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# UNRAVELING DEMONETIZATION

## UNRAVELING DEMONETIZATION

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### **Abstract**

*In the last couple of months, India's economic and political landscape has been dominated by the Government's sudden decision on 8 November 2016 to demonetize high value currency notes. This paper dissects the economic impact of demonetization on the Indian economy and presents a balanced picture of the possible adverse effects and potential benefits of this move.*

### **Introduction**

On 8th November at 8:15 p.m., when the entire nation was focusing on the outcome of the US Presidential election, Prime Minister Narendra Modi delivered a bombshell. He banned the use of Rs.500 and Rs.1000 currency notes as valid legal tender with immediate effect. The initial response was that of shock and awe and this step did receive widespread acceptance and accolades from the masses and the classes however, the implications sank in later. As the days went by, the country came to a standstill as liquidity dried up and sale of goods and services declined precipitously. While the debate and discussion on the pro and cons of this government action continues. Any economist will swear that consumption is what drives and economy

and higher the consumption, greater the prosperity of the society. Savings and capital formation are important but most governments would not like to risk de-growth of consumption as its effects are extremely detrimental to the economy. Lower household spending leads to lower output, which in turn forces enterprises to scale back, and that in turn affects wages and income, which in turn further reduces consumption and a vicious cycle of lower income, declining prices and slower growth encompasses the entire nation. This phenomenon is called a recession and when it is quite severe, and then it is termed as depression. India, at present is in a recession. Production has slowed down significantly and the average consumer is trying to conserve / exchange currency. Spending is not a priority. This phenomenon

## UNRAVELING DEMONETIZATION

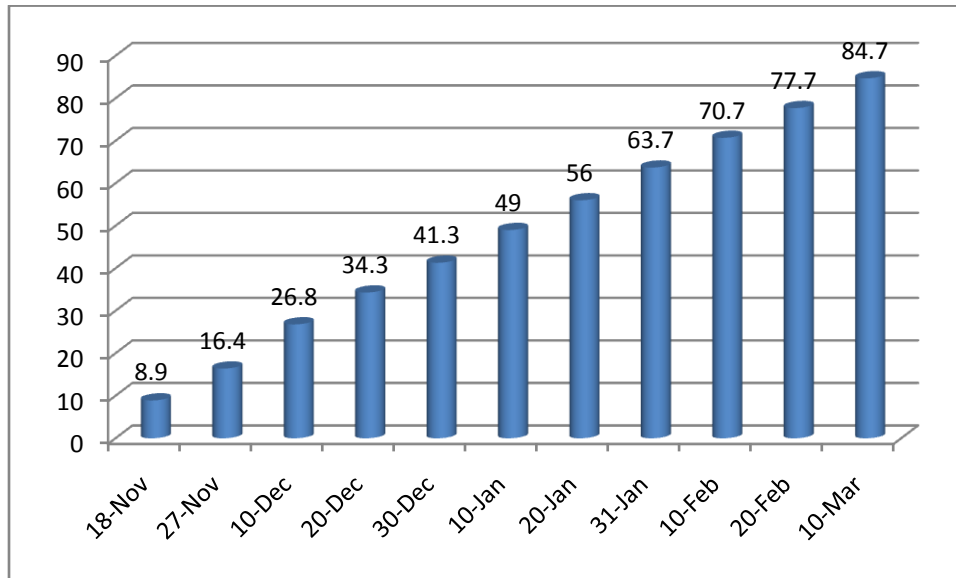
had resulted into three inter-related but distinct policy challenges: a) Containing its contractionary effects, compounded by a

demand slowdown b) Ensuring a lasting blow on the black economy c) Uplifting digitization of Transactions

### **Demonetization the inequality**

Chart 1

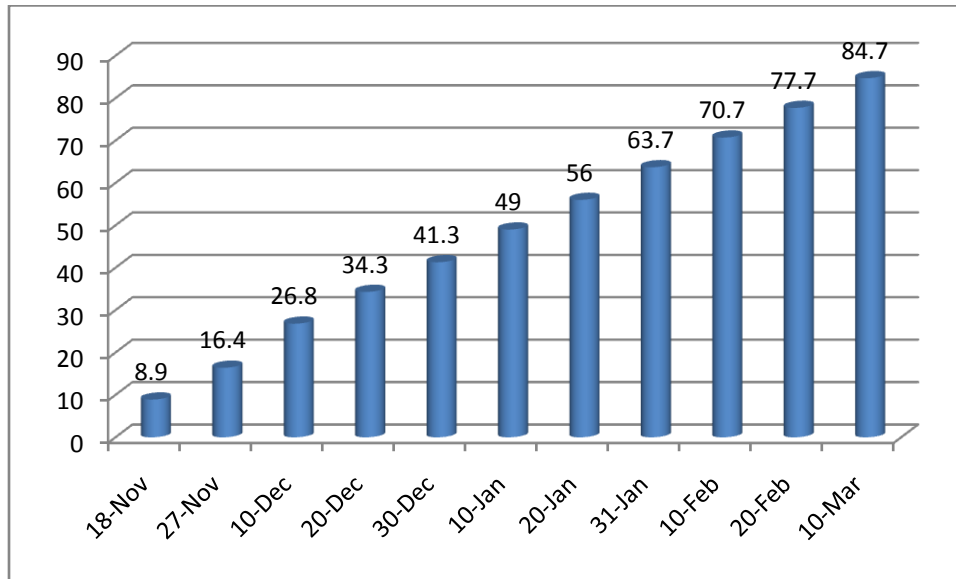
Cumulative re-monetization (withdrawal and exchange) as a percentage of value of demonetized currency



