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Impacts of Demonetization on Indian Economy

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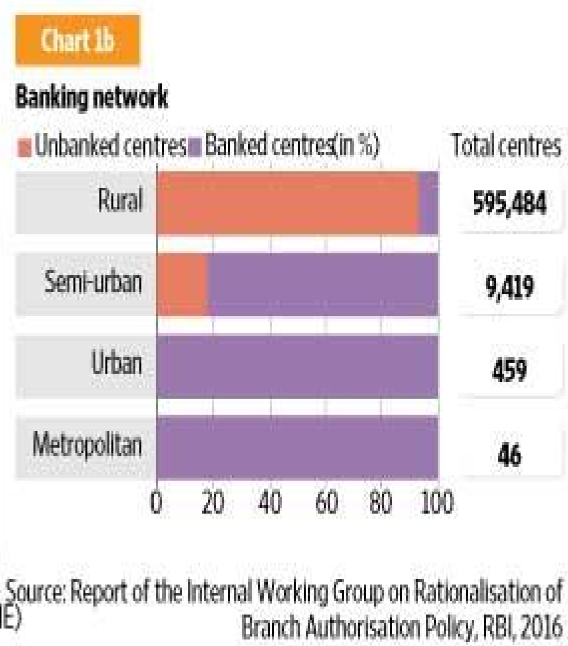
Abstract: This demonetization is Prime Minister Narendra Modi's attempt to reduce bribery and the black money so that India may shift towards digitalized money transfers, which are more traceable and taxable. Only 2.89% of Indians filed any income taxes in 2013, compared with 45% of US citizens. Although the majority of Indian's incomes are probably below the tax threshold in the first place, there is no doubt that India's black market is huge: the World Bank estimated it to be 23.2% of the total economy in 2007. As economic theory states, both fiscal and monetary stimulus can be implemented in isolation or taken together and hence, the Demonetization or the DeMo 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.

Keywords: Black Money, Demonetization, Economy, Income, Tax.

