Theme: General Management

Title: “Effectiveness of Demonetization as a Monetary Shock”

DR. (MS.) GIRIJA SHANKAR

Professor, Vice Principal and Head, Dept. of Banking & Finance,
Ness Wadia College of Commerce, Pune – 411001.

Rector - Neville Wadia Institute of Management Studies and Research, Pune – 411001.
Phone No.:(020) – 26165755
Mobile No.: +91-7798883412
Email:girishankar31@gmail.com

Theme: General Management

Title: “Effectiveness of Demonetisation as a Monetary Shock”

Abstract:

Demonetization is a big experiment and all eyes are on India watching whether it is going to be a major breakthrough or a fall out, how it is coming about and what mistakes to avoid.

This Research Paper seeks to explore:

1) The anti-cash chorus.
2) Whether the note-ban will hurt India’s growth story.
3) What corrective action should be taken if demonetization is not going as envisaged?
4) The economics of demonetization – to analyze the data and watch digitalization and wait.

Keywords:

Demonetization, re-monetization,shadow economy, e-payment, surgical strike, SMEs, Purchasing–power parity, tender green shoots, cashless economy.

Theme: General Management

Title: “Effectiveness of Demonetisation as a Monetary Shock”

Text of the paper

Introduction:

With the not-so-encouraging response to its income Declaration Scheme 2016, which unearthed just about 0.5% of GDP, the government came out with the policy surprise of discontinuing 500 and 1000 rupee notes. As the government is determined to curb terrorism,financing counterfeiting as well as unaccounted income, the demonetization measure is clearly a bold one and expected to be effective. However, given the share of the value of these currency notes is about 86.3% of currency is circulation at the end of financial year 2016, the success of this policy depends heavily on the speed and smoothness at which the existing currency in circulation is replaced with new currency.

Objectives:

The demonetization exercise of November 8, 2016 of Rs. 500 and Rs. 1000 notes has evoked mixed reactions across various strata of society – from frustration and anger to praises.

This research paper seeks to examine how a major demonetizationaccompanied by equivalentre-monetization does nothing but cause enormous hardship in the interregnum. However, if demonetization is accompanied by lower re-monetization and reduces the currency in circulation it is likely to reduce GDP growth rate in the near future and thereafter gradually peter out, as India adjusts to 20-25% less currency. Moreover it will force people towards cashless transactions via debit and credit cards as well as e-payment platforms. This is where we can, witness the success or failure of the monetary surgical strike.

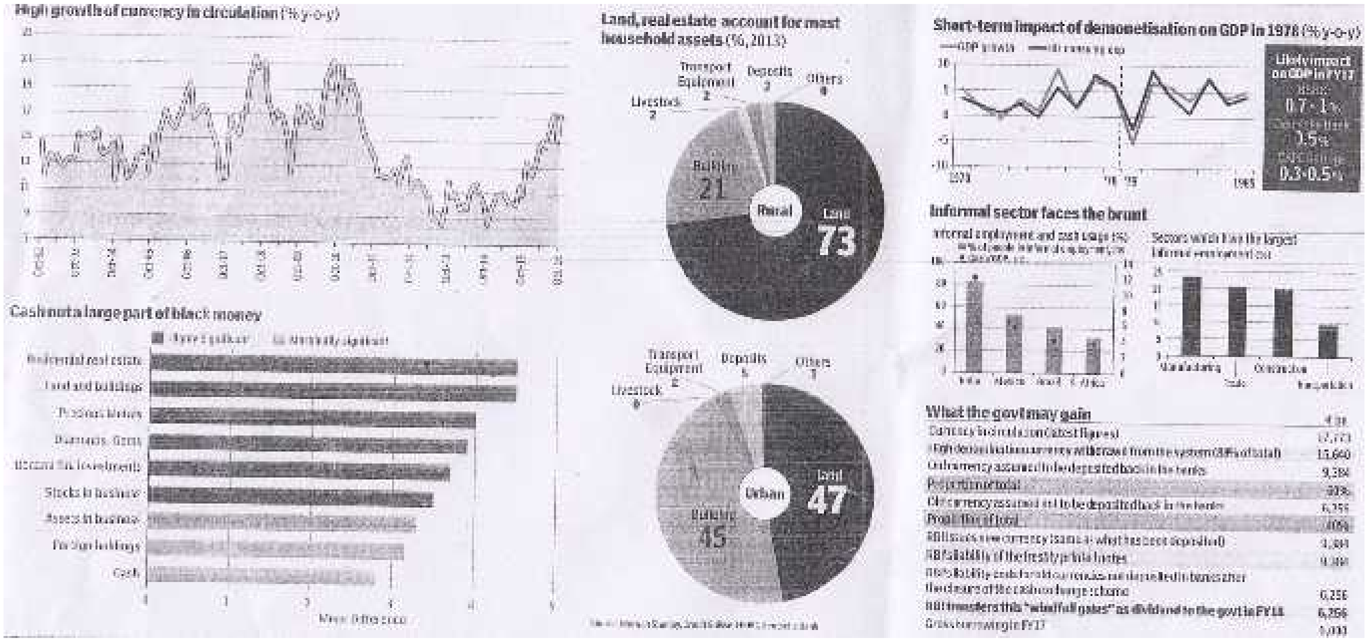
Research Methodology:

