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Demonetization: Impact on major macroeconomic variables

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Abstract

The Government of India announced the demonetization of all 500 and 1,000 currency notes on 8 November 2016 with the objective to curtail the shadow economy, combat corruption, to check tax evasion and to crack down on the use of illicit and counterfeit cash. However, this move is expected to cleanse the formal economic system and discard black money from the same. The stripping of currency notes of its status as legal tender could have both positive and negative impacts on the economy. Hence, this paper intends to study the impact of demonetization on some of the major macroeconomic variables of Indian economy such as- Inflation, Industrial production, GDP estimates, Agricultural production and Employment growth. The study found that even after observing a fall in the growth rate of Agriculture production, Purchasing Managers' Index, Employment, Inflation and GDP forecasts, these indicators are expected to retain their growth rates in the near future.

Keywords: Demonetization, macroeconomic variables, agricultural production, industrial production

1. Introduction

On 8th November 2016 the Hon'ble Prime Minister of India announced the demonetization of all 500 and 1000 currency notes and the issuance of new 500 and 2000 currency notes in exchange for the same. As per the data available with the RBI, Rs. 17,54,000 crores worth of currency is in circulation in India, of which 45% is accounted for by Rs. 500 notes and 39% by Rs 1000 notes. In other words, Rs. 16,32,000 crores worth of currency stands demonetized. The motive behind this move was to curtail shadow economy, crack down on the use of illicit and counterfeit currency to fund terrorism and illegal activities and to curb black money. Further, it was accompanied by the idea of reducing inflation and digitalization. The government of India stipulated a period of 50 days to exchange the demonetized notes and to deposit them as credit in their bank accounts. However, the demonetization affected the economy both positively and negatively.

On the very first note, all citizens faced severe cash shortages as it made them to stand in lengthy queues that led to several deaths because of the inconvenience caused due to the rush to exchange cash. Nobel laureate Paul Krugman said that it is difficult to see gains from demonetization, while there may be significant costs to it. Nobel laureate Indian economist Amartya Sen severely criticized the demonetisation move calling it a "despotic action" among other things. Former Senior Vice-President and Chief Economist of the World Bank, Kaushik Basu called it a 'major mistake' and said that the 'damage' is likely to be much greater than any possible benefits. However, Finance Minister Arun Jaitley said that demonetisation would clean the complete economic system, increase the size of economy and revenue base along with the upcoming Goods and Services tax (GST) as "an attempt to change the spending habit and lifestyle." Arundhati Bhattacharya (Chairperson of State Bank of India) and Chanda Kochhar (MD & CEO of ICICI Bank) praised the move in the sense that it would help curb black money. International Monetary Fund (IMF) issued a statement supporting Modi's efforts to fight corruption by the demonetization policy.

The objective of this paper is to study the impact of demonetization on some of the major macroeconomic variables of Indian economy such as- Inflation, Industrial production, GDP estimates, Agricultural production and Employment growth. The paper also intends to study the prima facie consequences of these on Indian economy.

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The paper is based on secondary data and the data is collected from sources like Reserve Bank of India, Ministry of Statistics and Programme Implementation, Ministry of Commerce and Industry etc. and the newspapers reviewed are The Hindu, Business standard, and The Economic times.

2. Literature Review

This move regarding demonetization is not a new one. there are also prior instances of demonetization in 1946 and 1978 in India. In 1946, the government demonetized bank notes of 1000, 5000, & 10000 rupees with the motive to combat tax evasion. Whereas, in 1978 the reason behind demonetization to eliminate the illegal transfer of money for financing transaction which are harmful to the national economy. However, this move miserably failed because the demonetization recommended by Wanchoo committee (1970) was of public nature. Hence, alerted the black money holders and gave them ample of time to get rid of their hoardings resulting into ineffectiveness of the decision. Moreover, The Experiences from countries like Ghana (1982), Nigeria (1984), Myanmar (1987), soviet union (1991), North Korea (2010) etc. have reported negative consequences due to demonetization.

Tax research team (2016), suggests that “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.” Chanda (2016), in his interactions with individuals from various walks of life and income levels, he found that there is clearly a willingness to suffer through the inconveniences so that corruption can bring under

control. However, this support is not unconditional and depends on the speed with which the current liquidity crunch is resolved. Singh and Singh (2016), states that “if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries show that the move was one of the series that failed to fix a debt-burdened and inflation-ridden economy.” Rani (2016) in her study based on primary data analyzed that initially the demonetization effects on market were painful but this also instigate the shopkeepers and consumers to adopt cashless means to buy goods. Moreover, demonetization effect will be positive in coming time for Indian economy. Kaur (2016) in his study based on secondary data suggests that “this is a historical step by Modi government and should be supported by all. This decision of government will definitely fetch results in the long term. From an equity market perspective this move would be positive for sectors like banking and infrastructure in the medium to long term. This could be negative for sectors like Consumer Durables, Luxury items, Gems and Jewellery, Real Estate and allied sectors, in the near to medium term. This move can lead to improved tax compliance, better fiscal balance, lower inflation, lower corruption, complete elimination of fake currency and another stepping stone for sustained economic growth in the longer term.”