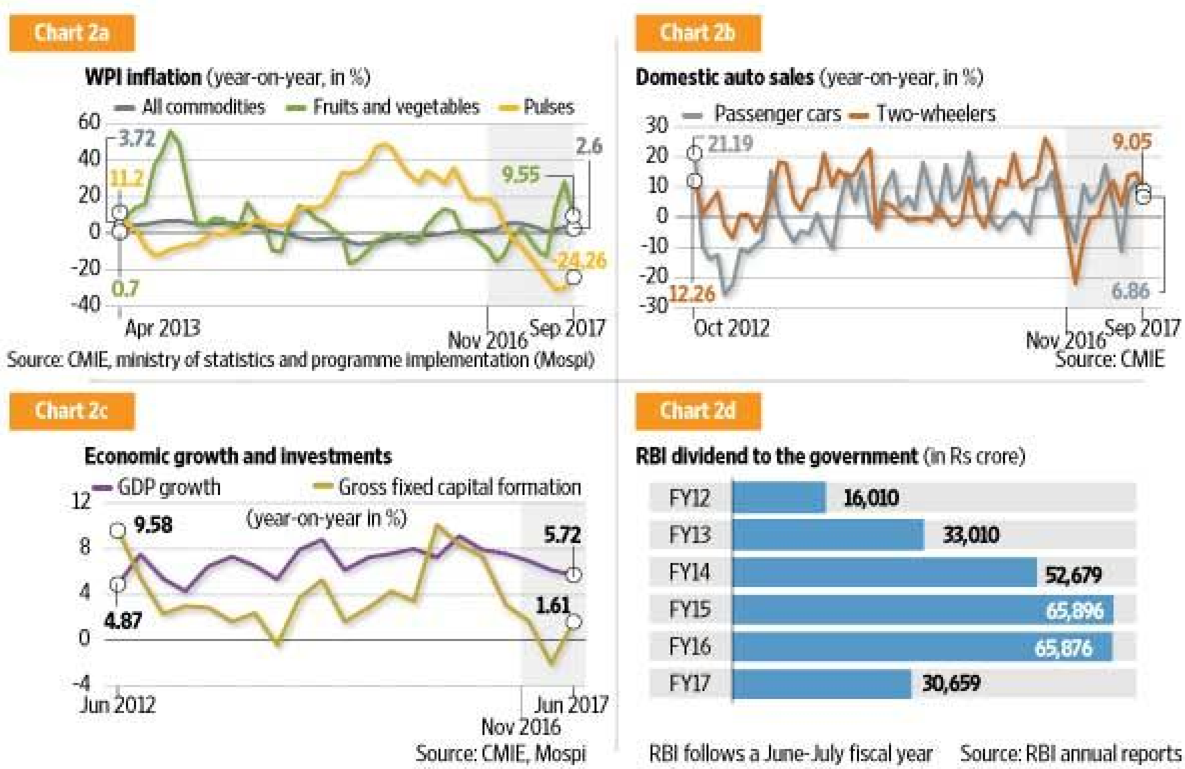
I. INTRODUCTION

A year ago, Prime Minister Narendra Modi announced the scrapping of high-value banknotes which amounted to 86% of currency in circulation. The demonetization of currency notes was supposed to be an attack on black money, on counterfeit notes, and projected as part of a broader push to promote digitization and non-cash payments. A year later, progress on all these counts appears to be very modest, and should make us question whether this exercise was needed at all to fulfill its stated aims. The costs imposed by the currency-scrapping exercise were, however, quite severe, at least in the short term, disrupting ordinary life across the country for several weeks. The hardest-hit were those in rural areas, where access to banking and the internet are quite low. A 2016 Reserve Bank of India (RBI) report on branch authorization policy classified 93% of rural centres in the country as unbanked, with the population dependent on roving banking correspondents and on distant urban or semi-urban branches. Access to the internet is equally patchy, with only 3% of households in underdeveloped rural areas reporting access to internet in a 2016 consumer economy survey.



II. ECONOMIC COSTS

The rural and informal economy suffered disproportionately because most transactions are cash-based. The liquidity squeeze led to a pile-up at wholesale markets, leading to a sharp decline in the Wholesale Price Index (WPI) of perishables such as fruits and vegetables in the immediate aftermath of demonetization. By turning farm markets into buyers' markets, demonetization may have also contributed to the decline in prices of pulses. Rural consumer sentiment too took a hit, with domestic sales of two-wheelers plunging sharply. Car sales also declined but the decline was less severe than in the case of two-wheelers. slowdown in the economy, which started before demonetization, also seems to have been exacerbated by demonetization. New project announcements declined sharply in the wake of demonetization, a Centre for Monitoring Indian Economy (CMIE) analysis showed, hurting the capex cycle. Contrary to what some economists predicted, the dividend from RBI to the government was lower because of demonetization. RBI's domestic earnings declined as it had to pay interest of Rs 17,426 crore after it mopped up excess liquidity in the banking system following demonetization. The previous year, the central bank had earned interest of Rs 506 crore in its liquidity management operations. RBI's printing costs also went up because of the move.



III. UNCERTAIN BENEFITS

The one big promise of demonetization was a rapid expansion in the tax base but the actual results have been quite modest. According to the finance ministry's estimates published in the latest Economic Survey, the tax base expansion attributable to demonetization was Rs10,600 crore, lower than what RBI spent on interest expenses, and equivalent to only 0.1% of India's gross domestic product (GDP). The full effect on tax collections "will materialize gradually" as reported income of new taxpayers grows, said the survey. How far such gains materialize remains to be seen. Another stated aim of demonetization was to detect and eliminate counterfeit notes. The growth in detected counterfeit notes after demonetization has not been unusually large, shows RBI data, even as counterfeits of the freshly issued notes have already emerged in the system. Demonetization did provide a boost to non-cash payments in the short term but that effect may be waning, with the cash-to-GDP ratio back to double-digits. There seems to have been some impact on the stock of black money (rather than the flow), given that the construction sector has been hit hard. But this may also have led to large-scale job losses. The proportion of high-value notes (Rs500 and above)—often viewed as conduits of black money—has also been rising as new notes have entered the system. At the end of fiscal year 2017 (FY17), the proportion of high-value notes stood at 74%, considerably lower than that in FY16. But this figure may rise significantly by the end of FY18.

