



SIX MONTHS AFTER INDIAN DEMONETISATION 2016 - AN IMPACT STUDY

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Abstract

Prime Minister of India, Mr. Narendra Modi, in an unscheduled event on 8th Nov 2016, announced the demonetization of Rs500 and Rs1000 notes, that brought the high tide ripples across Indians. In this single move, the Government tried to tackle three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing. Though, black money in the form of cash constitutes only 4% on which taxes are not paid or illegally earned. The rest money is in real estate, gold sector or in foreign banks. Recently, Bhartiya Janta Party's landslide victory in Uttar Pradesh, India's largest state, will be seen as an affirmation of Prime Minister Modi's policies and as a virtual referendum on Modi's demonetization decision. In this paper, the researcher tries to analyze the impact of demonetization on various sectors after six months. Though, it is too early to even imagine the impact on all sections of society and parts of the economy. In fact, the affect of this move will be felt only in the long-term if government brings more reforms to clean the administration. The tree of black money has been cut, but the roots are all there. So, we have to get rid of the roots.

Keywords: *Demonetization, Counterfeit Currency, Parallel Economy, Informal Sector, Black Money.*

1. Introduction

In the Indian economy, there is a dual existence of two economies. Each economy has its own set of transactions relating to production, consumption, distribution, investment of goods and services. One economy is called the legitimate economy as the entire set of transactions of the legitimate economy is held by the central or state government or any other authorized body. In other words, there is complete record of the transactions undertaken in lieu of such legitimate economies. The transactions of the economy that are not revealed in any accounting books whatsoever is called the black economy.

Black Money can also be termed as production of goods and services whether done legally or illegally but which is not taken into account for the official estimation of the country's Gross Domestic Product (GDP) because it is neither detected by the authorities nor is declared by its creators.

Black money includes 2 things,

- Income earned illegally - betting, extortion, smuggling
- Income earned legally but tax not paid

Black money proceeds are usually received in cash from underground economic activity and, as such, are not taxed. Recipients of black money hide it, spend it only in the underground economy, or attempt to give it the appearance of legitimacy through money laundering. Possible sources of black money include drug trafficking, weapons trading, terrorism, and prostitution, selling counterfeit or stolen goods and selling pirated versions of copyrighted items such as software and musical recordings.

It is also very unfortunate that the parallel economy is growing in India faster than the legal economy. It is also very important to note that the amount of black money or the rate of growth of black money in India depends on the general state of business in the economy. During boom period, the unaccounted income grows faster than the periods of depression. Thus, on one had when the country is growing, the amount of black money is also growing. The existence of such two economies is harmful for the nation. The black economy represents not less than one fifth of the aggregate economic transactions. Such a parallel economy will ruin the entire economic development of the country.

Various agencies have estimated black money (including but not only cash) at roughly 20 percent of India's GDP, at over Rs 30 Lakh Crore. According to World Bank, it was 23.7% of the GDP in 2007, i.e 20 percent of India's \$ 2.3 trillion, or Rs 156 Lakh crore economy. Black money generation has badly affected India.

2. Demonetization 2016

Demonetization was inevitable and it would have been too late to take this step five years later because the quantum of black money would have increased manifold and the economy would have collapsed. Black money was inhibiting the creation of mass employment and inflating asset prices while at the same time promoting consumption among a small section of the population.



On November 8th, nearly 14 lakh crore, held in Rs 500 and Rs 1000 notes, 86% of India's currency was nullified in a great demonetization effort that aimed to clean out the black market's cash supply and purge counterfeit notes from the economy which completely disrupted the social, political, and economic spheres of the world's second largest emerging market. All 500 and 1,000 rupee notes were instantaneously voided, and a 50 day period ensued where the population could (ideally) redeem their canceled cash for newly designed 500 and 2,000 rupee notes or deposit them into bank accounts. In this single move, the Government has attempted to tackle all the three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing.

