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Demonetization impact the Indian economy: A descriptive study

Dr. Jayashree R Kotnal

Abstract
The term demonetization is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data.
Since less than 5 percent of population in India had access to such notes and most banks never had such currency notes, demonetization did not have a big impact on the country. The decision was taken to curb the illegal use of high denomination currency which was used for corrupt deals in the country. However, with the latest round of demonetization, the common public and bankers are undoubtedly facing hardship since more than 85 percent of currency in circulation has been rendered illegal in one single stroke. Demonetization is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. The question that arises is why demonetization was required at this point of time. There are certain pros and cons of demonetization.

Keywords: Demonetization, RBI's, economic growth, monetary transmission

Introduction
Originally, the Reserve Bank of India Act 1934 provided for the proportional reserve system of note issue. According to this system, the Reserve Bank had to maintain not less than 40% reserves (against note issue) in gold coins, bullion, and foreign securities with the provision that gold coins and bullion were not at any time to be less than Rs. 40 crores.
The remaining 60% of the reserves were to be covered by rupee coins, rupee securities of Government of India, approved bills of exchange and promissory notes payable in India. After independence, with the introduction of economic planning, it was felt that the proportional reserve system was not adequately elastic to meet the developmental needs of the country.
In the beginning of Second Five Year Plan, India had to face foreign exchange difficulties. Its foreign exchange reserves fell from Rs. 950 crores in 1950-51 to Rs. 825 crores in 1955-56. Consequently, the Reserve Bank of India Act was amended in 1956 and the proportional system of note issue was replaced by the minimum reserve system. According to this amendment, the Issue Department of the Reserve Bank was required to keep a minimum of Rs. 400 crores of foreign securities and Rs. 115 crores in gold coins and bullion.
In November 1957, the Reserve Bank of India Act was again amended to reduce the minimum currency reserve in foreign securities. Under the second amendment, the value of overall minimum reserve to be maintained by the Reserve Bank is Rs. 200 cores, of which not less than Rs 115 crores should be kept in gold coins and bullion.
Thus, the present system of issuing notes in India is based on the minimum reserve method. The chief merit of this system is that it is perfectly elastic; supply can be increased up to any limit. But, there is also the danger of over-issue and inflation under such a purely managed system.

Objectives of the Study
1. To know the currency system in India.
2. To review the Pros & Cons of Demonetization in India.
3. To analysis demonetization Impact the Indian Economy.

Review of the Literature

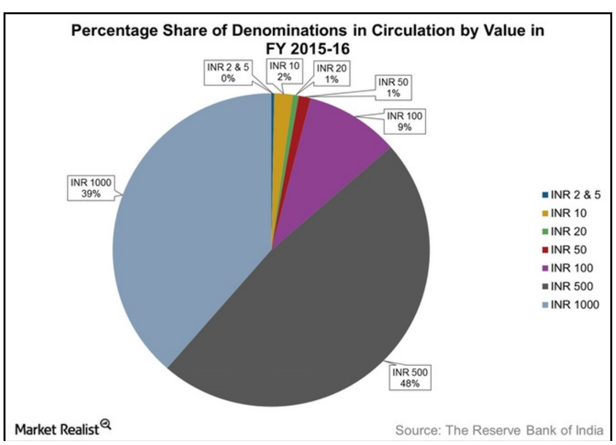
Bacchetta, Philippe (2002) [3]. The 'New Open Economy Macroeconomics' literature has investigated the implications of nominal rigidities in an open economy context and found that the currency in which prices are set has significant implications for exchange rate pass-through to import prices, the level of trade and net capital flows, and optimal monetary and exchange rate policy. While the literature has exogenously assumed in which currencies goods are priced, in this Paper we solve for the equilibrium optimal pricing strategies of firms. They find that the higher the market share of an exporting country in an industry, and the more differentiated its goods, the more likely its exporters will price in the exporter's currency. Country size and the cyclicality of real wages play a role as well, but are empirically less important. They also show that when a set of countries forms a monetary union, the new currency is likely to be used more extensively in trade than the sum of the currencies it replaces.

Richard Friberga (2008) [4]. They report survey results on the currency choice of a random sample of Swedish exporters. They find that for an overwhelming share of exports, the price, invoice and settlement currency is the same. The currency of the customer is the most used, with Swedish kronor and vehicle currencies accounting for approximately equal shares. Currency choice is similar for intra-firm and between-firm trade. We also find that negotiations are important for both the price and for the currency choice. A minority of firms use posted prices for their main exports — the median price adjustment for those firms is once per year.