This is a research paper which draws on secondary data of IMF, CSO, RBI and financial institutions.The analysis examines the fact that if demonetization is not going as envisaged, the government and RBI must take corrective action and avert uncertainty – an obstacle to economic recovery. A monetary shock like demonetization should be accompanied or followed by reforms to tax policy which reduces government's dependence on indirect taxes.

Main paper

Introduction:

The government's demonetization move will have an effect on the economy as currency in circulation in 14% of the GDP and more than 90% of all purchases in India occur through cash. According to ILO estimates, about 84% of Indians non-agriculture employment is in the informal sector with significant cash usage. Currency is the least prevalent mode of storing black wealth and most of it goes into land and real estate followed by bullion. A CBDT report in 2012 had underlined the issue of huge economic cost of demonetizing higher demonetization banknotes of Rs.500 and Rs.1000 and stated that it was not a feasible idea. While it will takeseveral months to replace the Rs.15 lakh crore of currency demonetized, the notes that will not be deposited back in the banks would get accounted as gainsforRBI. Deutsche Bank estimates that RBI may add around Rs.6-25 lakh crore to its asset side (as extinguishedcurrency) after it issues new currency to the extent of the cash deposited with the banks.

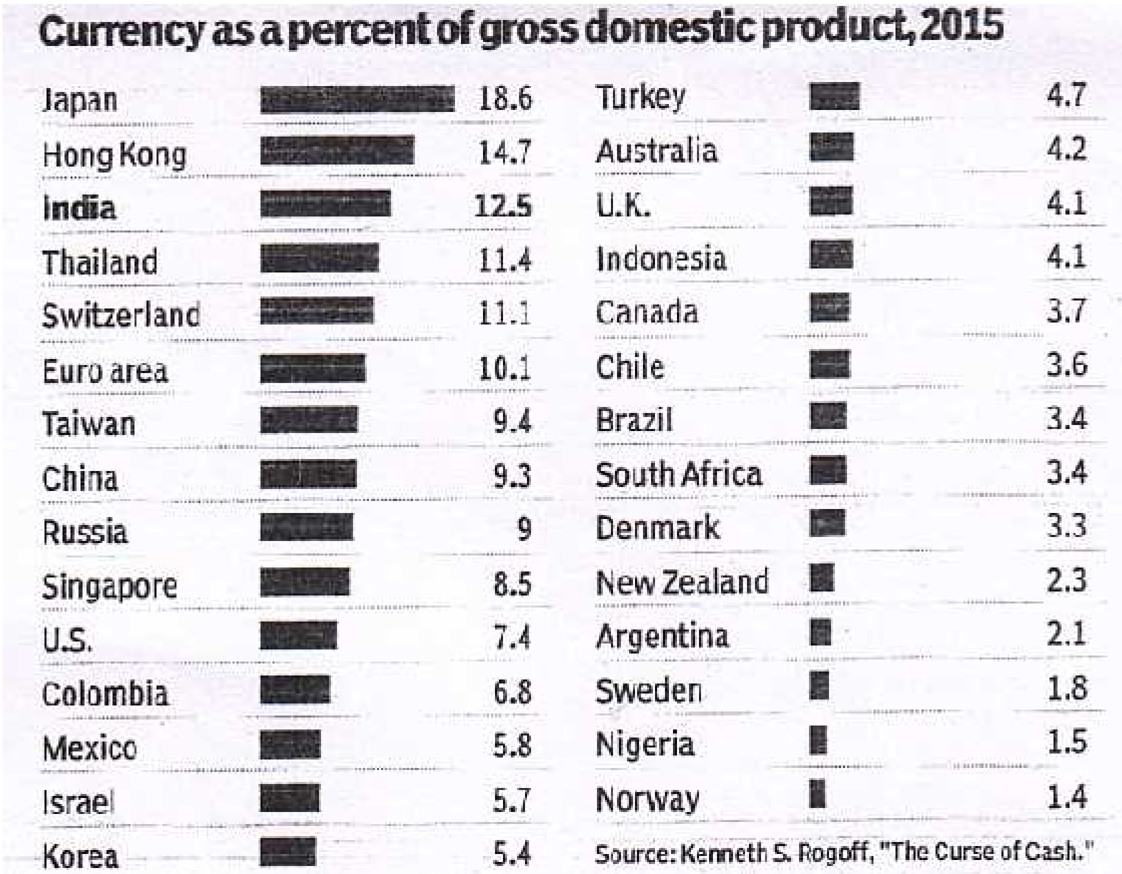


Anti-cash Chorus:

Since Nov 8th, 2016 ‘cash’ has taken a derogatory place, as a symbol that it must be eradicated forthwith if our country has to progress and provide a better life to its people. Cash is seen as the root cause of many evilsin India – Tax evasion, money laundering, terrorism funding etc.

However, it must be noted that Indians are not the only ones who use cash to pay for things they buy. According to a Deutsche Bundes Bank (the German equivalent of RBI).Report in Feb 2016 Germansand Austrians pay in cash for things 80% of the time, Australia – 60% and Americans – 45%.