This recent bout of demonetization was planned in secret by a small, tight-knit group led by Prime Minister Modi, and it overtook the country like a flash flood where the Indian economy is most cash-intensive economies in the world:

- India has a cash-GDP ratio of 12%.
- Cash in circulation to private consumption ratio in India is 20%, and
- Card transactions account for 4% of the personal consumption expenditure.

In such a cash-dependent economy, all of a sudden around 86% of the cash supply has been rendered useless. This has effectively imposed a tight constraint on real economic activity.

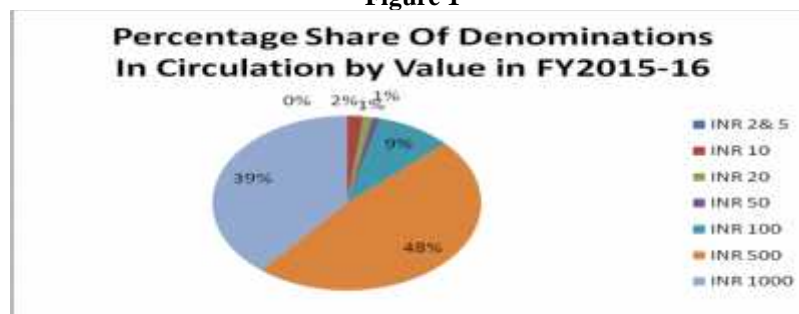
Demonetization could be a major beginning towards a structural change in the Indian economy. The government's move was bold in its intent and massive in its measure. Arguably, this is Modi's biggest move since he was elected prime minister. While the intent was clear, the implementation and impact is yet to be seen. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. One thing was sure though – the Indian economy just had a massive disruption overnight.

2.1 Demonetization

Demonetization is the act of stripping a currency unit of its status as legal tender. It is a process of removing a currency from general usage or circulation. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit.

RBI keeps a record of every currency note printed, the data of the notes in circulation is synonymous with the cash economy. India possessed Rs 14,180 billion cash in high denomination by March 2016. Out of this, around 30 per cent or Rs 4,254 billion was with banks and other government agencies, while cash with the public stood at 70 per cent or Rs 9,926 billion.

Figure 1



Source: Reserve Bank Of India

According to the RBI's (Reserve Bank of India) Annual Report for April 2015 to March 2016, the value of the currency notes at the end of March 2016 was 16.42 trillion Indian rupees. The 500 rupee and 1,000 rupee currency notes formed 86.4% of the value. In one stroke, the government removed 86.4% of the currency in circulation by value. In terms of volume, the currency notes of these two denominations formed 24.4% of a total 90.27 billion pieces. Also, RBI data showed that as of March 2016, 632,926 currency notes were counterfeit—known as an FICN (Fake Indian Currency Note). As a proportion of NIC (Notes in Circulation), the 1,000 rupee and 500 rupee notes were the highest. Nullifying these FICNs was also part of the demonetization move.

2.2 Impact of Demonetization on Various Sectors

2.2.1 India's Economic Growth

The demonetization of the 500 rupee note and the 1,000 rupee note—the two highest currency denominations available in India—likely hit the economy hard in the short term.



Growth of India's GDP (at constant 2011-12 prices) in year-on-year (YoY) terms eased to a five-quarter low 7.1% in Q1 FY2017 from 7.5% in Q1 FY2016, led by a 3.1% contraction in investment activity (gross fixed capital formation or GFCF), and despite a sharp 18.8% growth of government final consumption expenditure (GFCE).

However, growth of gross value added (GVA) at basic prices inched up to 7.3% in Q1 FY2017 from 7.2% in Q1 FY2016, led by a sizable improvement in growth of services (to 9.6% from 8.8%). The slowdown in GDP growth to 7.1% in Q1 FY2017 from 7.5% in Q1 FY2016 was led by the 3.1% contraction in GFCF in the just-concluded quarter, in contrast to the robust 7.1% expansion in Q1 FY2016. This deterioration reflects the de-growth in the output of capital goods and the Government of India's (GoI's) capital expenditure in Q1 FY2017, as well as the sluggish investment activity by the private sector. In contrast, GFCE expanded by a sharp 18.8% in Q1 FY2017. Additionally, exports recorded a growth of 3.2% in Q1 FY2017, in contrast to the de-growth of 5.7% in Q1 FY2016.

