

ECONOMIC ENVIRONMENT OF BUSINESS



ANALYSIS OF DEMONETISATION IN INDIA

[ANNOUNCED ON NOVEMBER 8, 2016]

NOVEMBER 21, 2016

SHRAVAN T

ANIRUDHA K

RISHABH MUNDADA

AMAN GUPTA

HARSH JAISWAL

INTRODUCTION

On 8th November 2016 the Government of India and the RBI declared that the 500 and 1000 Rupees note are no longer a legal tender. This decision definitely affects all of us and is a subject of debate for political experts. But we aimed to focus here only on the economic side of the policy. But even various prominent economists are divided on this issue, so we as an sophomore are obviously not in any position to give any conclusive statement about this policy in this project, rather we will just be analysing various aspect of this step and the possible future implications.

First we shall discuss some background about demonetization.

DEMONETISATION

Demonetization is the act of stripping a currency unit of its status as legal tender. This process can be used as tool to achieve various aims. It is a compulsory deed whenever there is change of national currency, like when the European nations adopted euro as their currency. They all demonetized their own currency with a fixed exchange rate for euro.

It could also be used as a counter attack for the tax evaders.

There have been various instances in past across the world where demonetization took place. The reasons were varied from country to country. Few of the cases are-

1. Australia

In 1996 Australia introduced Polymer currency and thus demonetized all the existing paper currency. But the process was gradual and had no unexpected results.

2. United States of America

In 1969 President Nixon declared \$500 and above, illegal tender. Before this there used to be bills of 500, 1000 and even \$10000. The significance of these bills at that time was, that they were used for large amount of transactions especially by government. But with introduction of Electronic transitions, the only role they had was in illegal drug

business and money laundering. So the U.S. government demonetized these higher denomination.

3. Zimbabwe

The intense hyperinflation in Zimbabwe forced the government to demonetize the currency. During 2009, the Zimbabwe dollar got so weak that finally government announced to phase it out with U.S. dollar, with an exchange rate of whopping 35 quadrillion Zimbabwe dollar = 1 U.S. Dollar.

4. USSR

In a series of various changes in monetary policy in 1991, the government of USSR declared denomination of 50 Rubles and 100 Rubles illegal tender. The reason for this was to put a check over tax evasion and black money. But this move was not well received by the people, and this along with various other policies caused widespread anger among people against the government which eventually ended with disintegration of USSR.

There were other countries like Nigeria and Ghana too, which used the measure of demonetization to control the check tax evasion, but none of these countries showed any promising results.

DEMONETISATION IN INDIA

This is not the first time that higher currency has been demonetized in India in order to control black money. Similar measures were taken in 1946 and 1978. Not a lot of information is available for 1946 demonetization. But it is for sure that this step was taken as a measure to put a control over unaccounted money.

THE 1978 DEMONETISATION

In the morning of 16th Jan 1978, the Morarji Desai government shocked everyone by declaring all denomination greater than Rs 100 to be illegal

tender. Back in those days we used to have notes for Rs 1000, Rs 5000 and even Rs 10000. Only 3 days' time was given to the people to exchange their money.

But this step didn't hurt the common people back then. Unlike today, Rs 1000 was a very high amount at that time. So one would only expect to find notes of such high denomination with very rich businessmen. We can have an idea that how large the value of these currency was back at that time by adjusting this value of money to inflation. And we get that

Rs 1000 of 1978 = Rs 20,370.11 of 2016

Rs 10000 of 1978 = Rs 2,03,701.11 of 2016

So we can clearly see that it must have been very uncommon to find currency of these denominations with middle and poor class people. According to RBI History Project data, about 9.5% of total money in circulation was in form of these notes.

Thus, it's safe to assume that the hardship for common people back then would have been very less compared to 2016 case, where 86% of currency is demonetized!!

THE 2016 DEMONETISATION

So almost every expert agrees that this move was part of well-planned series of steps for checking the financial irregularities in country.

1. Opening of Bank Accounts

Prime Minister Modi, after being elected in 2014 started the **Jan-Dhan yojna**, in which he targeted to open bank account for every household in the country. And the scheme succeeded with around 22 crore bank accounts opened and about 378 billion Rupees deposited into these accounts under the scheme. This step ensure that the country had basic financial infrastructure needed for any of the future steps.