Indian government's surprise

In an address to the nation on November 8, India's Prime Minister, Narendra Modi, declared that the two highest denomination currency notes—the 500 rupee note and the 1,000 rupee note—won't remain legal tender. The notes were demonetized at midnight on November 8. The move aimed to curb black money in the financial system. Black money is one of the factors holding back the economy.

The demonetization was a surprise. Since the announcement, the media discussed the pros and cons for consumers and the banking system (HDB) (IBN).



Lion's share put out of circulation

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.

In this series

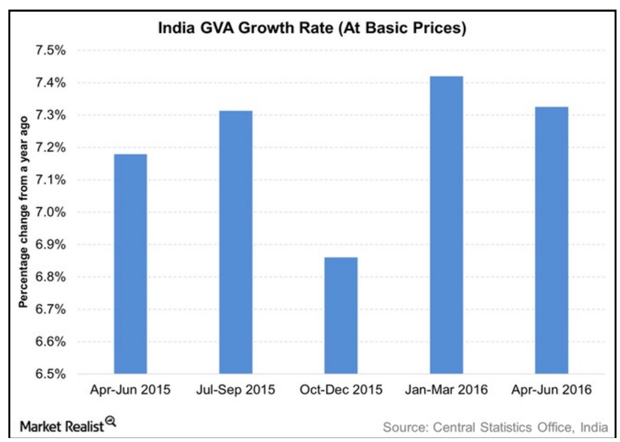
In this series, we'll look at the possible impact of the demonetization on the Indian economy. We'll discuss what it could mean for inflation, monetary policy, and financial markets (INDA) (PIN) (EPI). The series should help you assess what could transpire with your Indian investments in the short to medium term.

Let's start by looking at the broad impact that the demonetization had on the Indian economy.

How Could Demonetization Impact the Indian Economy?

Demonetization will hit the economy

The demonetization of the 500 rupee note and the 1,000 rupee note—the two highest currency denominations available in India—will likely hit the economy hard in the short term. The surprise move is expected to grind the consumption activity in the Indian economy to a virtual halt. The service sector, which dominates economic activity and involves a sizable chunk of cash transactions, will likely be hit the hardest.



India's economic growth

Growth in the Indian economy remained solid in the quarter from April to June 2016 (the latest available). In India, a financial year begins in April and ends in March of the following year. The previously mentioned quarter is the first quarter of fiscal 2016–2017. During that period, the GDP (gross domestic product) rose 7.1%, while the GVA (gross value added) rose 7.3%. The relationship between the GDP and GVA is:

GDP = GVA + taxes on products – subsidies on products.

The base year for calculating the GVA is 2011–2012.

The fall in economic activity due to demonetization could last from two to three quarters. As a result, GDP and GVA growth in the quarters from September to December 2016 and January to March 2017 could be significantly lower than previous years. Some bounce back should be seen in the first quarter of fiscal 2017–2018. In the medium term, the Indian economy can grow considerably after curbing the debilitation caused by counterfeit money and an increase in economic activity.

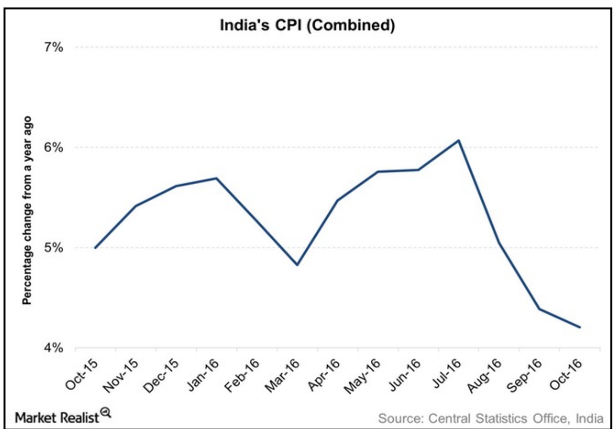
A fall in discretionary consumption will hurt companies operating in this space (TTM) (VEDL). However, a rise in tax flow and lower interest rates, are expected to help the Indian economy (PIN) (EPI) (INDA) grow stronger. In the next part, we'll discuss how demonetization could impact inflation in India.

Will Demonetization Impact India's Inflation?

Measures of inflation in India

The RBI (Reserve Bank of India) considers the CPI (consumer price index) as its primary gauge of measuring inflation. Prior to the RBI adopting the CPI in India (PIN) (FINGX), another measure of inflation—the WPI (wholesale price index)—was the key gauge of inflation and it's still considered for reference. To learn more about these measures of inflation, read India's different inflation measures—WPI versus CPI.