This big test of the idea that getting rid of cash can help address crime, corruption and counterfeiting might achieve nothing more than a lot of inconvenience.Criminals and corrupt officers often conduct business in cash, because it is hard to trace. So, in a sense, it is logical to assume that abolishing cash will help reduce criminal activity. eg. Scandinavian countries (Norway and Sweden) have extremely low cash usage rates – 1.4% and 1.8% respectively of the GDP 2015,and also lead the world in the lack of perceived corruption.


Currency as a percent of gross domestic product, 2015

Country	%	Country	%
Japan	18.6	Turkey	4.7
Hong Kong	14.7	Australia	4.2
India	**12.5**	U.K.	4.1
Thailand	11.4	Indonesia	4.1
Switzerland	11.1	Canada	3.7
Euro area	10.1	Chile	3.6
Taiwan	9.4	Brazil	3.4
China	9.3	South Africa	3.4
Russia	9	Denmark	3.3
Singapore	8.5	New Zealand	2.3
U.S.	7.4	Argentina	2.1
Colombia	6.8	Sweden	1.8
Mexico	5.8	Nigeria	1.5
Israel	5.7	Norway	1.4
Korea	5.4		

Source: Kenneth S. Rogoff, "The Curse of Cash."

However, the prevalence of cash is far from a fool proof indicator of criminality and corruption, Nigeria which is perceived as one of the world's most corrupt countries has a currency to GDP ratio (1.5%), ever lower than that of Sweden.

To fight corruption by policing cash may have the causality backwards. Scandinavian countries have discouraged illicit activity by creating a culture of financial transparency. For eg. Norway & Sweden make all tax returns publiclyavailable. It is harder to enjoy your illegal gains when your neighbors can easily check your lifestyle against your finances.

An objective analysis of why Indians, Germans and others use cash so often in paying for things i.e. transactions shows that cash is overwhelmingly used for transactions of small value in Europe & US, for items less than $10. So, one reason why cash is so overwhelmingly used in India for payments is possible that a very large proportion of consumer purchases in India are small value, Rs. 50 and below.

A second point which needs to be understood why such a high proportion of India's savings are not deposited in banks but 'under our pillows'. The answer is that the per-head savings for the vast majority of Indians is so low that it is just not worth their while putting it in a bank and that a huge number of Indians do not have a bank account. There are indications in future that it may not be worthwhile to deposit money in banks either because interest earned will be very low or that a fee will be charged if deposited in the banks.