2. Giving chance to declare unreported income

The Government declared that if any person declares his unreported income (black money) to the Income tax department, he/she will be just

penalised 50% of the total amount and no criminal or civil cases will be filed against them. So this was kind of a last chance for redemption, that any person may covert his black money into legal money just by surrendering 50% of it.

3. Demonetization

The sudden demonetization of larger denominations, which are generally the ones used for large transactions and for stocking cash. This step intends to make all the stocks of unaccounted cash worthless.

Steps in which demonetization took place

1. All the 500 and 1000 rupees notes were declared illegal tender. These notes constituted of about 86% of total cash circulated in the country.
2. People were given a deadline till 31st December to deposit or any exchange these currency notes.
3. A bank holiday was declared for the next day, so that banks can have time to be prepared for gigantic task that lies ahead them.
4. To avoid acute cash shortage, the government limited the withdrawal capacity to Rs 4000 per day, from account, which was later changed to 4,500 and then to 2,000.
5. Exchange amount was also restricted to Rs 4000 per day.

We must now discuss both positive and negative side of this action in a bit detail.

MERITS OF THE RECENT DEMONETISATION

Demonetisation has always been a topic of debate for many countries all over the world that have faced it. Now it's the case of India, which has witnessed demonetisation 12 days back. As it's a topic of debate so some of the advantages of demonetisation are discussed here. There are many economic aspects that could be benefited from this and almost all of them have the long term benefits, but two major that are most severe in India are Black Money problem and The Fiscal Deficit problem. So let's discuss all of them:-

DECLINE IN BLACK MONEY:-

- Black money has always been a major problem for India since decades and has recently increased a lot in last 10-12 years. It's seen that demonetization has put a check on black money amount in economy and its circulation.
- Most of the economists and media people believe that black money has been converted to gold and land assets and is no more left in cash. So only a little of it would be discovered. In economics there is a quantity theory of money and has a tool called velocity of money, which is the pace at which money gets multiplied in an economy. Simply let's say if an economy has Rs1000 products to be sold in a year, it doesn't need to print notes worth Rs1000 may be worth Rs200 notes will also work here. Because in a year money keeps changing hands, let's say 5 times then 5 is the velocity of money. In the case of black money the velocity might be more than white money. But money is present in the system only. Let's consider a case here:

Say Mr X has black money. He doesn't want to keep it in hand and immediately he buys land by paying to Mr Y. Now the black money is with Mr Y. If he also doesn't want to keep the money and he buys gold paying to Mr Z. Now the money is with Mr. Z. So we can see that someone has it in hand. They might be anyone like terrorists, naxalites, black marketers, politicians and even businessmen. They all are suffering. So it's absurd to say black cash is all converted. It's there in the economy and mostly in the form of 500 and 1000 Rs notes.

- So will this eradicate black money and corruption from India? Will this work with Indians? It's said by some experts that Indians would find a way to escape such traps of getting black money out. That might be true but the tax evasion and all the illegal businesses like human trafficking,

