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Demonetisation and Sustained Growth in Indian Economy

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ABSTRACT

Demonetisation- the 'buzz' word in Indian market is possibly the largest financial reform that the country has seen in the last decade. Hence it becomes imperative to have clear understanding to the term and its impact on the economy.

Investopedia defines Demonetisation as the act of stripping a currency unit off its status as legal tender. The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with the new one.[1]

The paper presents demonetization with special reference to India (both current and historical perspectives). It then moves on to bring out the immediate impact of Demonetisation on growth of the economy. With the relevant data, the paper also aims to chart a roadmap to Indian growth taking into account post-demonetisation impacts.

Key words: Demonetization, India, post-demonetization impacts JEL classification: E41, E42, E51, E52, E58.

1. INTRODUCTION

Demonetisation has been a far-reaching financial reform witnessed by Indian economy in November 2016 bearing profound cost with immediate effect and expectedly dramatic benefits in the long run. With this move about 86 per cent of the currency in circulation lost its status of legal tender except for use in some areas. The government to send a clear message of development pro introduced this reform with multifold objectives: to curb corruption; counterfeiting; terrorist activity funding; tax imposition on unreported incomes; targeting black money and curbing fake notes in the system. Demonetisation was aimed at signalling a regime change, emphasizing the government's determination to penalize illicit activities and the associated wealth. In effect, the tax on all illicit activities, as well as legal activities that were not disclosed to the tax authorities, was sought to be permanently and punitively increased.[2]

Unlike the other forms of demonetisation that took place across the world economy in events of uncertainty, the one that happened in India got initiated at the time when the country was doing exceedingly well on the growth scale.

Historical Perspectives : Demonetisation in India is not an unparalleled move; it has taken place twice in the history, viz. 1946 and 1978. However, the one that took place in 1970s also accounted for 86.6 per cent of then existing money stock but is still considered to have a negligible impact on the economy.[3]Introduction of demonetisation brought expectations of growth in GDP to come to a halt. This has also been supported by the figures wherein growth registered in the current trough was found to be 1.2 per cent only as against the previous four trough figures of about 3.3 per cent. Also, the monetary policy of the country has observed a quite different pattern from the world space with introduction of contractionary monetary policy.

In the wake of these movements financial system in the country has raised certain questions which demand a careful investigation; immediate and long term impact on GDP and its implication in the future course.

Short term Implications : With process of demonetization in place followed by slow remonetisation, the GDP growth of the country was expected to come to a halt due to its negative impact on both demand and supply side factors. With people holding lesser purchasing power their aggregate expenditure was bound to decrease. However, consumption expenditures made by people in this transition show an opposite trend. It has been observed with people depositing the currency that they held in their bank accounts which has resulted in greater transactions through electronic wallets, debit cards, credit cards, internet banking among others. This has resulted in higher consumption expenditures of people in the formal sector.

Also, the short term anticipated effect on GDP was a slow down due to reduced demand (cash, private wealth), supply (rendered liquidity and working capital, and disrupted supply chains) and increased uncertainty. Sectors which are largely based on cash transactions did face some serious concerns like agriculture, jewellery and real estate. The statistic agencies expected the informal sector to have a greater impact because of the way their growth is measured using formal indicators as proxy to them. Although this underestimation was expected to come down in the adjustment time.

The immediate impact on certainty and stability in the macroeconomic framework did not deliver very positive results. Households, unaware of the future economic policies and behaviour postponed consumption for the situation to settle down. This pent up demand has led a foundation stone for the economy to have a more sustained economic growth in future.

On a closer examination of the estimates, we can quote agencies like Nomura expected the Indian growth rate to rise from 7.3% in 2015 to 7.8 in 2016 and further 8% in 2017 primarily because of demand side factors. The economic survey also anticipated the growth rate to fall by 0.25-0.5 per cent this year bearing the impacts of cash squeeze in the economy. Also, RBI in its Sixth Bi-monthly Monetary Policy statement in February estimated GVA growth in 2016-17 at 6.9%, lower than what it estimated the same in December.[4] The NCAER also cut down on its estimates on growth from 7.6% to 6.9% for 2016-17 in the same month.[5]

However as per recent data released by Central Statistical Organisation in March 2017, the growth rate ticked at 7% in the third quarter of 2016-17. This growth rate cannot be considered as abysmally low if compared with growth rate in second quarter of 7.4%. In line with country's performance on GDP and consumption front, Indian statisticians project the country to grow at 7.1% by the end of March. [6]Such a performance of country on growth trajectory has surprised all the economists of the country who expected the economy to slump a little because of lower consumption demands withstanding the impacts of lower cash held by people. This may be explained by sharp rise both in agriculture and manufacturing sector which held the economy growing and that too a sustaining one.

Long Term Implications : The immediate impacts of the financial revolution have given a glimpse of future movements. Economists across the globe have projected actual impact to be felt only after a year of the change. Nevertheless some early signs of alterations may be felt across the country like digitalisation, real estate, consumer durables, jewellery and others.

