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"Demonetization" – Past, Present and Future

Introduction: Historical announcing on November 8, when the whole world was waiting for the outcome of US presidential elections, Prime Minister Narendra Modi came out with his master stroke on corruption, counterfeit currency, terrorism and black money by announcing demonetisation and ceasing Rs 500 and Rs. 1000 notes as a part of legal tender in India. 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, 1934 and a new redesigned series of Rs 500 banknote, in addition to a new denomination of Rs 2000 banknote is in circulation since November 10, 2016.The new redesigned series is also expected to be introduced to the banknote denominations of Rs 1000, Rs 100 and Rs 50 in the coming months. The term demonetisation is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetised in January 1946 and again in January 1978, according to RBI data.

Indian Economy before Demonetization: The government's move to demonetise, even then, was to tackle the issue of black money economy, which was quite substantial at that point of time. In January 1978, the Indian government demonetised Rs 1,000, Rs 5,000 and Rs 10,000 notes which was quite substantial at that point of time. The move was enacted under the High Denomination Bank Note (Demonetisation) Act, 1978. Under the law all "high denomination bank notes" ceased to be legal tender after January 16, 1978. People who possessed these notes were given till January 24 the same year — a week's time — to exchange any high denomination bank notes. The main difference between then and now is that currency of higher denomination was barely in circulation, unlike the Rs 500 and Rs 1000 note today.

Indian Economy during Demonetization: significant portion of the household cash on hand is generated by economic transactions that are not reported to tax authorities or generated through corruption, says the report. Scrapping the higher denomination money would either result in these being brought into the system or the money just disappearing.

If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact.

We look at five likely impacts on the economy if a substantial portion of the cash is either reported or is consumed in the economy.

1) Tax: The central government, which has earlier opened a voluntary disclosure window for people with unaccounted money, has now closed it and announced that henceforth it will 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. According to a report by Philips Capital, 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.

2) Interest rates: One of the biggest impacts of demonetisation 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. Banks would benefit with higher 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.

3) 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 we expect an increase in their receivables in the December quarter.

4) GST: The demonetisation move comes at a time when the country is heading towards a new tax regime with the implementation of GST. Demonetisation 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, says CLSA.

5) 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.

Indian Economy after Demonetization: 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.

Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination.

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.

1. 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.
2. **Liquidity crunch (short term effect):** 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 press 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.

3. **Welfare loss for the currency using population:** Most active segments of the population who constitute the 'base of the pyramid' uses 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 labour 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.

4. **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 ↓

5. **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.

6. **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.

7. **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. such a nationwide awareness and urge will encourage government to come out with even strong measures.

8. **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 activies 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.

Conclusion:

The Narendra Modi-led government may miss its deficit goal in 2017-18, say research reports, indicating higher borrowing and spending than what was indicated during the last budget. Fiscal deficit is the gap between the government's revenues and its expenditure. To bridge the deficit, governments borrow from various sources – from financial institutions and the central bank through the debt market, from multilateral donor agencies through loans and from the public through savings schemes such postal deposits or provident funds.

The Budget for the financial year 2017-18 will be presented on February 1. "We think that the government will have to tread very carefully between the need for stimulating demand in a weak economic environment after demonetization and continuing on the path of fiscal consolidation. We expect the government to Budget for a fiscal deficit target of 3.3% of GDP, 30 basis points higher than planned in the government's medium-term fiscal consolidation program," Goldman Sachs said in its research report.

An SBI internal research report, Eco wrap, has pegged in a "fiscal deficit target of Rs 5.75 lakh crores for the financial year 2017-18, at 3.4% of GDP." Fiscal deficit for the financial year 2016-17 is budgeted at 3.5%. According to the credit rating agency ICRA the "Government is unlikely to budget a fiscal deficit that is higher than 3.5% or lower than 3%."

The new deficit estimated would mean the net borrowing would go up from Rs 4,10,000 crore to Rs 4.3-5 lakh crore in the coming fiscal year. To put things in perspective, the higher limit of the difference in borrowing could allow the government spend three times money it spent on its flagship rural job plan – MNREGA – last year. The idea of controlling the deficit was former finance minister Yashwant Sinha's, in 2001. In 2003, the Fiscal Responsibility and Budget Management Act (FRBM Act) was implemented, which aimed at keeping the deficit under 3%. It remained until 2008, and hit a 30-years low in 2007-08.

Then came the global financial crisis, and the deficit surged to 6%, and since then the government has not been able to bring it below 3%.

Budget 2017 is expected to be a feel-good one. The income tax slab restructuring and increasing the exemption limit are on the cards. Social sector spending, such as NREGA, food subsidy, insurance schemes, and welfare pensions, is expected to go up.

The ICRA report said, "Meaningful recovery in private sector investments is unlikely in the next one to two quarters. Therefore, we expect the government to significantly expand its budgetary allocation." But actual result is depending upon future. We must follows simple thought "Waite and watch".

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