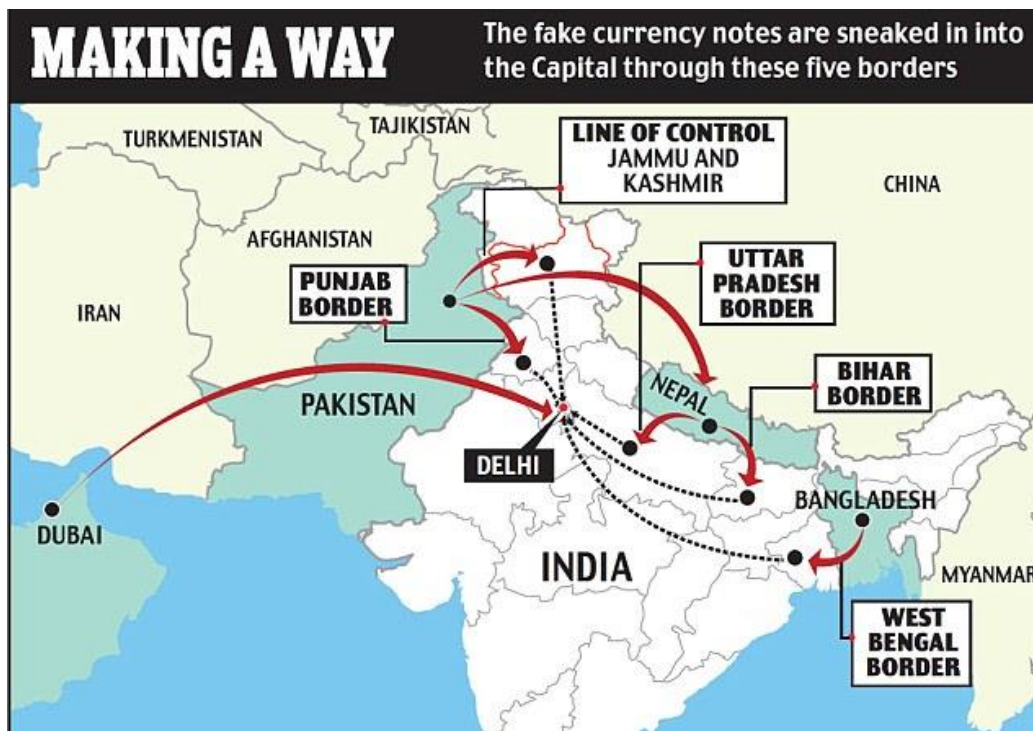
drugs, smuggling, terrorism would be even more expensive now and difficult to do. Passing large bills will not end such criminal activities but it would surely increase the less liquid methods of payments and would reduce corruption.

FAKE CURRENCY – MAJOR SPONSOR OF TERRORISM:-

There's one more important problem, which is of fake currency. About 250 out of every 10 lakh notes are reportedly estimated to be counterfeit currency. So it was becoming necessary to take a preventive measure against this.

- Fake currency has caused a lot of problems in Indian currency market. Many innocent people were fooled and also suffered because of this. Fake currencies help run the terrorist organisations and even the Naxalites get their funds by replacing the original notes with the fake ones. So this is a double loss to the nation.
- As we go by figures, out of the overall figure of 16.6 lakh crores about 87% is in 500 and 1000 Rs notes and the fake currency in circulation that is not counted within this 16.6 lakh crores. This has a lot to do with nation's security. This can even be proved by an incident that occurred after the decision of demonetisation was that about 3% of the total money in banks was deposited in Jammu & Kashmir in banks though the extremists threatened people not to go and deposit. And after that there has been a sudden drop which clears that this decision has proved useful in a sensitive area like J&K.
- The new currency in denomination on 2000 will replace the fake currency in 500 and 1000's. About 50 to 60000 croreRs are used for naxalite funding and this all couldn't be deposited back to banks. And with no fund terrorism will be definitely suffer with a severe setback because of this decision.

These are some ways how fake currency enters into our markets:-



Source- acdemocracy

DEPOSIT BASE:-

- As there has been the return of 500 and 1000 Rs notes. Lots of money is coming back to the banking system from the cash economy. Now the credit availability would increase with the banks. As previously it used to happen that banks are running out of cash, this this problem would also be solved now.
- Let's go with some figures, according to an estimate by the state bank of India out of 12 lakh crores in cash economy about 3 lakh won't be coming back to the banking system. So this would be the monetary surplus with the RBI. Out of 12 lakh cr that would be coming to government about 2 lakh cr substantial tax revenue could be generated. And this would have far reaching consequences on growth. Also we can see that there is a lot benefit in depositing money in the banks instead of keeping in cash economy, we can see it by an illustration like if there are 5 lakh crores in cash economy then they would be 5 lakh only instead if deposited in bank then as per the credit creation process and fractional reserve basis it would become 20 lakh cr.
- To understand it better let's just assume that there is 100Rs deposited in bank and about 25% invested in government bonds. Remaining 75% will

go in credit creation and would multiply in system to about 3-4 times and thus will increase money and prosperity in economy, which can never be achieved by black or cash economy.