Table 1

	Q1FY2016	Q2FY2016	Q3FY2016	Q4FY2016	Q1FY2017	FY2015	FY2016
Private Final Consumption Expenditure	6.9%	6.3%	8.2%	8.3%	6.7%	6.2%	7.4%
Government Final Expense Consumption	-0.2%	3.3%	3.0%	2.9%	18.8%	12.8%	2.2%
Exports	-5.7%	-4.3%	-8.9%	-1.9%	3.2%	1.7%	-5.2%
less Imports	-2.4%	-0.6%	-6.4%	-1.6%	-5.8%	0.8%	-2.8%
Gross Fixed Capital Formation	7.1%	9.7%	1.2%	-1.9%	-3.1%	4.9%	3.9%
GDP	7.5%	7.6%	7.2%	7.9%	7.1%	7.2%	7.6%
	Q1FY2016	Q2FY2016	Q3FY2016	Q4FY2016	Q1FY2017	FY2015	FY2016
Agriculture, Forestry & Fishing	2.6%	2.0%	-1.0%	2.3%	1.8%	-0.2%	1.2%
Industry	6.7%	6.3%	8.6%	7.9%	6.0%	5.9%	7.4%
Services	8.8%	9.0%	9.1%	8.7%	9.6%	10.3%	8.9%
GVA at basic prices	7.2%	7.3%	6.9%	7.4%	7.3%	7.1%	7.2%
GVA ex-Agri	8.0%	8.1%	8.9%	8.4%	8.2%	8.6%	8.3%

Source: Central Statistics Office (CSO); ICRA research

GDP and GVA Data

Table 2

GDP	Q1 FY2016	Q2 FY2016	Q3 FY2016	Q4 FY2016	Q1 FY2017	GVA at Basic Prices	Q1 FY2016	Q2 FY2016	Q3 FY2016	Q4 FY2016	Q1 FY2017
Constant	7.5%	7.6%	7.2%	7.9%	7.1%	Constant	7.2%	7.3%	6.9%	7.4%	7.3%
Current	8.8%	6.4%	9.1%	10.4%	10.4%	Current	7.1%	5.0%	7.5%	8.5%	9.9%
Deflator	1.4%	-1.2%	1.8%	2.4%	3.3%	Deflator	-0.1%	-2.3%	0.7%	1.1%	2.6%

Source: CSO; ICRA research

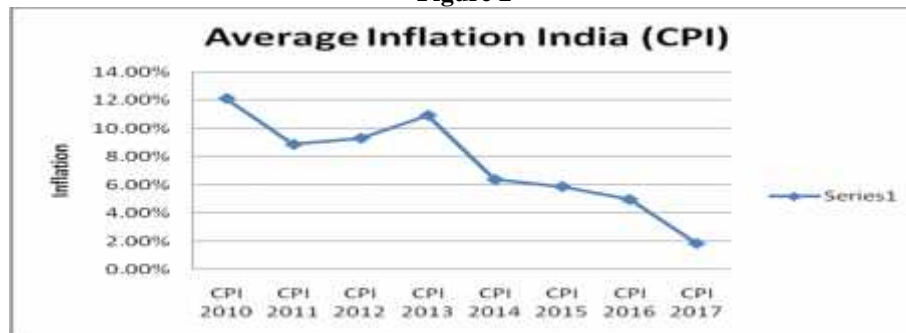
2.2.2 Inflation

Consumer Price Index (CPI) inflation for the whole of 2016-17 is likely to be below the RBI's target of 5%, stated the Economic Survey. This trend would possibly be aided by the softening of the wholesale and retail prices of food items especially in the second half of the current financial year, as well as the demonetization drive leading to lowering of demand in the economy. The demonetization that has been in effect since November 9 is expected to have a negative impact on inflation. Consumer spending activity fell to a near halt. Consumers are refraining from making any purchases except essential items from the consumer staples, healthcare, and energy segments.

