

## **Demonetisation – An Active Volcano**

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**Abstract:** *On the midnight of 8th November 2016, the Government decided to eliminate the existing Rs 500 and Rs 1000 notes from circulation and gradually introduce a new set of notes. Essentially, demonetisation is a radical monetary step in which a currency unit's status as a legal tender is declared invalid. The primary objectives of demonetisation are control the counterfeit notes that could be contributing to terrorism, to undermine or eliminate the black economy and to lower the cash circulation in the economy which is directly related to corruption in the country. This paper evaluates the Indian economy, benefits of demonetisation, short term and long term impacts.*

**Keywords:** *Monetary, demonetization, economy, country and impacts.*

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### **I. Introduction**

Ordinary citizen's queue up for cash and economists are busy estimating the extent to which economic growth will be hit because of the ongoing drive to replace high-value banknotes, there has been a lot of discussion on whether the government can use the current situation to push India towards a cashless future. People seeking to exchange their notes had to stand in lengthy queues, and several deaths were linked to the inconveniences caused due to the rush to exchange cash. The civilians in the country are divided across the country on the issue of demonetisation at large. Whilst there seems to be a broader consensus across the country on the intent of the policy, there have been significant roadblocks in implementing such policies. The digital infrastructure is not ready to replace cash transactions for making this policy to be implemented smoothly. More importantly neither business, citizens of India are ready to move into cash less state nor the implementers of such policy being the banks, regulators and other fin tech operators who can give access to digital platforms are adequately resourced to deal with such a change in the government's policy of achieving a cashless economy.

### **II. Indian Economy**

India is a cash intensive economy with a whopping 12% of GDP existing in the form of currency notes and coins in circulation. The ratio of money held in currency notes and coins to the amounts held in bank deposits is 51:49. Indian citizens and businesses still prefer cash to other modes of payment. Cash transactions are free, final, irrevocable and instant. Cash is the preferred mode of payment due to habits, poverty, illiteracy and most importantly, lack of easy access to the banking system. Most Indians lack the means to use non-cash payment alternatives due to the low penetration of banking facilities in the country. As per the World Bank estimates, approximately 35% of the Indian population above the age of 15 years have an account with a bank. Population having debit/credit cards are way below 10% of the total. These ratios further go down in case of "rural" population and "female" population segments. Within the 35% having an account with the bank, many are dormant accounts as the distance to travel to the bank branch; the travel time and the cost thereof are significant. Year 2015 statistics suggests that 87% of the total transactions in India were in cash. This just suggests that we have sucked out most of the cash from the economy, leaving the cash economy gasping for breath!

#### **Benefits Of Demonetisation**

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. The move is also likely to have a habit changing impact in the Indian populous and there could be increased belief of keeping cash in the banks rather than stashed at home and use formal banking channels for their spending needs. With a large part of the cash moving through the banking channels, the banking sector is likely to be flush with funds in the near term and this would help them reduce cost of funds for such period. Also with more money being kept in the banking channel, some of these low cost deposits may be sticky and improve the

medium to long term Current Account and Savings Account (CASA) ratio of the banks. 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. 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 demonetisation 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.

### **Short-Term Impact**

#### **Severe contraction in money supply**

Eighty six percent of the currency in circulation removed, a severe contraction in the economy has been observed. This would affect individuals who earn incomes in cash and spend it in cash. To a lesser extent, it would impact individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes

#### **Demand- based sectors to face compression**

The sectors where the demand is backed by cashed, especially those not with organised retailing, to be adversely impacted. A slow-down in the spending is highly probable, Transport vehicles, fruits and vegetables and all perishable goods will experience a negative impact since they are backed by purchasing power. This will eventually lead to excess supply over demand, which basically would lead to a fall in prices. However, if supply too gets curtailed for want of a medium of exchange, prices may rise

#### **Increase in credit transactions**

Both the retailers and other agents in the economy might take recourse to credit in the hope that when the liquidity status is corrected, the payments can be realized. In these cases, the price of commodities might raise instead of falling.

#### **Decrease in demand for non-essentials**

In the face of uncertainty in the availability of cash, the demand from segments which have access to digital medium of exchange would remain unaffected, but that from the rest of the economy would get compressed. This would transmit the effect to the rest of the sectors in the economy as well.

#### **Impact on the real estate**

Agents who have earned unaccounted incomes and placed them in the real estate would see a fall within this segment or a cease in the transactions. Where this in itself is a positive development, it could lead to a compression in the investment rate in the construction sector. This will further adverse income and employment consequences for the economy.

#### **Impact on the demand for gold**

With the ban on Rs 500 and Rs 1000 notes, the gold market has seen a sharp decline. The sales have gone down since and are not likely to grow in the short-term. There has not been a drastic increase in the gold rates as well

#### **Increase in the tax collection in the short-term**

People in the attempt to get rid of unaccounted cash balances through purchase of goods and services, or payment of property taxes, a spurt in the indirect taxes as well as property tax collections is expected. This would mean a higher tax net and a better tax to GDP ratio.

### **Long-Term Impact**

#### **Changes in spending behavior**

There is a possibility of changes in spending behavior as a result of moving to instruments other than cash. Substitutes for cash, such as cheques, debit cards, credit cards, mobile wallets, will see increase in the level of its usage. With frequent use of debit cards, the consumption levels are expected to increase. This will encourage spending on non-essentials, In the long-run it is expected to have an impact on the lifestyles as well as the budgets and priorities of the agents of economy. If not suitably managed, it could channel towards consumer debt with a lower saving in the economy and adversely impact the investment within the domestic economy.

**The asset quality of banks will improve**

This drastic currency step will improve the asset quality of the banks as the cash coming in will lead to higher CASA (current account, savings account), in turn de-clogging the system. It will no longer hold up the flow of bank credit for private sector investment in the country. It will lead to increase in the current account and savings account deposits.

**Formalisation of the economy**

In the long term, combined with the GST legislation, it will help propel economic growth as more of the informal economy becomes formal.

**Rate cuts**

Monetary stimulus to be observed in the form of rate cuts and liquidity infusion in the formal system. Demonetisation will also lead to lower inflation, leading to reduced interest rates. Higher deposit growth and continuing weak credit growth would create opportunities for lending rate cuts and investment activities to pick up.

**Current Account Deficit**

In the long term, the current account deficit may be financed through borrowing. This is considered to be unsustainable since in the long-term the economy will be burdened with high interest payments. Additionally, a current account deficit may also imply that the economy is relying largely on consumer spending and the market is becoming uncompetitive. This will eventually dampen the export sector, Overall long term impact is expected to be neutral as demonetized currency is also being replaced with higher value denominations.

**III. Conclusion**

The impact of the bold move taken by the Government 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 interpreting the phenomenon, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. However, with this step, the poor will be the most impacted, both in the rural and urban areas who work in the vast informal sector of the country. The possibility of recouping black money by its hoarders is not unachievable, fake money may be pushed out of the economic cycle, but black money may continue to remain.