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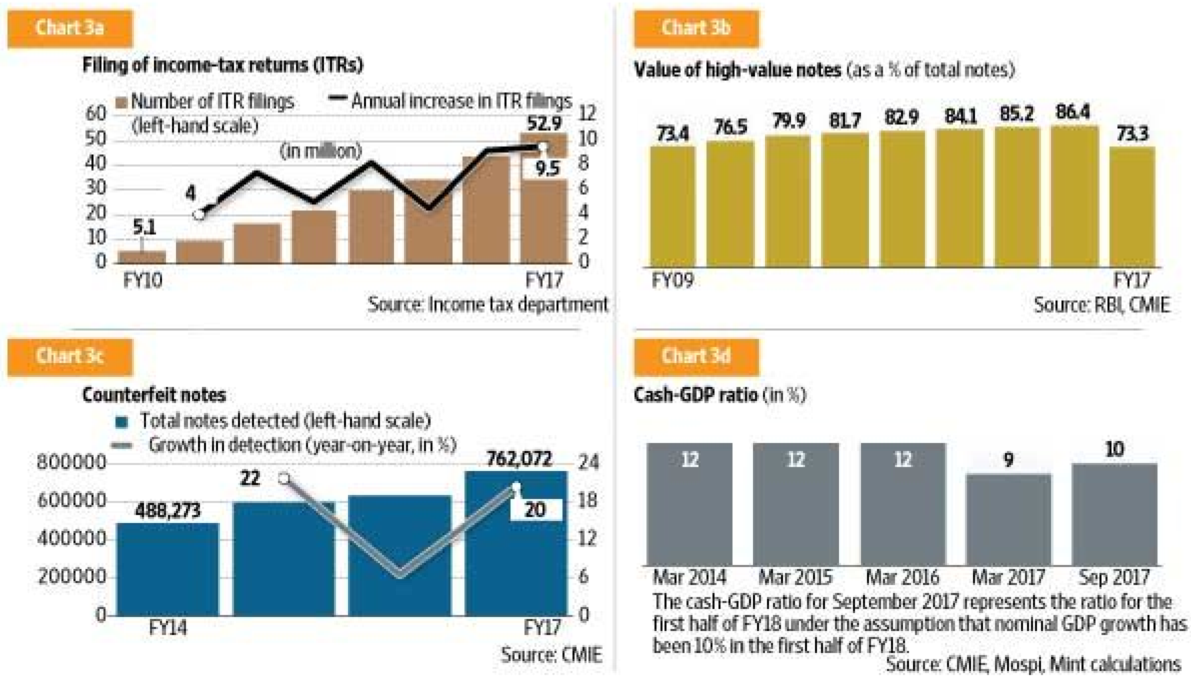

IV. CONCLUSION

The Indian Economy which was billed as the “fastest growing major economy” in the world and the “only bright spot” among Emerging Markets seems to have slowed down even before the latest “shock therapy” of “demonetization”. Indeed, the recently released growth figures from the CSO or the Central Statistical Office considered to be the official department that releases projected, and actual growth figures (apart from the RBI or the Reserve Bank of India and the Finance Ministry) hints at a slowdown in the Indian economy even during the quarter before demonetization happened. While this is indeed cause for concern with projected growth figures revised downwards from 7.6 % to 7.1% for the financial year ending March 2017, what is cause for greater worry and even alarm is the view among some economists including the former Prime Minister Dr. Manmohan Singh (who is a reputed economist in his own right) that the current and ongoing attempt to flush out black money would shave a good 2% of the GDP or the Gross Domestic Product. Indeed, some think tanks and research institutes such as Ambit Research have given even more dire assessments with their projections of growth figures tending to be in the less than 3% range. Of course, the consensus view among many economists is that while there would be indeed a noticeable slowdown in the economy for a “quarter or two”, most of them seem to agree that growth would indeed bounce back and the Indian economy would regain its momentum as well as turnaround with a renewed sense of vigor due to higher tax revenues. Having said that, one must keep in mind the fact that 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 IT (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 or the DeMo 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. Given that mainstream economists tend to debate and argue both sides with equal passion and vigor, it is the case that as the cliché goes, the "proof of the pudding is in the eating" and hence, the actual growth figures have to be watched. Of course, there are other indicators to keep track of as well in the form of various Indices such as the PMI or 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. The point here is that any such "disruption" must be both communicated and implemented well and given some of the concerns expressed in this regard by many commentators, one must indeed look for "straws in the wind" to make sense of the economic impact of Demonetization on the country.