The real reason why Indians do not deposit their money in banks and continue to use cash for transactions may be because the Indian banking system lives in make-believe world. Banks do not lend money to a small businessman, so he borrows from the friendly money lender; if he has some spare cash it is far smarter to lend it to the same money lender who will give an interest rate much higher than banks.

And most of all, a deep set belief that using cash prevents over spending.

Growth Story:

There is a grim impact from the government's move. The sudden demonetization drive has served a "body-blow" to the entire industrial sector, and the worst-hit will be small and medium enterprises (SMEs). The massive supply constraints on the cards would be a greater blow for exporters, who are already facing demand constraints. The short-term loss to the economy could be at least Rs. 12 lakh crore or 8% of GDP according to a Delhi based think tank – NIPF (National Institute of Public Finance). The move could dent' consumption growth in Asia's third largest economy, which could otherwise have received a boost from a bountiful rainfall.

	FY17 GDP growth estimate	
	Current	Previous
Goldman Sachs	6.8%	7.9%*
Ambit Capital	3.5%	6.8%
Care Ratings	7.3-7.5%	7.8%
Emkay Global	6.5%	7.4%
ICRA	7.5%	7.9%
ICICI Securities	7.4%**	7.8%

*As per a Bloomberg poll done on 28 October;
** ICICI Securities' estimates are first cut estimates, and will be revisited soon

Source: Mint research

AHMED RAZA KHAN/MINT

The scrapping of Rs. 500 and Rs. 1000 notes, which comprised about 86% of all cash in circulation, will put a dent in India's growth. How big is a matter of speculation? The most pessimistic view would possibly see India slipping back behind China and losing its title of fastest-growing major economy in the world. In the short-run, demand will dry up in response to the lack of liquidity, but in the long-run a strong rebound can be anticipated when the expected benefit of the move kick in.

Most put the revised number at around 7% against earlier estimates of nearby 8%, an optimism that had been bolstered by good monsoons and a pay commission-led consumption boost. The Indian economy expanded 7.6% in financial year 2016. The IMF had put financial year 2017 growth at the same level. China grew at 6.8% in 2016 and is expected to slow to 6.2% in 2017.

Consumption oriented sectors, particularly those which witness a sizable magnitude of cash transactions, such as red estate, construction, jewellery, retail, travel and tourism and trade are likely to be most affected. Cash based transactions in the unorganized sector would also get disrupted, particularly in rural areas.

Indian’s own domestic market offers a significant opportunity. India has become the third-largest economy in purchasing power parity (PPP) terms and is currently the fastest growing large economy. Empirical evidence suggests when an economy is in the middle-income phase in purchasing power parity terms which India recently entered- demand for manufacturing goods accelerates with every unit increase in income. (Towards More Balanced Growth Strategies in Developing Countries: Issues Related to Market Size, Trade Balanced and Purchasing Power by Jorg Mayer; 2013). Thus, the Indian domestic market seems to be at the cusp of an expenditure boom.

However, the potential of the domestic market can only be realized of there is a catholic improvement in purchasing power; and domestic demand is primarily dependent on domestic income.

The current note ban will result in long term changes in consumption patterns.It has imposed a cash crunch, which has resulted in a sharp drop in consumption. That drop will last for several more months simply because there isn’t enough cash. By the time the cash crunch ends, quite a lot of people will be unemployed. Some of them will be white-collar people in cash-sensitive industries, others will be lower-income folks slipping below the poverty line.

By the time cash is back in the system, the power and the desire to consume may well have been reduced. People who see recession looming tend to be cautious.

People,who have been prevented from touching their own money for several months,tend to hoard it, when they can get their hands on it. People will buy gold or dollars; they won’t buy chocolates. Such a behavioral change could result in a longer recession than most assume will be the case.

An analysis based on 101 companies from the BSE 500 index in two wheelers, passenger cars, buildings materials, consumer durables, garments, retail and fashion, restaurants and the film exhibition business show that the liquidity squeeze hit has begun to ground whole sale and retail trade, beside the transport sector. The biggest blow has been on stocks in construction related sectors such as ceramics and tile makers, cement makers and paint manufacturers. Transactions in construction are largely settled in cash and the liquidity squeeze from demonetization has led to a sharp decline in off take of building material. Sales of two-wheeler and tractors, a barometer of sentiment in rural India, also dipped in November, the month of demonetization.

