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DEMONETIZATION SCENARIO IN INDIA

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Abstract

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency. The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with new currency. This paper deals with Impact of Demonetization on Economy. It outlines the effects of demonetization on GDP growth and impact of demonetization on business. This paper makes a special note on merits of demonetization. This paper concludes with some interesting findings along with policy suggestions.

Introduction

"Demonetization is the withdrawal of a particular form of currency from circulation." Through demonetization the old currency is replaced by the new currency or a currency circulation is blocked. There are multiple reasons why a country demonetizes its currency; some reasons include checking the inflation, to curb the corruption and to promote the cashless transactions. Recently the Indian government decided to demonetize the biggest denomination notes i.e. 500-1000 Rupees notes, this step has been declared as a master stroke for the Indian economy by various experts. This is not the first time that India has demonetized its currency, earlier it was done in 1946 with the complete ban of Rs 1000 and Rs 10000 notes to deal with the unaccounted money i.e. black money. Second time it was done in 1978 by Government headed by Morarji Desai, when Rs 1000, Rs 5000 and Rs 10000 notes were demonetized. The main objective of this step is to unearth the black money, to curb corruption, counterfeit currency as well as terror financing. This step is considered as the biggest cleanliness drive against the black money in the history of Indian economy. As per RBI, 87% transactions in India are cash transactions and this loophole is used by corrupted people to build a parallel economy with unaccounted money. This parallel economy helps in terror financing which in turn hampers the growth and development of country. Currently high- values notes account for total value of 86% of the notes in circulation in India. It is expected that this step will help in reducing the fiscal deficit of India and promote the cashless economy in India which can be easily monitored.

Impact of Economy

As per the recent estimates by some economists, nearly 90% of the total cash in circulation has come back into the banking system and hence, the stated purpose of the Demonetization exercise which was to "extinguish" black money and enable the RBI to lower its liabilities thereby providing the government with a huge dividend seems to have been belied. Of course, there are some who now argue that the Indian Banking System is now “flush with cash” and this has enabled the government to “nudge” the RBI to cut rates as well as to allow banks to pass on the benefit of ample liquidity to consumers by lowering lending rates.

However, the flip side of this has been that banks have cut their deposit rates as well which is natural considering that any cuts to lending rates have to be accompanied by cuts to deposit rates. This has resulted in a situation where banks with enough deposits seem to be encouraging spending more than saving and this can indeed create demand in the system since more money with consumers means more spending thereby leading to an uptick in sales of goods and services and which has the “multiplier effect” of resulting in more growth.

On the other hand, with more taxes being collected due to higher deposits in banks that can be taxable as well as increased compliance due to greater scrutiny and oversight by the Income Tax Department, the government too might be tempted to announce lower rates for taxes and other aspects of what are known as fiscal measures. In this context, it is worth remembering that fiscal stimulus which is by lowering taxes and providing more incentives to consumers as well as producers by boosting supply can be complemented and supplemented by the monetary stimulus which is by boosting demand for goods and services by lowering lending rates thereby putting more money in the hands of consumers.

As economic theory states, both fiscal and monetary stimulus can be implemented in isolation or taken together and hence, the Demonetization as it is being called might indeed act as a catalyst for growth. Having said that, one must remember that India is primarily a cash transaction based economy and hence, removing 86% of the money in circulation is indeed a “brave” move since there are reports that large sections of the informal economy have come to a grinding halt.

Moreover, there are also reports of farming sector taking a hit due to lack of cash as well as sales of automobiles and other capital goods falling even though inventories are building up. Thus, it remains to be seen as to how the growth figures for the next quarter and the overall financial year turn out to be. Of course, there are other indicators to keep track of as well in the form of various Indices such as the Purchasing Managers Index which tracks industrial activity as well as the rates of investment and the credit pickup as well as the Inflation figures. Having said that, one must also note that given the lack of communication about some of the economic indicators from the government is indeed worrying given that Demonetization has been billed as the “Biggest Monetary Experiment” in recent times in the entire world.

Cash is the preferred mode of transaction globally, accounting on average for 85% of them. In some of the developed countries, transactions carried out through cash are less than 50% of total transactions. In India, this ratio is at around 95%. Easy accessibility, its certainty of acceptance and efficiency as the settlement is not dependent on any additional infrastructure, and no additional charges make it universally the most preferred mode. The only problem of cash transactions is the anonymity and difficulty of establishing an expenditure trail which make it an ideal mode for unreported transactions as well.

