

Demonetization and after shocks in Indian economy: A Survey

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Abstract

Demonetization of economy is a splendid idea to revive the economy which is driven by jobless growth. From 1971 to 2000 six countries goes to demonetized their economy, viz- North Korea, Myanmar, Soviet Union, Nigeria, Zimbabwe and Ghana. The result of demonetization in case of these countries was not a pleasant one. Lack of demand in the market severely impact in the volume of business and investment. But the recent experience of demonetization in Indian economy tells a very different story. After remonitization of Indian economy a more transparent and strong scenario is appearing in respect of investment and growth. This paper emphasizes in various facets of demonetization and aftershocks in Indian economy, like-Investment shocks, remonitization, accounting profit, tax reform, cashless economy.

Keywords: demonitization, remonitization, investment shocks, cashless economy

Introduction

Demonetization is the process of devaluating a piece of currency to zero, making it no value greater than a regular piece of paper. Demonetization for us mean that Reserve Bank Of India has withdrawn the Rs,500 and Rs,1000 notes and declare the same as no more legal tender. The fact behind demonetization of Indian economy is presence of large number of counterfeit notes in the market, curb terrorist funding and contain black money in the economy which combinly create a situation of jobless growth. 6, 32,926 fake notes were circulated in Indian market before demonetization and India is one of the largest tax evaders in the world. All these facts mutually create a shadow economy which in turn creates jobless growth in Indian economy. Aftershocks of demonetization felt in every sector of the economy viz. Agricultural sector, Service sector, and Manufacturing sector badly for lack of demand in the market and lack of currency of Rs,500 and Rs,1000 which formed 86.4% of total currency notes. But after December 2016, when remonitization has been started, Indian economy again gearing up slowly. It can be safely presumed from the recent trends of Indian economy that after remonitization a more transparent and viable economy will appear in near future. This paper emphasizes on the impact of demonetization in investment and demand, how far demonetization addressed the problem of black money and future impact of demonetization in Indian economy. The objectives of the present studies is to-

1. Analyze the impact of demonetization in investment and demand and to measure of accounting profit by Reserve Bank of India.
2. Analyze the impact of demonetization on black money.
3. To analyze the needs of tax reforms after demonetization.
4. To analyze the future impact of demonetization in Indian economy and addressing jobless growth.

Methodology

Type of Data

The present study is quantitative in nature and secondary data will be used for the purpose of analysis.

Source of Data

The present study is based on secondary data. The sources of data include the facts released by Reserve Bank of India (RBI), Exchange, Central statistics office India and Different banks websites.

1. Impact of demonetization in investment and demand:-

Demonetization technically is a liquidity shock; a sudden stop of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. The exercise may produce following short term and long term, impacts on Indian economy.

- a) Liquidity crunch (short term effect): liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Nearly 16000 million units of Rs 500 notes were in circulation as on end March 2016. Towards end of March approximately 10000 million units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.
- b) Welfare loss of currency: Most active segments of the population who constitute the base of the users of currency do not meet their transactions. The daily wage earners, other laborers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class.
- c) Consumption will be hit: When liquidity shortage strikes, it is consumption that is going to be adversely affected first.
- d) Consumption $\downarrow \rightarrow$ Production $\downarrow \rightarrow$ Employment $\downarrow \rightarrow$ Growth $\downarrow \rightarrow$ Tax revenue \downarrow
- e) Loss of Growth momentum- India risks its position of being the fastest growing largest economy- reduced consumption, income; investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.

- f) Impact on bank deposits and interest rate: Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. They saved this money into banks just to convert the old notes into new notes. It will be converted into active liquidity by the savers when full-fledged new currency supply takes place. Most of the savings are obtained by public sector banks. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.
- g) Impact on black money: Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depends upon the amount of black money held in the form of cash and it will be smaller than expected
- h) Impact on counterfeit currency: the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise. Overall economic activities will be dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