The RBI has CPI growth targets to adhere to while deciding its monetary policy stance. By January 2016, it was supposed to keep inflation below a target of 6%, which it was able to do. Its next target is to keep inflation at or below the 5% mark by March 2017.



Impact of demonetization

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. Activity in the real estate sector, which includes a lot of cash and undocumented transactions, slowed down significantly, Metropolitan and Tier 1 cities reported up to a 30% fall in house prices.

Food item inflation, measured by changes in the Consumer Food Price Index, accounts for 47.3% of the overall CPI. Due to 86.4% of the value of the currency notes in circulation going out of the financial system and re-monetization being slow, the supply and demand of food items fell. It will exert more downward pressure on inflation.

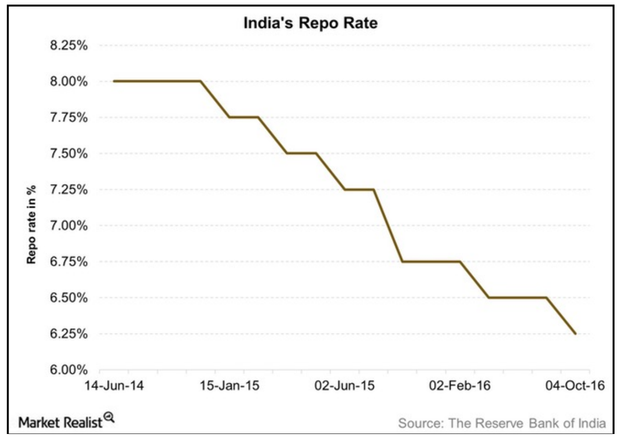
Investors in India-focused funds (EPI) (WAINX) should continue to monitor CPI inflation. It will determine future rate cuts by the RBI. A change in the repo rate will impact interest rate–sensitive sectors and industries like financials (HDB) (IBN) and automobiles (TTM), among other sectors like the tech (WIT) (INFY) sector.

In the next part, we'll discuss how demonetization could impact India's monetary policy.

RBI Cut the Repo Rate: Will More Rate Cuts Follow?

Repo rate cut

In its last policy meeting on October 4, the RBI's (Reserve Bank of India) Monetary Policy Committee reduced the country's repo rate by 25 basis points on October 4, 2016. The rate reduced 6.3% from the said date. The October meeting marked the second rate cut in 2016. The combined quantum of the cuts for the year stands at 50 basis points.



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 (IBN) (HDB). Other rates, like the reverse repo rate and the MSF (marginal standing facility), are fixed against the repo rate. The rate impacts the movement of the rupee, which impacts the revenue of exporters and tech companies (WIT). It feeds into India-focused funds (ETGIX) (INDA) as well.

More rate cuts to follow

With the announcement of demonetization and the subsequent impact on cash transactions and consumption, inflation will likely fall. Banks already started reducing their deposit rates. Lending rates are expected to fall as well. Due to the expected fall in inflation, the RBI will likely undertake more cuts in the repo rate.

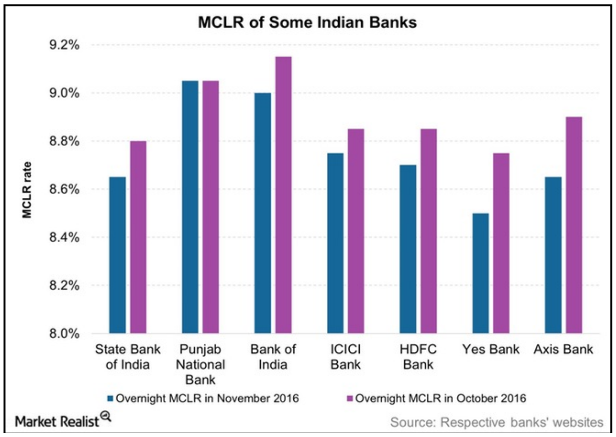
These rate cuts will aim to boost consumption. They will work to get the temporarily derailed economic growth back on track. A cut in interest rates boosts economic activity and raises hopes that after a lull for two to three quarters, economic growth will rise. In the next part, let's take a closer look at how demonetization can impact interest rates in the financial system.

Will Demonetization in India Impact Your Loan Burden?