Tax

Having closed the voluntary disclosure window for undisclosed money, it has been reported that government will keep a close watch on deposits over Rs 2 lakh in cash. This would mean increased tax net, higher tax collection and a better tax to GDP ratio. It could be noted that the extent of parallel economy, which was 23.2% of GDP, is now around 25-30% of GDP. As the money gets accounted and more taxes are collected, government might be tempted to reduce tax rates going forward.

Interest Rates

One of the biggest impacts of demonetization would be high value transactions, especially land and gold. This would result in lower inflation, tempting the central bank to reduce interest rates. But the bigger impact on interest rates will be the liquidity with which banks will be flushed. CLSA's points out that banks would benefit with higher CASA (current account savings account) growth as a part of the $ 190 billion cash pile gets deposited with them. Higher deposit growth and continuing weak credit growth would create opportunities for lending rate cuts and investment activities to pick-up.

Liquidity

Movement of goods and money will be hit in the short. A Bank of America Merrill Lynch note says that wholesale channel forms over 40% of the sales for the Indian consumer firms. This channel works mainly on cash transactions and will likely witness liquidity constraints in the near term. This could disrupt the supply chain and impact growth in the December quarter. The report further adds that consumer firms typically provide tight credit terms (<7 days) to the distributors, who in turn provide credit to the wholesalers/ outlets on their own accounts. Due to overall tightening of the cash-liquidity in the supply chain, consumer firms may be forced to offer easier credit terms to the distributors in the near term. As a result one expects an increase in their receivables in the December quarter.

GST

Demonetization comes at an important as the country heads to a new tax regime with the implementation of GST. Demonetization would increase the tax net and along with GST result in reduction of black money generation. Along with GST, demonetisation will lead to a higher tax/GDP ratio.

Financial Assets

As money lying idle comes in the main economy it would move to higher yielding and liquid assets. Money is likely to move to financial assets from gold, precious metals, real estate and plain cash. Equities might reflect the panic in the economy in the short term, but the move is will be beneficial in the long run say most of the broker's report and expert comments.

Effects on GDP Growth

Some rating agencies have estimated a decline of around 40 basis points in GDP growth for 2016-17 and of a smaller magnitude in 2017-18. These estimates are based on quicker liquidity injection and a sharp shift to cashless transactions. However, there is a section of the population which will still like to deal in cash because of religious beliefs. The estimation of a 40 basis point decline in GDP, given the casual nature of employment for nearly 80% of workforce, may not materialize, at least in the time frame envisaged. It is believed that, the dent in GDP growth may be larger than anticipated and recovery to the normal growth trajectory may take three to four quarters.

Black Money

At one stroke the Prime Minister has choked the supply of black money stacked inside the country. Of the Rs 17 lakh crore of total currency in circulation in the country, black money is estimated at mind-boggling Rs 3 lakh crore. Black money is nothing but a plunder of the nation. Black money operators run a parallel economy which shakes the very foundation of the Indian economy. With Modi's demonetization move, all domestic black money will either be deposited into the banks with heavy penalty or be simply destroyed.

Political reaction

In the run up to the crucial assembly elections in Uttar Pradesh, Punjab, Goa and Uttarakhand, Prime Minister Modi's demonetization announcement has come as a shock and awe for the political parties and politicians for whom black money is a lifeline. The pulling out of the old Rs 500 and Rs 1,000 currency notes made the election process clean and transparent. But it has brought tough times for the political parties and politicians who believe in the idea of purchasing votes in exchange for notes. That is precisely the reason a rainbow coalition of a galaxy of regional parties and the Congress is building up against Modi, because their political interests are badly hurt.

Hawala Transactions

Demonetization has crippled the hawala rackets. Hawala is a method of transferring money without any actual money movement. Hawala route is used as a means to facilitate money laundering and terror financing. Hawala rackets run again on black money. With black money suddenly being wiped out of the market, thanks to demonetization, hawala operations have come to a grinding halt. According to an India Today report, one of the hawala operators in Mumbai has destroyed currency notes worth about Rs 500 crores.

