits directly into bank accounts has resulted in the declaration of hitherto unaccounted income, subject to higher tax and other penalties.

In an important move, the Government of India declared yesterday that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI will issue Two thousand rupee notes and new notes of Five hundred rupees which will 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 in 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.

Keywords: Demonetization, Transition Issues, Problems, Short Term Consequences, Impact, Challenges for the Government.

Introduction:

This move by the government is likely to have long term benefits for the economy. The extinguishing of the major proportion of unaccounted currency would reduce from the liabilities of the government and would add to its finances. This can have very strong implication as the government would get money to spend without borrowing from the market. This would mean that while interest rates can be low, the government spending on large infrastructure (we assume that the government

would use large proportion for infra spending) projects would kick start capex cycle and push economic growth higher in the medium term. Another element of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable to some extent.

The government has implemented a major change in the economic environment by demonetizing 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.1 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 demonetization 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".

This may be visible more in the rural belt, where many non-farming entities purchase fertile farmland, not for farming but for money parking purpose. The demonitisation and consequent reduction in shadow economy would bring the demand for such farm lands down. This move is likely to lead to better tax compliance, raise the Tax to GDP ratio and improved tax collection. This could lead to lower borrowing and better fiscal management. Also with lower cash transactions in the near term, inflation may see downtrend in the near term. Also with higher tax to GDP ratio, the government may also get enough headroom to reduce the income tax rates, which can lead to higher disposable income with people and can improve consumption demand in the medium to long term.

To understand the effects of these dimensions, it is important to first understand what is it that cash does in the economy? There are broadly four kinds of transactions in the economy: accounted transactions, unaccounted transactions, those that belong to the informal sector and illegal transactions. The first two categories relate to whether transactions and the corresponding incomes are reported for tax purposes or not. The third category would consist largely of agents who earn incomes below the exemption threshold and therefore do not have any tax liabilities. The uses that cash is put to for these various segments of the economy can be summarised in the form of Table 1.

Finally, there would be demand for cash for illegal purposes like bribes in elections, spending over sanctioned limits, dealings in crime and corruption.

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. For instance, in many parts of the economy, there is limited and intermittent supply of electricity as well as mobile connectivity. In these areas, it would be difficult to expect people to shift to electronic medium of exchange.

2. Consumer behavior 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. The latter requires agents to be educated to the extent of comprehending the content of transactions. If this transition is not suitably managed, agents might be tempted to move to non-official cash substitutes.

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. In the latter, while a fraction of the deposits would be for transactional purposes – e.g. salary earners – another fraction would be depositing only savings into the account. By eliminating high value currency notes, these agents who were operating through cash, would now have to move to non-cash instruments and hence, the balances in their accounts would not be savings but transaction values which will be retained in the account for shorter durations of time. The banks therefore would need to re-model their decisions on how much of the deposits can be lent out and for what duration. It is, for instance possible, that a larger proportion of the deposits would be retained for short-term lending and can even be dedicated to the call money market.

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.

Thus, larger is the extent to which cash is used as a means of transacting, smaller is the total credit that can be generated. With a withdrawal of cash from circulation, the deposits will continue to remain in the bank, it would merely shift from account to account or from bank to bank. Thus, even on the earlier deposits, the amount of credit that can be generated would be larger. This is another reason why the banks would need to remodel their investment decisions corresponding to a given level of deposits**.**

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. While this can be considered a transition issue, there are two different implications of such a development:

1. If the premium on cash is high, it would encourage both the shift to non-cash instruments on one hand and to informal substitutes of cash on the other.