Rural India's bad luck does not seen to end. After two consecutive years of drought, the prospects for the rural economy were finally looking up with a good monsoon in 2016. With expectations of a record *kharif* production, rural consumption was expected to rejuvenate overall economic growth. But the demonetization of November 8, has severely disruptedthe rural economy.

The real trouble is that the rural economy has an overwhelming dependence on cash transactions, unlike the urban middle class, which has other options such as online and mobile banking and plastic money. This obvious weakness has been made worse by the fact that over 90% of rural areas are unbanked and as such the government's ability to reach out with new currency is furtherhampered.

Unsurprisingly, this has led to a liquidity crunch that has deflated the rural economy. Rural incomes have hit an all-time low. Much of this has also got to do with the timing of the demonetization move: it was smack in the middle of hectic agrarian activity, with farmers either busy wrapping up kharif harvests or sowing the rabbi crops. Many farmers find no takers for their produce as buyers do not have money and prices have collapsed. Those lucky enough to have sold their harvest earlier are suddenly rendered without cash because they do not have the currency notes. Such farmers do not have the means to buy the necessary inputs to initiate the new crop cycle. The agriculture sector contracted by 0.2% in 2014-15 and grow by 1.2% in 2015-16. Even on this low base, revised estimates suggest growth of less than 1% in the current financial year.

Thus the demonetization of high value currency notes has crushed the tender green shoots of economic recovery in rural India by choking off life sustaining money supply and impeding the wheels of commerce from spinning. The demonetization shock is expected to nip the budding recovery as it will have an adverse impact on demand, corporate performance and the labour market, and have a ripple effect on various other fronts. The cumulative impact will vary depending on the time it takes for the economy to remonetize and on the quantum of notes extinguished.

In the process of demonetizing 86% of currency in circulation and ushering in the idea of a cashless economy, a war has been waged on cash and demonizing cash. It has been termed as a surgical strike. Little realizing that the bulk of money transactions of Indian people are legitimate and in cash,the question is whether the demonetization is going to end bribery, counterfeiting and black money.

On the question of bribery, those who take bribes will now take them in the new notes. On the question of counterfeiting – if one human can print notes with new security features, another human can find a way to copy those features. The most counterfeited currency in the world is the US dollar. One way to combat counterfeiting is to phase out, periodically, old series of notes and introduce new series and try to stay one step ahead.

The last time we did was in Jan 2014.On the issue of whether it will plug generation of black money it needs to be understood that sectors which are prone to use unaccounted money (wholesale,trade,construction,jewellery,higher education, election, funding etc.) will continue to demand unaccounted money and, therefore, ways will be found to supply unaccounted money. No major economy is entirely free from the scourge of a black or shadow economy. Accordingto a World Bank study, the shadow economy in the U.S. is 8.6% of GDP (about $1,600 billion); in China 12.7% (about $1,400 billion); and in Japan 11% (about $480 billion).India's shadow economy is estimated to be $500 billion (22.2% of its GDP of $2,250 billion). It is large, but not unusual, and the good news is that its size is shrinking. Brazil, Russia and South Africa have larger shadow economies; Israel and Belgium are comparable.

Conclusion:

What determines the impact of demonetization is the ease at which the replacement of currency takes place so that there is no significant disruption to normal transactions Compatibility problems of existing ATM's with the new notes as well as doing away with the 1000 rupee notes during the crucial transition period (although the government, as an afterthought, announced that it could bring 1000 rupee notes soon) imply that replacement process could be prolonged and painful.

References:

1) DipankarDasgupta–'Theoretical Analysis of 'Demonetization' – EPW, Vol. 51, Issue; 51, 17 December, 2016.
2) Demonetization: Impact on the Economy. Working Paper No. 182., Tax Research Team, National Institute of Public Finance and Policy, New Delhi, 14 November, 2016.
3) John Stuart Mill (2016). Principles of Political Economy: Mill's Works. Vol. 5 of Mill's works, VM e-books, 2016.
4) Rajakumar Dennis J;S. L. Shetty. Demonetization: 1975, the Present and the Aftermath. EPW; Vol. 5, Issue No. 48, 26 November, 2016.
5) www.forbes.com
6) www.hdfcbank.com
7) www.rbi.org.in
8) www.annualreport.rbi.org.in
9) www.imf.org
10) www.cso.ie
11) www.mospi.nic.in