Counterfeit Currency

Demonetization has dealt a death blow to the counterfeit Indian currency syndicate operating both inside and outside the country. Counterfeit currency seriously devalues the real worth of Indian currency. A study conducted by Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency (NIA) suggests that fake Indian currency notes amounting to Rs 400 crore are in circulation in the country at any given point of time and around Rs 70 crore fake notes are pumped into Indian economy every year. The estimation is based on recovery and seizure made by various agencies. But the actual figure could be much larger. A One India report, quoting an Intelligence Bureau dossier, says fake Indian currency worth Rs 12 lakh crore has pumped into Indian financial system over the years. Needless to say that most of the fake currencies circulated in India are of Rs 500 and Rs 1000 denominations. It is also pertinent to mention that the fake currency floating inside the Indian financial system is not counted within the Rs 17 lakh crore of total currency in circulation in the country.

This is an open secret that Pakistan has been printing fake Indian currency at its government printing press in Quetta and its security press in Karachi. The enemy nation funnels the counterfeit currency through the frontier at Jammu and Kashmir and via India's porous border with Bangladesh and Nepal. With Prime Minister Modi's decision to pull out the old Rs 500 and Rs 1,000 notes and replace them with new Rs 500 and Rs 2,000 series has completely stalled the circulation of counterfeit Indian currency. Experts say the new currency notes have come with advanced security features which are almost impossible to replicate. So Pakistan has no option but to shut shops of its fake Indian currency.

Terror Financing

Terror financing is sourced through counterfeit currency and hawala transactions. This is how terror financing works. Fake currency circulation is routed through a multi-layered network of hawala operators which are closely linked to satta (gambling) and smuggling of drugs, opium and arms. Indirectly, they all end up financing terrorism. In addition, the terrorists collect huge donations and then route the money through hawala transactions. With the circulation of counterfeit Indian currency completely stalled and hawala transactions stopped, all windows for terror financing are closed.

Advantages of Demonetization

Demonetization is a deep psychological strike on black money. Demonetization move has killed the very motivation of those people who have the ability to generate black money. A person who had black money has already paid more than the effective tax rate just to convert his black money into legally tender-able currency / assets. Such people are in a state of shock as though they have already paid tax at a higher effective tax rate but still their black money has not got converted into legitimate income. To top it up their wealth has substantially gone down as they have overnight lost more than 50% value in their real estate holdings.

Demonetization has killed the very motivation of that person to generate black money and when a person loses his motivation to generate black money it is certain that the person would not generate black money irrespective of that person's ability and resources available at his hand to generate black money.

Demonetization would produce a lot of indirect taxes. Demonetization has made the common man realize that he was the one who though paid his taxes, ended up playing a big role in generation of black money. This was because most of his spending were in cash. Common man is street smart and with this harrowing experience he would change his bad habit of withdrawing cash from ATM and then spending it on purchases. Demonetization seeks to bring in a sharp, sudden but long lasting behavior change that encourages electronic payments. That means a lot many transactions would get reported and that would lead to a direct increase in income taxes.

Demonetization has recapitalized banks in 21 days flat. The total NPA of banking sector is Rs. 6 Lakh crore. Banks have got low cost deposits of Rs. 11 Lakh crore and still counting. This money would not leave the Banks as the pace of outflows would not match the inflows. See my answer on: Ankur Arun's answer to Eleven of the 14 lakh crore rupees have already been deposited in the banks. Has the Modi government failed since all this money will turn into white?

An aggressive RBI can now reduce base rate by 2 - 3 percentage points that would lead to a reduction in interest burden on farm loans, mudra loans, housing loans and corporate loans thereby benefiting farmers, SME, middle class and Corporate. Demonetization would lead to generation in employment. Government can now lend massively to infrastructure sector through the recapitalized Public Sector Banks. This would generate a lot of employment opportunities thereby moving more people out of poverty.

The effective impact on black money itself is going to be minimal since it tackles only the cash component. However just as an Enterprise would come to a standstill without free cash flow even if it is asset rich, limiting the circulation of black money will have an impact on real estate transactions and the shadow economy due to cash crunch. To that extent it is going to limit the transactions until the new black money is generated, unless oligarchs dumped notes as donations to political parties and are awaiting the fruits in the coming months. It is also a good decision for re-capitalization of the banks, since it means more money is under the purview of government fiscal policy like interest rates etc. For instance Bank of Japan is having trouble kick starting the economy even with negative interest rates because many Japanese hold on to Cash. And lastly it is also helping people to think about digital money digital payments etc.