2. This might undermine the confidence that people have in the currency and hence, encourage move to other currencies.

PROBLEMS IN IMPLEMENTATION AND PAIN OF COMMON MAN

- The common man, who are illiterate and have no access to banking facilities, will be the ones to be hit by such steps.
- Most of the country's ATMs are not built to accommodate the new 2,000 and 500 notes. Thousands of engineers are working as fast as possible to retrofit the country's 2.18 lakh ATMs. This enormous undertaking is expected to take a few more weeks.
- All small shopkeepers like cloth merchant, moblie shop, accessories vendor cannot procure goods. The cost of purchasing is somewhere between fifty thousand to one lac Rs. The daily revenue which used to 2000 rs average a day has dropped to 300 rs per day.
- Who is responsible for the number of death of the innocent citizen who were deprived of medical facility due to lack of legal currency.
- The marriages which are getting affected contrast to the BJP minister spending 500 cr rs on his daughter's marriage.
- Small vegetable farmers sitting road side cannot sell vegetables because people are now going to big balls to purchase vegetable by cards.
- Similarly small kirana shops sell has dropped to 10% in absence of legal currency.
- Products of non essential commodities have fallen and essential commodities are increasing. In two days the price of wheat has increased by 18%
- The price of agro products for next cycle will increase because farmers in absence of legal cash have missed the harvest season. Instead of using seeds they are using grains which will also result in poor yield.
- The head of All India Bank Officer's Confederation, D Thomas Franco, on Monday called for the resignation of Reserve Bank of India (RBI) governor, Urjit Patel, on moral grounds because11 bank officials who died due to stress.

SHORT TERM CONSEQUENCES OF THIS DECISION ON VARIOUS ECONOMIC VARIABLES AND ENTITIES

- **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

1. 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.
2. Temporarily stall the vast circulation of counterfeit currency and – curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

- **Effect on Money Supply**

Until the new 500 and 2000 Rupees notes get widely circulated in the market, which is a huge task as the only outflow of these notes is through banks or ATMs, money supply is expected to reduce in the short run. However, money supply will pick up gradually (2-3 months) as the new notes get circulated in the market.

- **Effect on Prices level**

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

1. Consumer goods: Marginal fall of prices is expected due to moderation in demand as use of cards and cheques would compensate for some purchases.
2. Real Estate and Property: Prices will fall drastically in this sector because major part of the transaction is cash based. In the medium term, the prices could regain some levels as developers rebalance their prices (maybe charging more on cheque payments).

- **Effect on various economic entities**

With a temporary cash crunch, certain sections of the society (majorly the unorganized sector) could face short term disruptions in facilitation of their day to day transactions. These sections are:

1. Agriculture sector

2. SME
3. Services Sector
4. Household sector
5. Political Parties
6. Professionals like doctor, carpenter and other utility service providers, etc.
7. Retail outlets will have the most significant impact of the demonetization decision.

- **Effect on Banks**

  Bank accounts will be flooded with cash. However, these are mostly emergency funds and therefore there would be withdrawals at a later stage.

- **Effect on Online Transactions and alternative modes of payment:**

  Alternative forms of payment will see a rise in demand. Digital transaction systems, E-wallets, apps, online transactions using E-banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increase in demand. This should effectively lead to strengthening of such systems.

Reasons for Demonetizing

- The widespread use of cash in high denominations has led to an artificial increase in the cost of goods and services which was reflected in the government's success in bringing out Rs 1.25 lakh crore of unaccounted money.
- A structural transformation agenda which the drive against black money can bring about a modification in the medium term and the political gains.
- Progressive shift to a cashless economy with a greater focus on electronic transactions is being envisaged.
- The removal of large bills will make several criminal and illegal activities more costly such as tax evasion, human trafficking, drugs, extortion and terrorism.
- Scaling back large bills will not end crime, but it will force the underground economy to employ riskier and less liquid payment methods.

Aim for less-cash & not cash-less

- Cash greatly facilitates transactions and there are legitimate high value transactions in every economy.
- The fundamental idea behind this exogenous shock is to raise the cost of illegal transactions and not going cash less.
- Going less-cash is a fine balance between maintaining ease of financial transactions and curbing malpractices.
- As cash facilitates crime because it is anonymous and big bills are easy to carry.
- Besides, the new Rs2,000 bills have been designed with enhanced security features, so this is not just new money replacing old money in the system.

Challenges for RBI

- To ship enough currency notes to ensure that bank branches are able to meet the tidal wave of demand
- The logjam may be particularly acute in rural areas where both bank branches and ATMs are in short supply.
- While rural India reportedly has 6 lakh villages and had 44 crore savings account holders, they were home to just 48,000 bank branches.
- The 12 lakh ATMs that are in operation across the country will also need to be reconfigured to dispense the new denominations.
- Add on the necessity of ID-proofing all the walk-in depositors and one can visualize the chaos at banks over the next couple of weeks
- There will be an urgent need for debit cards, electronic transfers and mobile payment platforms to be widely adopted.