## UNRAVELING DEMONETIZATION

Chart 2

Cumulative net additional deposits as a percentage of value of demonetized currency



*Estimates based on available information; Ratios are indicative*

*Source:*

*1 RBI Press Release (28 November 2016) "Withdrawal of Legal Tender status of banknotes of ₹ Rs. 500 and Rs. 1000: Activity at Banks during November 10-27, 2016"*

*2 RBI Monetary Policy Press Meet dated 7 December 2016*

Demonetization happened in one stroke; however, re-monetization is constrained by the RBI's capacity to print and supply new currency, resulting in a severe cash crunch. According to available information from RBI1, by 27 November 2016, 55.4% (by value) of the demonetized money had come back: only 16.4% (by value) through re-monetization and 39% (by value) through additional bank deposits

value. This figure increased to 78% by 7 December 2016. It is expected that re-monetization will progressively increase and the cumulative share of additional bank deposits will fall after reaching a peak. These two trends are depicted in Charts 1 and 2. By the last week of February 2017, the cumulative re-monetization should exceed 75%, which may end the period of severe cash crunch.

## UNRAVELING DEMONETIZATION

### Short-term growth influences on the economy

Table -1

FY17 GDP growth estimates

Entity/rating agency	Post demonetization	Previous	Percent point change	Percent of previous estimate
The RBI	7.1	7.6	0.5	6.6
Care Ratings	7.6	7.8	0.2	2.6
ICRA	7.5	7.9	0.4	5.1
ICICI Securities	7.4	7.8	0.4	5.1
Morgan Stanley	7.3	7.7	0.4	5.2
Fitch	6.9	7.4	0.5	6.8
Goldman Sachs	6.8	7.9	1.1	13.9
Emkay Global	6.5	7.4	0.9	12.2
Ambit Capital	3.5	6.8	3.3	48.5

*Source: RBI's Monetary Policy Review (7th December 2016) and Mint Research (24th and 30th November 2016)*

The cash crunch resulted in a sudden contraction of demand, adversely affecting growth and employment in sectors with a relatively high share of unorganized activities, such as agriculture, construction and some service sectors. Table 1 gives a

summary of assessments undertaken by the RBI and selected rating agencies on the impact of demonetization on GDP growth for FY17. Many of the recent assessments have revised down India's FY17 GDP growth down to close to 7%.

## UNRAVELING DEMONETIZATION

### Ensuring long-run growth: supplementary policy support

Table 2

RBI assets and liabilities (INR billion)

<b>Entity/rating agency</b>	<b>Post demonetization</b>	<b>Previous</b>	<b>Percent point change</b>
Notes issued	13,072.5	Foreign currency assets	23,193.0
Deposits	8,961.0	Gold coin and bullion	1,367.9
Other liabilities	9,254.9	Rupee securities including Treasury bills	7,563.1
		Loans and advances	555.5
		Bills purchased and discounted	0.0
		Other assets	109.6
		Investment	23.2
<b>Total liabilities</b>	<b>31,288.4</b>	<b>Total assets</b>	<b>32,812.5</b>
		<b>Excess assets</b>	<b>1,524.1</b>
		<b>FY17 GDP</b>	<b>1,50,650.1</b>
		<b>Excess assets as a percent of GDP</b>	<b>1.0</b>

*Source (Basic Data): RBI and EY Estimates (As on 11 November 2016)*

Contraction in money supply may result in a fall in GDP growth over the long run if the currency-to-money supply ratio remains constant. Furthermore, the contractionary effect may accentuate if investment demand remains weak. Recently released data shows that for three quarters in a row, gross fixed capital formation has contracted with an increasing magnitude. It is expected that with digitization, the

currency-to-money supply ratio may fall, the money multiplier may increase and its long-term contractionary impact may be neutralized.

#### **Opposing the black economy**

For a tangible dent on the black economy, supplementary policy interventions would include reduction in stamp duty rates, reduction and simplification of tax rates and tax codes

## UNRAVELING DEMONETIZATION

relating to both direct and indirect taxes, effective and transparent provisions for financing of elections and an effective penalty regime concerning proven cases of black money generation. Exchange of information between India and the countries that serve as tax havens and complete abolition of “benami” property registration would provide sharper teeth to combat the menace of black economy.

### **Conclusion**

The demonetization undertaken by the government is a large shock to the economy. The impact of the shock 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 it has been argued that the cash that would be extinguished would be “black money” and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange. In other words, while the cash

was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetization on the economy and its agents.