Digitalisation : Country while demonetising its currency had one of the objectives to introduce more white transactions in the economy. For a layman this would imply lesser cash transactions and increased electronic or digital transactions so that all the economic activities may be recorded and accounted for while calculating national expenditure/income. This would also boost the formal sector savings thereby contributing further in the growth process if accompanied by tax compliances. Watal Committee in its report in December 2016 illustrate 78% per cent of the country's dealings to be carried out completely on cash basis.[7]Princewaterhouse Coopers (2015) also provide enough evidence to show cash based transactions in the country to range up to 68 per cent of the total and around 98 per cent by volume.[8] The similar number for China are 45 per cent and 90 per cent respectively and are as low as 11 per cent and 48 per cent in developed countries like United Kingdom and United States. One cannot outlook the perks offered by cash transactions which range from being convenient, wider acceptance, anonymity, to less costly but one can also not ignore the fact that the designing of cash transactions by default leaves a wide room for tax evasion. This lower tax base is already a key constraint faced by Indian government. On the other hand digital transactions do offer significant benefits to the economy by connecting all the sectors and leaving lesser room for people to evade taxes and hence expanding the tax base. It requires a well equipped economy and aware masses able to identify the use and benefits of making digital transactions.

Digitalisation in India may be seen extending its impact on three sections of the society, the poor, the less well-heeled and the prosperous ones. The first out of these are left outside the net of the term called digitalisation due to lower level of literacy and negligible knowledge of digital transactions. The second category is the one who are being slowly included in digital bracket for them being covered under Jan Dhan accounts and RuPay cards. However, the third of these is the one already being digitally integrated via plastic and electronic money. In order to quantify these categories numbers show, out of the 1250 million people living in the country approximately 350 million are digitally excluded (without cellphones), 350 million own featured phones and the rest 250 million possess smart phones.

Hence, the government has to intervene dramatically to equip the nation with social overhead capital and create awareness about digital transactions. In the rouse of cashless economy, the role played by government deserves applause. With launch of BHIM application for smart phones making use of Unified Payment Interface, about 1 million transactions have been catered followed by approximately 10 million downloads. Not only has this BHIM USSD 2.0 allowed around 350 million featured phone possessors to have digital transfers. The government has also tried to include the 350 million people without mobile phones by launching the Aadhar Merchant Pay which makes the use of Aadhar card and biometric identification for transactions.As per the data released by National Payments Corporation of India in January 2017[9], a theatrical move has been experienced by the country. The National Automated Clearing House show the value of transactions to increase from 1196.97 billion in 2014-15 to 3715.09 billion in 2015-16 and to 5787.17 billion from April'16 to January'17. Also the Aadhar Mapper Enables Services show an increase in volume from 118.11 million in 2015-16 to 175.50 million in the first three quarters of the current fiscal. RBI survey data indicates that during December 2016 digital wallets accounted for just Rs 95 billion in transactions and UPI only Rs 7 billion, compared to Rs 314 billion for debit (excluding RuPay and ATM transactions) and Rs 270 billion for credit cards. Still they are growing rapidly.

In the wake of demonetisation, steps taken by government and its responses from masses clearly indicate a move towards a more digital, transparent and corruption free economy reflecting great performance on growth trajectory.

Real Estate : Real estate in India is one sector that easily absorbs peoples' unaccounted cash by providing a medium to evade taxes on property sales. Demonetisation is expected to bring down this tax evasion by increasing electronic transactions using white money. These anticipations have been supported by estimates of Knight Frank and Survey[10] calculations stating that the real estate prices have been continuously dropping since fourth quarter of 2015 and also plumped to become negative in third quarter of fiscal year ending 2017. However such a deceleration in property prices is considered to be a sign of prosperity in the country since it clearly increase affordability of the middle class and facilitates labor mobility across the country.

2. CONCLUSION AND DISCUSSION

On deep investigation of the term called Demonetisation and its impact in India clearly reveals that the country's performance turned out to be surprising augmenting the early anticipation of slowdown in the country. Rather the statistics denote a scope of further improvement on growth numbers followed by inclusion of pent up demand and tax reforms in the country. Such growth figures are expected to be more sustained and consistent one.

Demonetisation followed by larger cashless transactions, increasing the accountable income and tax base of the country will allow Indian government to have increased source of revenue thereby enhancing its capacity to introduce welfare programmes for people. Also a positive impact on income disparity and regional inequality is bound to follow. This may clearly be seen in various macroeconomic indicators.

The monetary sector of the economy has witnessed sharp increase in cash holdings of people followed by increased bank holdings. The central bank in its accordance decreased the interest rates on deposits, loans and government securities. However in the longer run the cash availability to people will settle down with relatively lower bank balances. This would further ease the credit availability in the country. Also the financial savings of the country in formal sector saw a pointedincrease which would further increase in the long run to the extent of decreased cash to deposit ratio.

Nevertheless impact on corruption could not been seen immediately but is expected to decrease if incentives for observance improve. A spectacular impact has been observed on the stock of unaccounted income or black money in the economy that fell obliquely for increased tax net and is further anticipated to fall with the formalisation of transactions.

Public sector wealth did not see any impact of demonetisation in the short run but is expected to increase certainly in the longer run with reduced liabilities of the central bank and increased revenue resources for the government. Although the impact on private sector is complete opposite. It decreased in the short run and would further decrease if accompanied by real estate sector observing a downward trend. The country has witnessed a significant increase in the number of digital transactions with cash squeeze which should further increase manifold times with people adjusting to the new system of payments. It is only on the certainty and reliability parameter, the financial move did not perform very well. Peoples' believe in the financial system shook considerable which is expected to settle but only after a considerable period of settlement.

2.1. Footnotes

(i) Nomura Research Institute is a research institution hailing from Japan which undertakes the market research to discover and create new social paradigms in order to contribute to the growth and development of Japan, Asia and the world.

(ii) As per NCAER Quarterly Review of Economy, February 2017, http://www.ncaer.org/uploads/photogallery/files/1488281969Press%20release%20QRE%20Feb%202017.pdf

(iii) A sound financial eco system would imply financially literate masses making informed choices to their access to well functioning financial system offering a wide range of financial instruments and services.

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