- Also it's said that it would benefit small businesses as well. Let's see how that would happen- Once so much deposits gets available to the banks then there would be more supply and lesser demand for credit, and this would make banks to lower the lending interest rates as it has been done by SBI by decreasing it by 15 base points. So these lesser interest rates would be benefiting the small businesses. Large firms used to get loans even from international markets at lower rates but smaller firms were hurt in an environment with high interest rates. So this will increase their business and thus will benefit the economy.

INFLATION:-

- When money supply in an economy decreases and the amount of goods is same then prices fall causing inflation to decrease. It has been a long time since every politician talks about the inflation and the problems caused by it. But any measure hasn't solved the problem yet. But demonetisation has proved to be an anti-inflationary move ever done post-independence. This will cause prices to fall and will lead to deflation which has never been witnessed before in India. So in a way we can say that the people those who have converted cash to gold and land are also going to lose as the prices of these two are also going to fall and the value of their loot will come down considerably.
- Even there are some economists saying that purchasing power will go down which is actually incorrect as black money was used for hoarding and unproductive purposes and that won't be affecting the purchase power. Rather this increased the prices of land and gold and everything else. Now with this reduced phenomenally, there will be deflation.
- Now discussing about the land prices, they are going to be down by 30-40%. "The real estate sector is the biggest receiver of black money, so it will take a massive hit," says Ajay Jain, ED, Investment Banking and Head Real Estate Group, Centrum Capital. So short term impact on real estate sector could be very serious. The prices in residential sector and even land markets can see a downward trend. However in long term there would be more transparency in transactions and clear use of cash.

Because of the withdrawal of the black money from this sector the land prices would be moderate and the affordability for houses will increase however construction prices are based on the prices of raw materials and commodities.

TAXES:-

- Taxes have always been a major source of revenue for government and a kind of burden on people on their income. Right now the interest rates are high and would be as it is in short term. But this factor of demonetisation would cause deflation in long term and hence also decreasing some direct taxes like income tax could be seen in long term as also there are deposits with the banks and interest rates are also lower.
- Also apparent aim of demonetisation before GST is to make business persons do transactions in white, so that low rate of GST is viable. As keeping GST high would have benefited taking on rich more than poor. But now this move has made government to keep GST low. So that proper distribution of income could take place.

GOVERNMENT FINANCES AND BOND MARKETS:- This move of Demonetisation has benefited so many other sectors for public and the private sectors. Let's see how it will benefit government itself.

- Demonetisation is mainly done for overcoming the fiscal deficit and that has been the primary reason in case of India as well. There has been a large amount of unaccounted money in the country which because of threat of getting turned to paper is making its way to the formal channels of banks which in turn will benefit with higher income tax collections. And this will help government cushion its FY17 fiscal deficit target, especially after a large shortfall in the expected revenue from the sales of spectrum. It was about 5.6lakh crore Rs. But was actually sold for about 66,000 crore Rs. So this deficit could be healed.
- Also the latest move will take the economy from unorganised sector to more organised sector, along with the GST architecture that will be coming on board next year. As there is more organisation and GST instead of sales, excise and VAT. There would be lesser tax burden and

Tax avoidance and tax evasion will also decrease as it will enhance government's ability to tax the commercial transactions which will help attain a better tax to GDP ratio in the economy.

- As we have discussed earlier that there would be a considerable rise in the deposit base with the banks. But there has been a little problem with the time of announcement of demonetisation. Actually during this year or can say this whole period has not witnessed that much credit intake by the public. So will be post demonetisation. So there would be much of the extra deposit or surplus left with the banks and this will make them reduce the interest rates and one more consequence could be increase in SLR(statutory liquidity ratio) demand and this will increase the government bonds being bought by banks, which would ultimately benefit the government to have them as a back-up.
- As we have discussed in the earlier points that a better tax to GDP ratio could be attained and this will also lead to a better tax buoyancy on supply side as tax rates remaining same revenue will rise. And as revenue increases fiscal deficit of government will decrease resulting in rationalized supply of Govt sectors. Another reason for this is FRBMA(Fiscal Responsibility And Budget Management Act) is underway.
- Anticipation of the easiness for monetary availability to further support transaction of government bonds due to increment in revenue, SLR and decrease in fiscal deficit.
- So as a conclusion we can say-
In the long run, it is a significant positive shock to the Indian economy and society. Implementing it substantially might send a strong signal about India's anti-corruption drive, thus improving country's reformist stance. This would also provide a support and boost the government's financial inclusion drive and hence pushing more households towards efficient banking and payment infrastructure related to various bills and taxes over transactions, also as we have discussed earlier in the immediate run we are likely to witness larger bank deposits, price corrections and better tax collection possibilities in the economy- all this would be great for Indian Bonds.

