



An Empirical Study on Demonetisation: the Recent Economic Reform

Economics

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ABSTRACT

The argument posited in favour of demonetisation is 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. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy.

Further, the impact of such a move would vary depending on the extent to which the government decides to remonetise. This paper elucidates the impact of such a move on the availability of credit, spending, level of activity and government finances.

KEYWORDS

demonetization, cashless transactions, credit, tax evasion

Introduction :

The government has implemented a major change in the economic environment by demonetising the high value currency notes – of Rs 500 and Rs 1000 denomination. These ceased to be legal tender from the midnight of 8th of November 2016. People have been given up to December 30, 2016 to exchange the notes held by them. The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat. The reasons offered for demonetisation are two-fold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the “black economy”.

There are potentially two ways in which the pre-demonetisation money supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange. The empirical extent of these two components will be unravelled only over the next six months. These two would have different effects on the economy in the short term and in the medium term.

Objectives of the study :

1. My study describes the current status of existing condition of the Economy where I could practically focus on.
2. To study the impact of the demonetisation on the economy and its agents.
3. To overview the various transition issues that need to be managed for the effective Economy.
4. To know the global changes and their influence on vital emerging organisations.

Very short-term impact :

The demonetisation, by removing 86 per cent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy. This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash. In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organised retailing.

For instance, transport services, kirana, fruits and vegetables and all other perishables, would face compression in demand which is backed by purchasing power.

Transition Issues :

There are a number of transition issues that need to be managed for this transition to be effective:

- **Infrastructure Issues:** There is need for a significant upgrade of the banking system as well as in the telecom infrastructure that would provide the backbone for digital transactions. For people to be able to transact at any time and place as well as for them to consider it a reliable medium of exchange, it is important that not only the banking system is upgraded to ensure that transactions can be completed without a hitch, but the supporting infrastructure too is up to the mark. For instance, in many parts of the economy, there is limited and intermittent supply of electricity as well as mobile connectivity. In these areas, it would be difficult to expect people to shift to electronic medium of exchange.
- **Consumer behaviour Issues:** Apart from the technological issues, there is a behavioural change that is being expected in people from using cash as a medium of exchange to using other cash substitutes both for making payments and receiving payments. This transition requires individuals to make two changes in their behaviour: one, agents need to move from tangible means which can be seen and felt to forms which are less tangible or not tangible, and second, they have to learn to rely on technologically advanced tools to undertake regular day to day operations. The latter requires agents to be educated to the extent of comprehending the content of transactions. If this transition is not suitably managed, agents might be tempted to move to non-official cash substitutes.
- **Accessibility in language:** In addition to all of the above, most of the banks and the mobile instruments for transaction are currently adapted to a single to two languages. If the bulk of the population of this country needs to come on board, it might be important to make these facilities available in a myriad of Indian languages to ensure that the user can comprehend the transaction that they are entering into.
- **Transition issues for banking sector:** The banks too might have a transition issue to deal with. Banks would have a model of the fraction of deposits that they can safely lend without an excessive risk of withdrawal of the amount. This is important since, while banks can borrow money from the call money market, the costs of such borrowings can be large. These models, however, might need to be altered in the new regime since the character of the new deposits that come into the bank would be different from the pre-existing deposits. In the latter, while a fraction of the deposits would be for transactional purposes – e.g. salary earners – another fraction would be depositing only savings into the account. By eliminating high value currency notes, these agents who were operating through cash, would now have to move to non-cash instruments and hence, the balances in their accounts would not be savings but transaction values which will be retained in the account for shorter durations of time.

- **Mode of payment and spending behaviour :** There is growing literature that points out to the possibility of changes in spending behaviour as a result of moving to instruments other than cash. There are many substitutes for cash in the modern economy ranging from cheques, debit cards, pre-paid cards, credit cards and mobile wallets. When compared to cash, these instruments differ in a number of key characteristics. Temporal separation or degree of coupling is the extent to which a purchase and the payment for the transaction from resources are separated in time.

Effects on government finances:

The effects of demonetisation on government finances can be divided into three categories:

- **Through RBI's finances:** The RBI earns seigniorage through the printing of currency. In the demonetisation, a part of the currency will be extinguished. For this part of the currency, the RBI can print the notes given the assets on its books, but there would be no takers. In other words, this part of the currency would be like new money that can be introduced into the economy and hence yields seigniorage to the RBI once again when released into circulation. RBI, however, cannot lend this to the government since that would involve additional liability buildup on its balance sheet. So, this currency can only be released when foreign exchange is being converted to rupees for instance and not sterilised thereafter. At this point there would accrue some dividends to the government as well. However, to the extent the government and the RBI seek to move the economy towards digital instruments, this option might not be exercised and the dividend might not accrue.

Impact through taxes:

There are multiple channels through which taxes will be affected:

- At the point of transition to the new regime, people have attempted to convert cash balances into commodities like gold or luxuries. On these transactions the governments would have a spurt of taxes. This would however not last beyond the transition phase.
- On property taxes, some local bodies have given people a window of opportunity to pay old as well as current taxes in the scrapped notes. This would result in an increase in revenue collections in property tax.

Through financing of fiscal deficit:

The generation of additional deposits and credit, as a result of the SLR requirements can make more credit available to governments. Given the FRBM (Fiscal Responsibility and Budget Management) limitations, the amount of borrowing that governments can take on may be limited and the additional supply can mean a decline in the interest rate that governments pay on their debt. This could be a positive spin-off for the governments.

Conclusions :

The demonetisation 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. 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 demonetisation on the economy and its agents.

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