Now the negatives, while there is a lot of propaganda on how this is a 'surgical strike' etc, very little information is actually coming through from the Government on how the exercise was thought through and what is the measure of success. While the implementation is shoddy, the public opinion can be fostered if the facts are laid out in a transparent manner. It certainly cannot be a few news articles and media blitz on IT raids confiscating a few hundreds of crores. Most importantly the political donations are exempted from falling under the scrutiny due to demonetization. This probably explains why political parties are playing the soft ball and not panicking as expected.

Real Estate Investment Markets

Projects could get stretched as informal sources of capital may not be available. This, in fact, spells more opportunities for institutional capital. FDI, private equity and debt players will suddenly find the market even more transparent and attractive. Moreover, banks could start funding land transactions, thereby decelerating land prices.

Retail Real Estate

Retailers could see some impact on their business in the short-to-medium term due to reduced cash transactions. The luxury segment is likely to be hit because of the historically high incidence of cash acceptance. However, credit / debit cards and e-Wallets should come to the rescue. Overall, the domestic consumption story remains intact, with no threat to the overall strength and growth of the Indian retail industry.

Land Sales

Where land transactions have been happening in the realm of joint ventures, joint development or corporate divestments, will see very little impact of the demonetization move. All of these are quite institutionalized, with little or no cash involvement. However, those carrying out direct land deals will doubtlessly suffer - especially when it comes to agricultural land transactions, which tend to involve significant cash involvement.

Developers

There will be minimal impact on large institutionalized players with a solid brand and governance framework. Sales, largely driven by the salaried class or investors with limited cash involvement would not suffer. Smaller developers are understandably very concerned right now because many of them have depended on cash transactions.

Conclusion

It could be seen clearly from the above discussion that demonetization is the urgent need of the hour in India. In order to enhance the money value and regulation of black money circulation, the efforts taken towards demonetization is very essential in Indian context. Accountable money transaction is most important aspect of monetary reforms, due to lack of proper accountable system; one can find accumulation of income and wealth in the hands of a few individuals. This situation results in income inequality and economic inequality among different segments of population. Demonetization is welcomable efforts of the government on the part of the honest tax payers. In India, the government employees are the honest tax payers as their tax in dedicated from their salaries itself On the other hand a large number of industrialists and businessmen are not the perfect tax payers and they evade tax by utilizing various loop holes in the legal system. The income generation from industrial and business activities should be regulated.

In this context, cashless transaction is the best option. The digital model of money transaction through bank account is very sensitive to accounting system. In this situation, a proper estimation of money transaction is accounted. Such accounting system clearly indicates the level of taxation on the part of the individuals. The success of demonetization depends on the following facts.

1. There is a need to prevent the misuse of bank accounts of poor households.
2. The government should monitor the sudden accumulation a huge amount of deposits in the bank accounts of poor households.
3. Cashless money transaction should be followed in every business through bank accounts with a view to prevent the under reporting of business turn over.
4. In certain pockets of the country the digital model of money transaction is distorted, due to ATM operation problem and inadequate storage of money stock according to the needs of the customers. Hence, such problems should be corrected with a proper intervention on the part of the bank officials.
5. In some place the availability of electronic money transfer system is found to be inadequate to cater the needs of a large number of customers. Hence, the government should provide more number of electronic fund transfer system in such places.
6. Some businessman may not accept the electronic fund transaction during their sales even in some petrol bunk. In this context, the government should give proper instructions towards acceptance of debit/credit card in business transaction.
7. The electronic fund transfer suffers from lack of awareness on the part of the illiterate and semiliterate population. Hence, there is a need to create awareness about the electronic fund transfer system and its advantages with the involvement of local branch bank officials.
8. Though the government has introduced some incentives towards permission of electronic money transaction at the macro level, at the local level, such incentives system is not properly functioning. Hence efforts should be made to promote digital transaction of money at the local level by the way of announcing some incentives to the customers.

9. The government should take efforts to prevent poor households from becoming victims of high income households by the way of protecting their black money and unearned income.
10. The government should rank the income tax paying limit with a view to prevent the tax evasion on the part of the income tax payers.

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