CASHLESS AND DIGITAL INDIA

This move had to come. Cash to GDP ratio was increasing each year. This ratio must decrease for a successful economy. Not because all cash was black money but cash economy would be an unorganized economy.

Now with this move most money will become organized.

This has many important advantages for the economy.

- **Increase in transaction history**
- **Reduced tax avoidance**
- **Improved credit access and financial inclusion.**

Also the citizens are now being pulled into digital transactions. With a serious cash crisis, people are now using more and more plastic money and E-transaction. Even the E-commerce giants like Flipkart and Amazon reported an increase in prepaid orders by about 30% since 8th November.

The below are a few instances where local vendor's are trying to transact online.



This move is likely to give a massive boost to our Prime Minister's vision of a **Digital India.**

DEMERITS

We must first recognize that the people who have collected huge wealth from black money, i.e., unreported income, hold most of it as real estate, gold and other real assets. Some of it is also held as assets abroad. None of these offenders will be affected by demonetization. A relatively small portion held as non-bank money to finance “*black*” transactions. This component is the target of demonetization.

However, black money cannot be simply separated from white money. Thus, we may purchase something from our tax-reported income, i.e. from white money. But if the shopkeeper doesn’t report the transaction, the money now becomes unreported money. If he then spends it on something with tax-compliant billing, the money is transformed back into white money.

Alternatively, he could under-report our transaction by, say, 20%. In which case 80% of the transaction is white money and the rest 20% is black. Thus, the same Rs 1,000 note may be white, black or partly black in different stages of the transaction. It is therefore almost impossible to estimate how much of the money in circulation is white or black or, for that matter, how much of India’s national income is white and how much is black.

We are likely to see a significant dip in economic activity till January or even till the end of the financial year because of this disruption.

It will cause deflation in the market as people who have stacks of black money would be afraid to declare the money as they may be prosecuted by the Income tax department on the legitimacy of their income.

Attached are excerpts of an interview for former RBI Deputy Governor K.C. Chakrabarty:-

What is your view on the ongoing demonetization exercise?

It has no economic rationale. It does not serve any purpose.

Why do you say so? The government claims that the move is aimed at curbing black money.

What is black money? No notes are black. All notes are white. It is the process that creates the black money. When a person does not pay tax, it becomes black money. Here you are killing the notes and not the fellow who is not paying tax.

You were the deputy governor of RBI when the UPA-II government was at the centre. Was there any such proposal from the government during your tenure?

Yes, it had come from the UPA government. After examining the proposal, we had said that this should not be done. The proposal never went to the board level.

Was it a formal proposal? What was the reason for declining it?

Whether it came officially or over telephone, is not the issue. But I definitely remember it had come. We said 'no' because it does not serve any purpose... the cost is high and the benefit is less. It has already impacted the banking system. For the next couple of months, banks will only concentrate on exchange of notes, no business can happen.

EFFECT ON ORGANISED WORKING CLASS

It is the cause of inconvenience for those who have to wait at the banks to exchange notes, deposit amount or withdraw the same. The situation has turned disruptive as there is a delay in the circulation of new currency. This is hampering the normal work of individuals.

Withdrawal Limit which has decreased from Rs.4000 to Rs.2000 is causing a big problem as working class requires cash for daily utilization.

With the release of only Rs.2000 notes it is causing problem in cash transactions of small denominations.

Individuals who have an upcoming weddings planned are having a problem in making arrangements for payments.

Hard earned money which is beyond the limit of 2.5 lacs can cause problems. This is one of the biggest limitations of Demonetization of 500 and 1000 rupee notes. For some people these amounts are in huge numbers like money with rich farmers.

SHORT TERM IMPACT ON UNORGANIZED SECTOR

All business keep large amounts of cash for operational activities. Since they have large amounts of black money for operational activities the business will be hit badly by demonetization. The owners won't be able to pay their employees.

