Demonetization: Its Impact on the Common Man and Indian Economy

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Abstract

The Reserve Bank of India manages currency in India and derives its role in currency management on the basis of the Reserve Bank of India Act . The argument posited in favour of demonetisation is that the cash that would be exitinguished would be "black money"and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy. Further, the impact of such a move would vary depending on the extent to which the government decides to remonetise. The reasons offered for demonetisation 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." The demonetization of the 500 rupee note and the 1,000 rupee note the two highest currency denominations available in India will likely hit the economy hard in the short term. The surprise move is expected to grind the consumption activity in the Indian economy to a virtual halt. The service sector, which dominates economic activity and involves a sizable chunk of cash transactions, will likely be hit the hardest. This paper elucidates the impact of such a move on the availability of credit, spending, level of activity and government finances. This study will try to find out the positive or negative impact on Indian economy of demonetization.

Key words: *Demonetization. Economy, Impact, Cashless transactions, credit, tax evasion.*

Introduction

Demonetization will hit the economy. There are potentially two ways in which the pre-demonetisation money supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange. The empirical extent of these two components will be unravelled only over the next six months. These two would have different effects on the economy in the short term and in the medium term, as will be explored below.

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

The legs that needed to hold this policy up government - issued IDs, widespread access to bank accounts, proliferation of banks and ATMs (both supplied with enough new currency and adequately staffed) were not ignored by the government. Over the last few years, India has made a huge push to issue ID cards according to the UIDAI, the body charged with issuing government IDs (called Adhaar cards), in 2015, 93 percent of adults in India had an Adhaar card. Another government program, called the Pradhan Mantri Jan Dhan Yojna inclusion with the goal of opening a bank account for every household in India. The Jan Dhan scheme did make some huge strides, at least according to their own data but even while the penetration rates for bank accounts surged, a reported 43 percent remained dormant, with only 39 percent of bank account holders having a debit or an ATM card. But as many have pointed out in the wake of this policy, those measures were not enough. Increasing bank account penetration from 35 percent in 2011 to 53 percent in 2014 is incredibly impressive, but that still means that almost half the country doesn't have access to banking, and a large proportion simply use alternative methods of financing (for example, cooperatives, which are more trusted), and 300 million people don't have the required government identification.

Further, the policy tried to tackle several problems: the more extreme, like counterfeited currency and terrorism, but also issues like the informal economy and the cash transactions that allow it to exist under the government's radar, and corruption, which everyday citizens are familiar with. But while on the surface these moves seems to tackle these issues, a closer look reveals that the effects caused by demonetization don't align as neatly with what the policy states will happen.

History of Demonetization

The First Currency Ban

In 1946, the currency note of Rs.1,000 and Rs.10,000 were removed from circulation. The ban realy did not have much impact, as the currency of such higher denomination was not accessible to the common people. However, both the notes were reintroduced in 1954 with an additional introduction of Rs.5,000 currency. Rs.500 and Rs.1000 notes were introduce in 1934 and after four years in 1938, Rs.10,000 notes were introduce.

The Second

That came in 1978; the then Prime Minister of India Morarji Desai announced the currency ban taking Rs.1000, Rs.5000 and Rs.10,000 out of circulation. The sole aim of the ban was to curb black money generation in the country.

Similarties in 1978 and 2016 ban

The note ban by Morarji Desai also aimed to drive away black money out of circulation in the economy. Hence, The High Denomination Bank Notes (Demonestisation) Act was implemented. Narendra Modi announced the currency ban is an address that was broadcasted across all news channels. Similarly, Desai announced the ban over the radio after which the banks were closed the following day. Both the affairs were kept confidential.

Differences in the ban

Unlike Modi, Desai didn't have the backing of the RBI Governor. The Governor I.G. Patel believed that the ban was implemented simply to immobilize the funds of the opposition party. Patel also believed that people never store black money in the form of currency for too long. It didn't have much effect on the people and affected only the privilege few. While the recent ban had shaken the whole country.

Coming back to 2016, there is also a buzz that smaller denomination currency notes like Rs.50 and Rs.100 will also be replaced by incorporating new features and design. And that reminds us of an incident dating back to early 70s, when there were rumours of withdrawing Rs.100 note from circulation, and immediately hoards of people were seen rushing to banks to exchange their Rs.10 and Rs.20 currencies.

Impact on Economy

Informal Economy

There are two questions at play when considering the informal economy and the policy's approach to it one, is the informal economy desirable, and two, is it avoidable in India? The first depends on what the informal economy comprises yes, it does contain the black market and can lead to trade of illegal or questionable goods, but it sometimes simply involves farmers or low-wage workers and local rural economies. In those situations, cash transactions are not a method of circumventing the government but rather the only practical means of exchange among those without access to banking, whose livelihoods are small, irregular and/or best suited for an informal setting without regulations.