2. Measurement of Accounting Profit by Reserve Bank of India arising out for Demonetization

Day after demonetization, in policy circles it was floated that demonetization would extinguish close to `3 lakh crore of RBI's currency liabilities. It was hoped, the net worth of RBI could then be transferred to the government in the form of a special dividend. However, two points may be noted in this context. First, the transfer of extinguished currency as dividend to the government was ruled out by the RBI itself. Secondly, as on 10 December, an amount of `12.44 lakh crore in the old series of notes had already entered the banking system. The public had time till 30 December to deposit old notes with banks, and they could continue to submit old notes to the RBI until around March 2017. In other words, there is likely to be very little money left with the RBI to extinguish. What is likely to be the net revenue gain from demonetization? As an illustration, let us assume that `1.6 lakh crore are voluntarily disclosed. A 50% tax on this amount would result in an addition of `80,000 crore to government's tax kitty. Besides, declarants are supposed to provide an interest-free loan equal to one-fourth of the disclosed amount to the government for a period of four years. Assuming a 6% interest rate on borrowings, the government would then save `2,400 crore in each of the next four years. The present discounted value of this income stream comes to `8,430 crore. The total revenue gain is then `88,430 crore. However, the government would also lose money. It will end up spending about `17,000 crore on printing and distributing currency, and conservatively, another `6,000 crore as the interest cost of managing the excess liquidity with banks. Let us assume that 2% of the nominal GDP is shaved off due to demand contraction; instead of growing at, say, 11.5% per annum, the nominal GDP would grow at 9.5% per annum. Taking the nominal GDP (at market prices) of `135 lakh crore in 2015-16 and a tax-to-GDP ratio of 17%, the combined loss of tax revenue to the centre and the states due to economic contraction would amount to `45,900 crore. The total loss of revenues due to demonetization would then be about `68,900 crore. The net revenue gain to the

government would then be `19,530 crore. In other words, it is hard to think that demonetization as a game changer for government finances.

3. Impact of demonetization on black money:-

The biggest mission of demonetization is described as fighting black money. India's economy historically holds a big parallel economy where unreported income is the norm. Hence, it is logical to classify the black money fighting effect of demonetization as (a) direct or immediate and (b) long term.

- a. Direct or immediate effects: Immediate effect of demonetization comes through the netting of black money deposited in the banking system in the form of banned Rs 500 and Rs 1000 notes from November 10 onwards. Around Rs 12 lakh crore of the Rs 15.44 lakh crore demonetized currency is with banks now and the extent of black money identified out of this will be the direct effect. Here, it is believed that an estimated Rs 1.5 to 2 lakh crore may be identified as black income. If Rs 2 lakh crore is revealed as black money out of demonetization, it will amount to around 1.75% of India's GDP. According to National Institute of Public Finance and Policy (NIPFP), black income amounts to nearly 40% of the country's GDP.
- b. Long term effects of demonetization on black money: The long-term effect will be much impactful and depends considerably upon how government deploys more measures to depress the shadow or black economy.

Shadow vs. formal economy

A high proportion of the economic transaction happens in the shadow economy and hence is unaccounted. The real estate sector is the most important example. Reducing the size of the shadow economy by enlarging formal economy is the way out. Here, transactions should be recorded and disclosure about the buying and selling property by quoting their financial ID or PAN card is mandatory especially for big transactions.

The process of formalization

Formalization means monitoring of the government. Here, two formalization options are needed: recording (a) high value transactions and (b) low value transactions.

Formalizing high value transactions

Post demonetization legal steps should be made to ensure mandatory PAN quoting for high value physical assets - gold/land etc. Though this measure is still prevailing, fragmentizing transactions into small helps black money. To avoid this, every small physical asset transaction should be made with Aadhaar ID proof.

Formalizing small value transactions

Here, digitalizing transactions in the form of prepaid payment instruments, debit and credit cards and online payments will reduce black money. Several post-demonetization steps were made by the government to promote digital payments.

A social shake up against black money

Awareness against black money and consciousness about legal and punitive measures is an intangible positive effect of this demonetization. It will change the mindset of the people and this shakeup of Indian society will be a big outcome though it may not be measurable.

4. Tax reforms after demonetization

The biggest challenge now a days after demonetization is that we still do not have a lucid picture to which extent the demonetization has actually worked for the government to curb black money creation or its distribution, or, more importantly, substantially raise the tax base by bringing a larger share of unaccounted, circulating paper currency under the monitoring of formalized financial networks. Let us assume that the government, through an increased number of deposits made in the banks, has somehow been able to marginally increase its tax revenue by bringing more people under the tax base by depositing unaccounted money in banks and reducing the transactional value of paper currencies under the push for a cashless India. Still, there remain some major questions for India's public finance management on both the revenue side and the expenditure.

On the revenue side, in spite of rising GDP and per capita incomes its tax to GDP ratio stayed more or less stagnant and how does India's tax structure split between direct to indirect tax at a 35:65 ratio remain a bigger incidental problem? On the expenditure side, do outlays of budgetary allocations necessarily transform into effective outcomes under these allocated areas? Does merely an increase in spending allocations improve economic efficiency? And what are the key prospective areas for the government in 2017 to focus in increasing its targeted spending?