Challenges for the Government

- On the other hand, there is no good estimate for how much of India's black money is in forms other than currency/physical notes such as gold, jewellery, land or any other form of wealth.
- While banning Rs 500 and Rs 1,000 notes will tackle the black money that is in the form of hard cold cash, it won't affect other forms of black money.

- On similar lines, this move will obviously have little effect on black money stashed away in foreign tax havens.
- At a time when private investment has been hit and with factory output contracting, scrapping high-value notes may prolong the economic pain.
- What the government needs to do now is to follow up the demonetization with a vigorous push to ensure greater universal banking access, and nudge the real estate sector to move towards greater transparency, besides offering more incentives to encourage electronic payments and use of cards.
- The challenge is not just in pulling out 85 per cent of the high-value currencies in circulation but also to ensure a culture of compliance.

Impact of Demonetization

The effect of this policy is not going to be uniform across the economy. Sectors that have a larger cash component in their transactions will be hit harder, such as real estate, movie production, campaign finance, etc.This will then be followed by a correction in these markets. Whether these corrections are deflationary (reducing prices) or contractionary (reduce business) is something to watch closely.However, these are corrections which will move the market equilibria to outcomes which reflect genuine demand and supply in the real economy.

Short-term Impact

Negative Effect

- Upcoming ordering as well as ongoing activities in roads, water, railways and transmission and distribution sectors, too, will be impacted as payment to labour is usually made in cash.
- Low number of bank accounts in remote, small villages and supply-chain disruptions could affect demand for consumer staples for a brief while, believe analysts.
- The demand impact of large-ticket consumer durables items such as apparels, white goods, apparel and the likes could also head south.
- Purchase of fertilisers and agrochemicals; usually done via cash, too, could come down.
- All metal companies will be negatively impacted as a large part of trading in steel and other metals is carried on a cash basis currently.

- The short-term debt servicing capacity of small borrowers could be reduced, which may impact the asset quality as well as credit growth of microfinance companies such as Bharat Financial Inclusion, Ujjivan Financial Services, Equitas, etc.
- Housing finance companies, too, could witness pressure on their credit quality as well as growth, as fall in real estate prices would impact the loan against property (LAP) business.
- Even e-commerce players are likely to feel the heat in the near- to medium-term. Cash on delivery forms anywhere between 70 and 90 per cent of e-commerce players' revenues and, hence, can impact valuations of retail e-commerce players

Positive Effect

- Banks stand to gain meaningfully from implementation of demonetization, but over a period of time. While operating costs could increase in the immediate future, there would be an increase in the low-cost current and savings accounts (CASA), which in turn will rub off favorably on the banks' funding costs and liquidity.
- This could also have the effect of bringing down deposit and lending rates further without the RBI having to cut its repo rate. A rise in deposit base will allow banks to lower the blended cost of funds
- Rising use of credit/debit cards, net banking and other online payment mechanisms will be another positive, as these would not only lower transaction costs but some of these could help earn some fee income as well.
- In the immediate run, we are likely to witness larger bank deposits, price corrections and better tax collection possibilities in the economy—all great for Indian bonds.
- Mining will be another sector to benefit from this move as this will hurt illegal/unauthorised mining activities, aiding organised players such as Coal India, NMDC, among others

Long Term Impact

- In the long run, this is a significant positive shock to the Indian economy and society.
- If substantially implemented, this will send a strong signal about India's anti-corruption drive and is very likely to improve the country's reformist stance.
- It also provides a boost to the government's financial inclusion drive, pushing more households towards efficient banking and payment infrastructure.
- Tax revenues will increase.

- Bank deposits will increase and they will have more capacity to support the economy. It will boost growth as it will expand and clean the formal gross domestic product.

Conclusion:

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. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. 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.

- Despite having many positives such as rising tax to GDP, higher GDP growth, lower inflation, higher financial savings, this demonetisation move may not curb the root cause of black money.
- "This initiative addresses the 'stock' of black money but not necessarily the flow/fresh creation of black money unless some mechanism is built to track the movement of the new high-value currency notes.
- However, such a sudden and drastic step by the government might dissuade some, if not all sections of the society from creating new black money reserves.

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