Small shops and business will shut and in turn increase unemployment.

Apart from this there are raids by Income Tax, Sales Tax and excise which can create problem for legitimate Business too.

It will be very difficult for half of the population who are not well versed with the card transactions, net banking, e-services and for those who don't have bank accounts.

Labourers who are paid by the day are losing out on wages due to:

- 1) Cut the manpower in construction and real estate
- 2) Losing out working hours by waiting in queues.

According to latest figures 60% workers in the unorganized sector face unemployment after demonetization. These figures have been claimed by All India Trade Union Congress (AITUC) Secretary D L Sachdeva.

EFFECT ON GOLD PRICES

Gold, one of the most precious metals has been in huge demand after demonetization. One of the reasons being that people have lost their trust in keeping piles of money which has turned into ash all of a sudden; they would instead invest their income in gold which always retains its commodity value.

The other reason for soaring gold prices is that people are converting their unaccounted money to gold by bribing jewellers to backdate the sale of their jewellery.

SHORT TERM IMPACT ON STOCK MARKET:

The extra fall of the Indian markets compared to others could be due to many factors, but it is highly probable that the demonetization effect is mainly responsible for the fall.

That is clearly seen if we dig a little deeper. The Sensex which is made up of very large companies was not impacted as much by the demonetization process. But BSE's mid-cap and small-cap indices have fallen by over 6%. In fact, the largest impact of the government's move is in the unorganized sector (mentioned above), which isn't even represented in the markets.

BSE Realty index fell by as much as 15% at the time of writing. Some stocks such as DLF Ltd are down nearly 20%. This industry (real estate) is known to run majorly on cash transactions of huge magnitude. Similarly, stocks of jewelry companies such as Titan Industries have fallen by around 11%, maybe because a lot of gold transactions are via cash. Besides, stocks of mid- and

small-sized finance companies which collect payments in form of cash have fallen by 8-10%.



DLF dropped 22 points on November 9 from Rs.142 to Rs.120

COST OF IMPLEMENTATION:

One major feature about this decision may be the high cost of implementation. Estimates suggest it could cost RBI Rs 12000 Crore for carrying this whole process of demonetization,

This cost is significantly high and does question whether future benefits will outweigh the cost of its implementation and the stagnant economics conditions by it.

INTRODUCTION OF RS.2000 DENOMINATION

One of the rational of the current demonetization which cannot be explained is the introduction of new Rs.2000 denomination.

These notes will make it easier to store black money as higher the currency denomination lesser is the space required to store the same currency value. Although initially the amount of black money will decrease but eventually when tax payers again start evading taxes this denomination will help them.

The purchasing power of Indian currency note of Rs.2000 is somewhat higher than our standard of living requirements. One cannot justify the need of Rs.2000 note when we have low per capita income.

The entire purpose of demonetization seems lost with the introduction of higher denomination as demonetization of currency generally removes the higher denomination note from existing than introducing even higher denominations. The demonetization in India in 1978 removed Rs.1000, Rs.5000 and Rs.10000 notes and the US demonetization of 1969 removed higher denominations of \$500 and above. Rarely has there been demonetization accompanied with the introduction of an even higher denomination note.

PREVIOUS ATTEMPTS AT DEMONETISATION

Indian currency has faced demonetization in 1946, 1978 and now in 2016. There seems to be a pattern that in every 30-40 years the currency faces demonetization.

But the efforts of previous demonetization attempts have not shown a very positive effect on curbing individuals from possessing black money. There is a short term fear generated which ceases to exist after some years.

So, to remove black money to larger extent stringent laws have to be placed so that this short term fear generated should last and in the long run there is actual decrease in black money.

CONCLUSION

“We support the measures to fight corruption and illicit financial flows in India. Of course, given the large role of cash in every day transaction in India’s economy the currency transition would have to be managed prudently to minimise possible disruption”

-International Monetary Fund (IMF)

Hence as summarized by IMF, above the objective of the move is praise worthy. This will boost the Indian economy if executed in proper manner. At this point after twelve days, we see that government is trying its best to make the transition least inconvenient. Although there are short term demerits, on an optimistic note we hope this decision would be a significant step to

“MAKE INDIA GREAT AGAIN”.