Rates are already on the decline

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

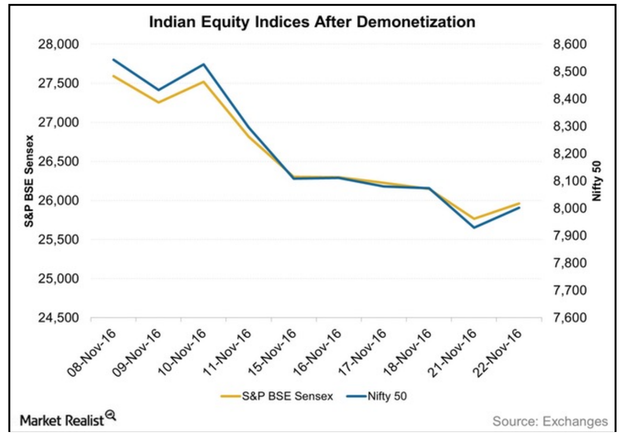
the Reserve Bank of India released on November 21, deposits crossed the 5 trillion rupee mark from November 10 until November 18. At 68.2 rupees to one US dollar, it translates to $75 billion in deposits in just eight banking days.
Banks also saw a rise in term deposit accounts since the demonetization. Due to these factors, commercial banks like State Bank of India, ICICI Bank (IBN), HDFC Bank (HDB), and Punjab National Bank, among a host of others, sharply reduced their deposit rates.



Loan burden will also fall
Apart from cutting deposit rates, banks reduced their lending rates as well. In India, loans sanctioned from April 1 are with reference to the MCLR (Marginal Cost of funds-based Lending Rate), instead of the Base Rate, which was used earlier.
It will translate into lower interest rates on existing floating rate loans and new loans. The reduction in lending rates is expected to stoke lending by tempting consumers to take out loans for purchasing expensive consumer discretionary items like vehicles and houses.

Demonetization can help monetary transmission
Monetary policy transmission is the translation of monetary policy actions into the financial system through banking and trading channels. The RBI (Reserve Bank of India) has been on a rate reduction cycle since January 2015. Before the January 2015 meeting, the repo rate stood at 8%. Its journey from that level to 6.3% currently includes six rate cuts totaling 175 basis points. However, banks have been slow in transmitting the benefit to consumers. After being flush with deposits, it's expected that banks will reduce their lending rates sizably, improve monetary transmission, and benefit consumers—both corporate (RDY) (VEDL) (WIT) and individual.
Any increase in economic activity due to more consumption on account of lower rates can be beneficial to India-focused funds (EPI) (FINGX) as well. In the next part, let's see how demonetization could impact India's financial markets.

India's Financial Markets Fell Due to Demonetization
Equities fall, but prospects are better
Indian equity markets have been on a near secular falling trend since the government demonetized the 500 rupee and 1,000 rupee currency notes after midnight on November 8, 2016. The two benchmark equity indices—the Nifty 50 and the S&P BSE Sensex—fell on each trading day since the demonetization except for November 10 and November 22. While the Nifty 50 fell 6.3% from November 8 until November 22, the S&P BSE Sensex fell 5.9% during the same period. Due to the rise in the US dollar, the dollar equivalents of the Sensex and the Nifty fell more than 8% each.



The S&P BSE 100 Index, which is comprised of 100 stocks compared to the Sensex's 30, fell 6.6% during this period. Mid and small-cap indices have been hit much harder than broader market indices. Even after a rise on November 22, the S&P BSE Mid Cap and the S&P BSE Small Cap indices fell 8.2% and 10.9%, respectively, in the previously mentioned period.
Apart from concerns about demonetization, Donald Trump's victory and concerns about his restrictive trade philosophy led to foreign investors pulling out of Indian equities. According to Bloomberg, foreign investors have net sold Indian equities (PIN) (INDA) worth $1.4 billion from November 9–17.However, once the short-term impact of demonetization is over, Indian equities will likely bounce back sharply. A rate cut from the Reserve Bank of India would be helpful and easy monetary conditions are generally beneficial for equities. Consumption-driven sectors and stocks (TTM) (VEDL) will continue to be hit in the short term.

Indian rupee fell
The Indian rupee fell against the US dollar. It mainly fell due to Donald Trump's victory in the US presidential election. Given the pressure on the local unit and its relative stability, it seems like the Reserve Bank of India has been working hard to keep the currency stable.
India's tech companies (INFY) (WIT) saw a sharp correction since the demonetization was announced. However, the rupee's weakness can benefit these stocks. For now, Donald Trump's trade philosophy will be the main driver of the Indian unit.

Conclusions
The demonetization 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. In other words, while the cash was mediating in legitimate economic activity, 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 demonetization on the economy and its agents. It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

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