Inflation Rate in India is expected to be 3.90 percent by the end of this quarter, according to Trading Economics global macro models and analysts expectations. Looking forward, we estimate Inflation Rate in India to stand at 4.50 in 12 months time.



Figure 2



Indian wholesale prices rose 6.55 percent year-on-year in February of 2017, following a 5.25 percent gain in January while markets expected a 5.90 percent rise. It was the eleventh straight month of increase and the highest since November 2013, driven by a surge in prices of food while cost of manufactured products and petrol rose further. On a monthly basis, wholesale prices went up 0.5 percent, compared to a 1.0 percent rise in the prior month.

2.2.3 Repo Rate

The repo rate, or repurchase option rate, is the key monetary policy rate for the RBI. It's the rate at which the RBI lends to commercial banks. The reverse of the repo rate—the rate at which banks park money with the central bank—is known as the “reverse repo rate.” A change in the repo rate signals an increase or decrease in rates to commercial banks. The rate impacts the movement of the rupee, which impacts the revenue of exporters and tech companies.

The RBI's (Reserve Bank of India) Monetary Policy Committee reduced the country's repo rate by 25 basis points on October 4, 2016 making it 6.25 per cent. The October meeting marked the second rate cut in 2016. However, in February 2017, RBI keeps repo rate unchanged to 6.25 per cent.

Figure 3



2.2.4 Interest Rates on Deposits

After the demonetization announcement on November 8, Indian banks saw a rise in deposits.

Banks also saw a rise in term deposit accounts since the demonetization. Due to these factors, commercial banks like State Bank of India, ICICI Bank, HDFC Bank, and Punjab National Bank, among a host of others, sharply reduced their deposit rates. Apart from cutting deposit rates, banks reduced their lending rates as well.

2.2.5 Stock Market

A reliable criterion to gauge the immediate economic impact of a sudden policy shock is to observe stock market trends. Traditionally viewed as a predictor of the economy, sharp and persistent plunges in stock market indices could indicate deterioration in economic activity. On November 16, after a week into demonetization, the daily closing price of NSE S&P CNX Nifty 50 index dropped by 5.1% as compared to November 8.

The Nifty 50 index is composed of firms from a varied set of industries. An analysis of NSE data indeed indicates so. We study the price movements of major sectoral indices at NSE. These include: automobile, consumption, realty and banking



sectors. The means of the closing value of the indices is compared for a period of 25 trading days before the event (October 3-November 8) with a period of 11 trading days after the event (November 9-November 24). The table below shows the impact. Difference in mean returns before and after demonetization.

Table 3

Sectors	Pre demonetization returns (%)	Post demonetization returns (%)	Difference
Nifty Auto	-0.06	-1.2	-1.12
Nifty FMCG	0.03	-0.82	-0.9
Nifty India consumption	-0.1	-0.93	-0.83
Nifty Realty	-0.2	-1.01	-0.81
Nifty Private Bank	0.01	-0.73	-0.74
Nifty Bank	-0.01	-0.5	-0.49
Nifty Metal	0.2	-0.14	-0.34
Nifty PSE Bank	-0.1	0.14	0.24

Source: NSE Website.

The table shows that the worst hit sectors, just after demonetization were Auto, FMCG, Consumer and Realty.

Figure 4



Source: wwwnseindia.com and wwwbseindia.com

However, once the short-term impact of demonetization is over, Indian equities bounce back sharply. The above chart shows the movement of Indices (Nifty 50 and BSE SENSEX) from Oct 2016 to June 2017.

2.2.6 Retail Sector

Demonetization has resulted in visibly reduced low footfalls in shopping malls, but this effect was temporary and turned around in few weeks as more currency circulates in the system and improves the purchasing power and appetite of the consumers. However, the use of plastic money and transactions through online payments continued to release the money into the retail market.

In the medium-to-long run, domestic consumption was stable owing to India's strong economic base and favourable demographics. Also, as more retailers encourage alternative/digital payment solutions, the market ecosystem will become more transparent and structured going forward.