India's tax-GDP ratio conundrum

While the economic success or failure of reform remains yet to be formally assessed and accounted for, one of the key targeted goals of demonetization has been to substantially increase India's overall tax base. In the Economic Survey report in 2015-16, India's abysmally low tax to GDP ratio was cited as a major reason for the further widening of income inequality, allowing less scope for the state to spend more on areas like primary healthcare and education. The average tax to GDP (%) for OECD countries remains much higher, at around 34.3%, it is noticeably higher even in emerging market economies like South Korea (25.3%), Mexico (17.4%) and Turkey (30%) in comparison to India largely because of their proportionally higher level of per capita incomes. India's GDP to per capita income still remains pretty low at around \$1,900. Conventional macroeconomic wisdom points out that a low per capita income may explain a low tax to GDP ratio for a given country. But what remains a conundrum for most economists is that India's tax to GDP ratio first diminished and then remained stagnant since 1991, while GDP to per capita income raised in post economic liberalization period-(India's tax-GDP ratio in % (1992-2012). Source: Trading Economics database)

So as a baseline estimate, one may expect GDP to per capita income to rise over time. But this may not necessarily mean that the tax to GDP ratio will rise at the same rate or even incrementally. In such a scenario, it may be wise for the government to reduce taxable exemptions for direct taxes and bring a wider base of the taxable population under the tax radar. In the aftermath of demonetization, perhaps the government may argue that this statistical anomaly between GDP to per capita and the tax to GDP ratio may change.

But there are other problems with India's tax revenue structure in addition to the tax-GDP ratio conundrum. First, the total tax split between the share of direct and indirect taxes in India are 35:65 ratio. It is quite opposite to, 67:33 in favor of direct taxes.

The issues remains critical for the government to at least reduce the large weight of tax revenue base on indirect taxes and gradually shift it towards direct taxes over time, which will also help in curbing income inequality. Second, to further increase overall tax revenue or ensure an ease in doing business.

5. Jobless Growth and Future Impact of demonetization in Indian economy

Indian economy before demonetization was fuelled by asset inflation that resulted in the creation of huge amount of black wealth. The quantum jump in illicit cash in the economy fuelled an asset price bubble in gold, stocks and real estate, which reflected as high GDP growth. However, that growth couldn't create jobs because it was black money spirited out of India and round-tripped back in the form of investment in assets. From 1999-2004 real GDP grew by 27.8 percent, annually 5.5 percentage points. Annual money supply that fuels inflation, by 15.3 percent, Prices by 23 percent, annually 4.6 percent, Stocks 32 percent, gold 38 percent and a phenomenal rise in jobs by almost 60 million. Real GDP grew by 50.8 percent, annually 8.4 percentage points, but only 27 lakh jobs were generated. This jobless growth arising out of asset price inflation, not production. India's cash to GDP ratio is very high vis-à-vis other nations. What explains this high circulation of cash? It is rise in high denomination notes which make it easier to generate black wealth. While in 1999 cash with the public was 9.4 percent of nominal GDP, by 2007-08 it had jumped to 13 percent. High denomination notes in the hands of public shot up from 34 percent in 2004 to 79 percent in 2010 and touched 87 percent. The economic growth during 2004-2014 did not improve the lives of the poor and the higher GDP failed to haul people out of poverty.

The Institute of Applied Manpower Research (IAMR), a think-tank of the Planning Commission, in a research paper published in 2013, found that not only did India witness jobless growth, it also saw millions pushed to become casual labour with little social security. It is revealed through their research that despite a phenomenal 8.5 percent growth in GDP, employment in total and in non-agricultural sectors did not grow. This jobless growth in recent years they found was accompanied by growth in casualisation and informalisation. According to the study, manufacturing sector saw the loss of 5 million jobs between 2005-10. The services sector witnessed only 4 million additional jobs in 2005-2010 as compared to a massive growth of 18 million jobs during 2000-2005. If this, points to a crippling problem that falsified growth while making it jobless, by sucking out extra, unmonitored cash, demonetization may help the economy do a much-needed course-correction.

Conclusion

The rewards of demonetization are much encouraging and for the long term interest of the country. Government need to ensure that there will be a smooth flow of currency exchanges. Demonetization will have a massive impact on parallel economy. The current demonetization initiative by the Government of India will take Indians ten steps ahead. Though it has given temporary pains, it taught financial lessons. It will also impact corruption, elections and terrorism. It is a reaping time for the banks that made considerable investments on digitization of banking services. The cashless and transparent mechanism has gained momentum post demonetization. It has

led to increased financial inclusion and this momentum should be continued till India achieves complete financial inclusion.

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