As The New York Times explains "Plenty of Indians do use cash transactions to hide their wealth and avoid taxes less than 3 percent of the population pays income taxes and the authorities occasionally arrest businesspeople or corrupt officials with currency hoards that can fill trucks. But plenty more people use cash because of habit, poverty or a lack of easy access to banks." This explains the disproportionate impact of this policy on the middle and lower wage classes and it is the derailment of the latter's lives caused by the demonetization that has caused many to that write the policy is a failure and others to go so far as to call it a criminal injustice. Forced to stand in long lines at banks and suffocated without the liquidity they need for daily wages and purchases, it is the vast majority of India, which the government wants to help with the recovered black money, who are actually paying the heaviest price for this policy.

But taxing the informal economy is one of the government's aims. As Ramesh Thakur reports fort the Japan Times, "Only 5 percent of Indian workers pay income tax, just 15 percent of the economy is inside the tax net and India's tax-to-GDP ration, at 17 percent, is 5 points lower than comparable countries." Which seems to answer the first question that an informal economy isn't desirable, even if it does contain more than illegal trade.

But the second question is harder because the informal economy in India is estimated to employ 94 percent of India's labor force and covers large parts of the country, each with varied reasons for being inaccessible to the government's net of regulation. This gray and black economy is not isolated, either it is very much interwoven with the white economy, and shocks to one reverberate through the other, and crippling one would necessarily cripple the other. And while the size of this informal economy can shrink, this policy brings into stark question whether the informal economy can end in India, and the adverse effects (a slowdown in GDP growth, for instance or the loss of livelihood for millions) its end would have.

Corruption

Corruption is simply a part of how things work in Indian bureaucracy a frustrating, callous, humiliating thing to admit, but nonetheless true. That it is holding India back and is a menace that needs to be solved for the country to develop further is taken for granted. And Modi's rhetoric implies that although this policy causes disruptions and difficulties, it will be worth it because it will fight corruption.

But it isn't clear how this policy will hamper corruption first, because as many experts have pointed out, most back money isn't held as cash but is converted to assets or transferred overseas. And second, even if money from bribes was held at home in gurney bags,demonetization would have to work perfectly with no loopholes for the rich, clever and/or powerful to navigate through. And third, although through this policy, some money obtained through bribes may now be worth nothing or at least brought into the bank system to undergo scrutiny, in a few weeks (if it hasn't started already), new bribes will be paid with the new notes. To stop that, the government has to go beyond this policy and tackle the underlying factors that allow corruption to thrive in the Indian economy it has to have more severe punishments for those asking for and those offering bribes, it has to actually enforce those punishments at a rate that would actually deter people from risking the crime, and it has to address the fact that underpaid, overworked government officials are simply more prone to succumbing to bribes and it has to change those incentives. It needs to address the structural problems India has that make it an environment where corruption flourishes the red tape a regular citizen has to navigate with their limited resources and the cultural expectations of what business as usual en Scrapping large bills may destroy some hidden wealth today, but the black economy will start regenerating itself tomorrow in the absence of deeper changes in the culture and institutions that foster it, which in turn is a function of a country's per capita income. Only as a nation gets less poor do corruption, black money and the role of cash decline. There is no shortcut."

This debate is characterized by those who support the move and those who oppose it. One side is called criminal for implementing the policy, and the other is called anti-nationalistic for questioning it. In talking about demonetization, several economists have weighed in to judge whether this policy will work, but the Economist writes " The question is not whether the scheme will work but whether the cost of implementing it is worth it" and I think there is value in both arguments. One approach examines the intent of the policy and whether it was the right economic lever to achieve that end; the other considers what the means to that end entail and what the real cost of implementation will be.

And that is the question I find hardest to answer: Can you separate the intention of a policy from its implementation and what does that mean in the context of an underfunded government riddled with corruption and charged with a sprawling population united by their diversity? How do we reconcile Modi's aspirations for a cashless economy in India with the sheer number of people in the economy leading a hand to mouth existence?

The government's aspirations for India are important India is a country that is young and bursting with potential, and we live in an exciting world of digitization and accelerated growth, and nobody wants to be left out.

The long-run gains of demonetization depend on implementation not intentions, not aspirations, but whether the government can deliver on its promises. The many implementation errors that made this move fail (e.g. making existing notes invalid instead of stopping the printing of new high denomination notes) and the defining characteristics of the Indian economy that remain unchanged by this policy (like the corruption accepted as a normal business practice, for instance) that are responsible for the problems the government wants to tackle.

India's Economic Growth

Growth in the Indian economy remained solid in the quarter from April to June 2016 (the latest available). In India, a financial year begins in April and ends in March of the following year. The previously mentioned quarter is the first quarter of fiscal 2016-2017. During that period, the GDP (gross domestic product) rose 7.1%, while the GVA (gross value added) rose 7.3%. The relationship between the GDP and GVA is:

GDP=GVA + taxes on products - subsides on products

The base year for calculating the GVA is 2011-2012.

The fall in economic activity due to demonetization could last from two to three quarters. As a result, GDP and GVA growth in the quarters from September to December 2016 and January to March 2017 could be significantly lower than previous years. Some bounce back should be seen in the first quarter of fiscal 2017-2018. In the medium term, the Indian economy can grow considerably after curbing the debilitation caused by counterfeit money and an increase in economic activity.