2.2.7 Real Estate Sector

In the present economical situation, black money has inflated prices in real estate, gold and a few other sectors, making it a challenge for a common Indian citizen to invest. However the government's attempt to curb black money will significantly lower the prices in such sectors. According to Finance ministry's report in 2012, "real-estate accounts for more than 50 per cent of the current black money market".

In the past one year, there have been a few positive and potentially long-lasting changes in the Indian real estate. The passing of RERA (Real Estate Regulation and Development Act 2016), the Benami Transactions Act and now the demonetization move will ensure that going forward, the sector will lose much of its historic taint and become more transparent.

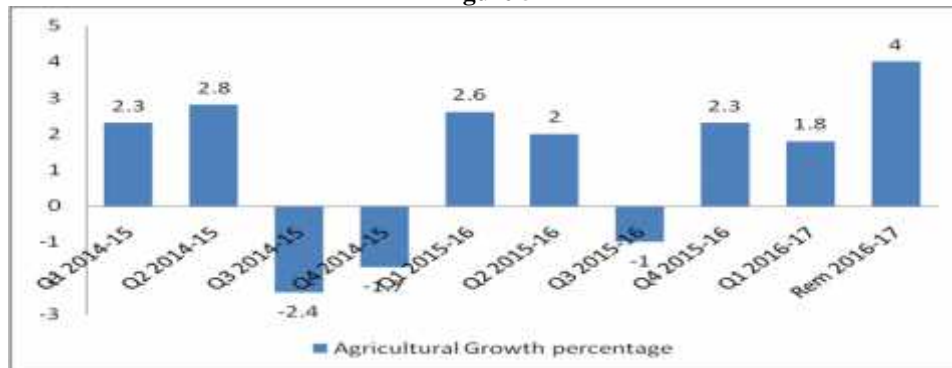


Now, the customers will be able to buy properties of their choice at affordable prices, in projects which will assuredly be delivered on time. Over the long term, the Indian real estate sector will emerge stronger, healthier and capable of long periods of sustained growth.

2.2.8 Agriculture Sector

The unorganized or informal sector accounts for more than 90 percent of the workforce in the country and contributes almost 50 percent of the national income. In agriculture which employs 49 percent of the population, nearly 97 percent of jobs are informal. The timing of demonetization, at the start of rabi season (October to March) might have hit farmers hard. However, Agriculture ministry figures revealed that the total sown area under rabi crops stood at 327.62 lakh hectares compared to 313.17 lakh hectares in 2015. It now appears the demonetization has had little impact on rabi sowing. With 2016 recording normal rainfall, agriculture was expected to grow at 4 percent this financial year, according to Crisil.

Figure 5



Source: key Economic indicators, Office of the Economic Advisor

* Note: For 2016-17, number represents prospective growth figures.

The rural economy—on which 800 million people, or 65% of India's population, depend—is largely driven by cash. The small and marginal farmers who sell off their produce in the village itself were hurt by the demonetization. Similarly, value chains with minimal processing and direct consumer sales such as fruits and vegetables were hit.

In fact the impact was not as severe as projected and that was evident from the fact that the supplies of essential commodities had not dried up and their too had been fairly stable. Moreover, in rural india, many systems work on credit.

2.2.9 Informal Economy

The existence of a large informal sector has been one of the most important factors in this dominance of a cash-based economy. Nearly 45% of gross value added (GVA) in the economy (average of 2011-15) was generated in the informal sector. The informal economy—which presently employs more than 80% of India's workforce—includes workers in small and medium industries, grocers, barbers, maids, construction workers, small retailers, farm workers and others. They had been severely hit and for weeks they were unemployed or on daily wages.

2.2.10 E-Commerce, Payment Companies to Benefit

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increases in demand. This should eventually lead to strengthening of such systems and the infrastructures required. Apart from e-commerce and online payment players, app based taxi services that accept electronic modes of payments seem to be the major beneficiaries.