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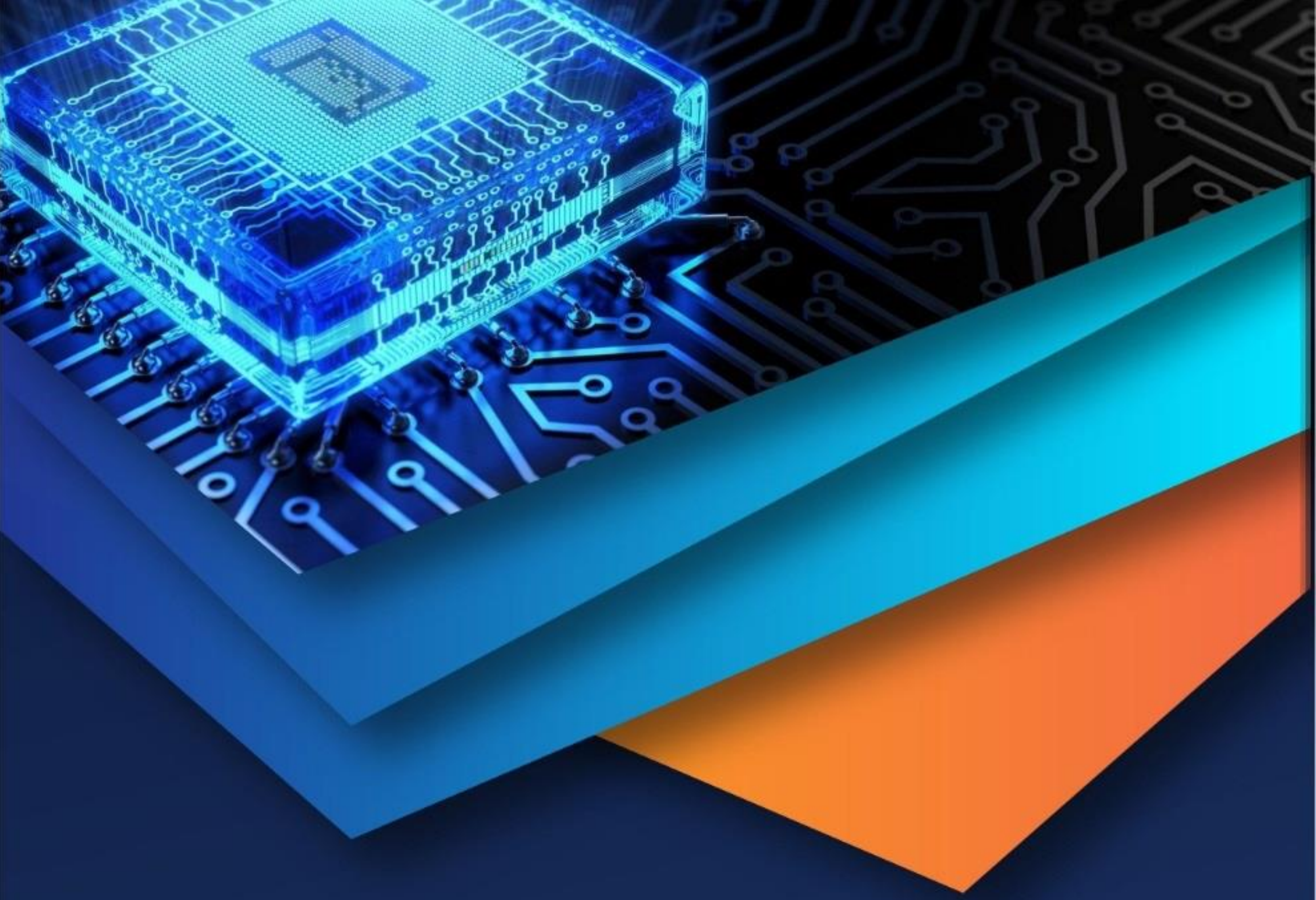

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