A fall in discretionary consumption will hurt companies operating in this space. However, a rise in tax flow and lower interest rates, are expected to help the Indian economy PIN EPI INDA grow stronger.

Demonetization did not have a big impact on the country. The decision was taken to curb the illegal use of high denomination currency which was used for corrupt deals in the country. However, with the latest round of demonetization, the common public and bankers and undoubtedly facing hardship since more than 85 percent of currency in circulation has been rendered illegal in one single stroke. Demonetization is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. The question that arises is why demonetization was required at this point of time. There are certain pros and cons of demonetization. Pros One of the biggest benefits of this move is that it is going to drastically affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalised and prosecuted by the authorities. Enemies of the country which are involved in counterfeit currency and terrorism will not be able to continue it further for quite some time at least. The smuggling of arms and dealing with the terrorist will not sustain further as all of the money will be on record now.

Secondly, the banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial inclusion. The existing white money of people will be known to the government and it will remain with banks so that it can be put on loan, and interest can be generated from it (though interest rates would fall) with a corresponding fall in inflation. Further Banking System will get a boost, as more that Rs. 7-8 lakh crore base money (new legal money) will enter the system. However, it needs to be seen how much money actually remains in the system, once the cash withdrawal limits are eased.

Thirdly, it will reduce the risk and cost of cash handling as soft money is safer than hard money. It will also reduce government liability. Since every note is a liability for the the government, the old currency will become worthless for those people, who choose not to disclose their income. Thus, this will extinguish government's liability to that extent. It is expected approximately Rs. 5 lakh crore may come to the government in the form of extinguished RBI liability, taxes and penalties. This amount is enough to take care of India's entire fiscal deficit for one year or more. It will also reduce tax avoidance. Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this period. Dealing in this period in sectors like jewelery and real estate will be on radar and those entering into Loan transactions may also undergo tax scrutiny. Search and Seizure activities of the IT Department will also rise to curb such Mal-practies. Limits have already been prescribed for reporting to the IT Department those bank accounts in which excess cash deposits are being made in this 50-day window (Rs.2.5 lakh in case of individuals and Rs. 12.5 lakh in case of firms).

Importantly, in the longer run, tax and interest rates on loans are expected to come down as higher income tax collections arising from better compliance would offer scope to reduce rates over the long term. This, in turn, will drive up disposable income.

Impact on Common Man

Merits/Advantages:

1. Purchasing power will be improved, directly correlated with inflation (Rise in prices) i.e. controlled prices will directly impact on common man and had much purchasing power.
2. Banks Interest rates will be reduced making it easy for common man to avail fresh loans in other words we can say lending would be much approachable for common man.
3. Govt. had scope of introducing new schemes for welfare of common man.
4. Lesser TAX Liability, Boost for savings and consumption
5. New Employment opportunities in place.

De-merits/Disadvantages in current scenario:

1. Currency crunch in market having its direct impact on demand and supply esp for common man.
2. Current currency exchange restrictions making it life difficult for common man, Although Govt. is regularly changing rules for better adherence.
3. Difficulty in cash deposits/exchange of Old currency notes esp. for ones with no bank a/cs although same is their hard earned money.
4. Frequent changing currency rules getting day to day activities affected both for common man and banking institutions.
5. Promotion of illegal activities till OLD Currency completely stopped in system.
6. Higher cash deposits in Nov. & Dec-16 attracts income tax authorities for verification even it is earned through proper taxable income disclosures and same needs to be justified else additional tax will be levied.
7. Dealings in cash adversely effected esp. for small retailers/dealers etc. Fear of unemployment in MSME and other small manufacturing/ unrecognised sectors where majority is cash dealings as same is largely affected/Temporary closed due to liquidity crunch.

Conclusion

Demonetization can give a positive impact on consumption demand in long term. Cons The liquidity squeeze caused by demonetization will be negative across sectors with high level of cash transactions. Real estate, jewelery, retailing, restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space will be facing short term instability. Those companies with high level of debt will face more pressure and can cafe loan defaults. Secondly, there will be an added replacement costs of currency. We cannot ignore the increased cost of operating ATMs need to be refilled more often and also it will be a huge burden on banks. Initially, it is very difficult to create a cashless society as more than 50 percent of Indian population is not well versed with card transactions. Also for these initial months, it will be very difficult to make cash transactions of a higher amount. But the government is taking steps to improve liquidity into the system and reduce inconvenience as much as possible. India is certainly going to experience "Acche Din" in Modi's regime. The decision of this surgical strike on black money was not taken in a day or two. Rome was not built in a day and similarly, this plan is the result of Prime Minister's meticulous planning and never ending fight against corruption. As a result, he has successfully made the right stroke at the right time. Further, the penal provisions are hefty enough to ensure that corrupt practices will find it hard to take roots again. Despite certain short term troubles, demonetization is certainly going to give a boost to the Indian economy in the long run. As of now, all of us should stand and support this bold move of our Prime Minister and help those needy, around us.

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