2.2.11 Move towards Cashless Economy

The biggest potentially positive impact of the demonetization campaign for India's government is its inherent push to get more people onto the dominant economic grid, where they can be more readily regulated and taxed. India's economy is essentially rooted in the cash-centric informal market, which is responsible for up to 45% of GDP and 80% of employment. Beyond that, until the demonetization campaign, upwards of 95% of all monetary transactions was conducted in cash and upwards of 40% of the population was completely unbanked. By disrupting the engine which drove the cash economy, more of the population can be brought into the fold by using taxable systems of economic exchange, such as bank accounts and e-wallets moving to cashless economy.



If a large amount of people and businesses are brought into the bosom of the formal economy via the demonetization program, then India could be in for a boost in liquidity, increasing transparency and an apparent increase in its recorded economic growth rate.

2.2.12 Black money Disclosure

In the biggest ever black money disclosure, at least Rs. 65,250 crore of undisclosed assets were declared in the one time compliance window, yielding Rs. 29,362 crore in taxes to the government. The black money declaration will go up once all the online and manual filings of undisclosed assets filed at the end of the four month window on September 30 are compiled, the government will get nearly Rs.14,700 crore or half of the due taxes, this fiscal.

2.2.13 New Taxpayers

The number of persons under tax net has increased by 91 lakh post demonetization, thus massive surge in the number of tax payers. During 2015-2016, there were only 55.9 million or 3.7 crore Indians who paid income tax in India. But during 2016-2017 fiscal year, total tax payers have increased to 65 million or 6.5 crore.

Tax revenue to Central government has increased by 18% to reach Rs. 17.1 trillion, as on fiscal year ending March 31, 2017. Central excise duty increased by 33.9%, service tax collection increased by 20.2%, compared to last year.

The government launched an online portal as an extension of its ongoing initiative of 'Operation Clean Money'. Through the use of data analytics and technology, it has become easier to detect tax evaders.

3. Suggestion

We all suffered with demonetization. Economists caution of a deflationary scenario, characterized by weak demand, low prices and low growth. As the saying goes "no pain no gain". In the same way short-term constraints will be associated with long-term benefits in this process. This is only the beginning and this move on its own cannot address the issue of black money. It is well known that cash is only a small component of the black economy, therefore, how much of the black money will come out into the system is still difficult to assess. Further many reforms should be initiated by the government.

- Rule of law is critical for a well-functioning economy. If illegal activities (smuggling, drug trafficking) as well as corruption continue, black income will be generated in future. This will be funnelled back into the economy and receivers of this—firms, businesses—will again have to hide these revenues from tax authorities.
- Structural reforms to make the economic transactions more transparent are, therefore, necessary to sustain the government's current initiative.
- Transparency should be brought to the sources of black money, such as real estate and political funding. The next logical step should be to move on to benami properties and simplify and reduce taxes and bring electoral reform.
- All donations made to political parties must be made digitally and known sources. Their accounts should be audited.
- The stamp duty in real estate transaction should be removed or reduced from the current 6-7 percent to 3 percent or less.
- Even income tax, on individuals and corporate world can be reduced and simplified.
- Direct Taxes Code and Goods and Service Tax should be implemented soon.
- Gold transaction need to be brought under the electronic payment system. Economy of a growing country cannot proceed with such large amounts of un-used cash lying in the lockers. Every penny needs to be in circulation.

4. Conclusion

Despite predictions at the time of demonetization, the nation did not break into riots, the economy did not collapse, stock markets remained buoyant and the global view on the future of the Indian economy did not change. Short term loss might be 0.2 percent but in the long term, it will accelerate the growth rate by 1-2 percent. The statistical figure given for new disclosure and high tax collection, clearly indicate that demonetization drive had positive effect on the Indian economy. In the long term, the economy will benefit from the reduction of the black money, which will lead to higher tax collection, better business environment, less corruption & more transparency. If the Uttar Pradesh election was a referendum on demo, the results loud and clear. The big take away from the assembly poll outcome in Uttar Pradesh, is that Prime Minister Narendra Modi has cleared his big political test on demonetization. The BJP's victory in the state is a vote for Modi. With his demonetization gamble paying off electorally, Modi is expected to push reforms including those perceived to be politically unpalatable.



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