3. Impact on major macroeconomic variables

This paper intends to study the impact on some major macroeconomic variables of demonetization. The data that is used for analytical study has been collected from secondary sources.

Table 1: Growth rates and estimates for Sectors of India (*In percentage*)

Sectors	Q3:2016-17	Q4:2016-17 (estimated)	Q1:2017-18 (estimated)
Agriculture & Allied activities	4.3	4.0	3.1
Industry	4.6	5.3	6.0
Services	7.2	7.7	8.3

Source: Reserve Bank of India

3.1 Agriculture Production

The above table shows that the growth rate for agriculture & allied activities has reduced to 4% in Q4 (2016-17) from 4.3% in Q3 (2016-17). According to forecasts conducted by RBI it is expected to decline to 3.1% in Q1 (2017-18). Since transactions in agriculture & allied activities takes place mostly through cash. Due to disruptions in the supply chain farmers have insufficient cash to purchase seeds, fertilizers and pesticides needed for the plantation of Rabi crops, usually sown around mid-November. Therefore, due to demonetization the growth rate of agriculture sector has reduced in short run. These are only the short term impacts on agriculture but in long run the sector may experience positive impacts. As per the governments' policy the farmers are now provided with direct benefit transfers which has reduced the role of agents in agriculture sector. Thus will reduce leakages and delays by crediting subsidies directly into their bank accounts. Moreover, in the Union budget 2017 the Government has proposed to double the income of farmers till 2022. Hence, it can be stated that the sufferings are only for short term and the agriculture sector may retain benefits in the long run.

3.2 Industrial Production

On the other hand industrial and services sector has experienced an increased growth rate from 4.6% in Q3 (2016-17) to 5.3% in Q4 (2016-17) and from 7.2% in Q3 (2016-17) to 7.7% in Q4 (2016-17) respectively. The index of Industrial Production (IIP) rose to a 13-month high of 5.7 percent in November compared with a contraction of 1.8 percent in the month of October according to the Business Standard. The growth in eight core sectors such as cement, steel and refinery products, which constitute 38% of the Index of Industrial Production (IIP), was only 4.9 percent in November as compared with 6.6 percent in October. However the growth rate increased to 5.6% in December 2016. This implies that only after a few days of demonetization the IIP of these eight core sectors regained the growth rate.

The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector and it is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment and these indicators were adversely affected post- demonetization. Hence, manufacturing sector activity fell to 49.6% down from 52.3% in November 2016. Demonetization made it difficult for the consumers to buy

goods and services on the same hand producers were also unable to purchase raw materials for further production due to cash shortages.

3.3 Inflation

As per the data of Ministry of Statistics and Programme Implementation in November 2016 CPI inflation was 3.63% which is less than 5.61% in December 2015 and after demonetization in December 2016 it further reduced to 3.41%. On account of demonetization less cash in hands of public has not only reduced the consumption and demand for conspicuous items but also for necessities. Hence, inflation is expected to fall in the short term period due to reduction in consumption but in the long run if government spending increases it will push up the employment & income and demand will be revived. Therefore in long run inflation rate may remain neutral.

3.4 Employment Growth

According to the National Commission for Enterprises in the unorganized sector (NCEUS), the unorganized sector comprises approximately 86% of the total persons employed in India. Within the unorganized sector cash is the only way to conduct business among large proportion of labour intensive sectors. The growth rate of employment for Q3 (2016-17) was expected to be 9.1% and it was

assessed as 3.8%. The data shows a great difference in the expectation and actual assessment of the growth rate of employment. For Q4 (2016-17) the expectation level has been kept low to 5.2%. On the basis of prediction of money market equilibrium models interaction of money demand and money supply will put pressure on the interest rate and due to reduction in money supply. Further, aggregate demand in the economy will be adversely affected in the short run thus reducing the price level for few months. Therefore, it will lead to building up of inventories which can eventually impact production activities. Adjustments in small and medium enterprises would be exposed to a higher order of demand risk affecting the growth rate of employment. The improvement will not be observed in long run until or unless public spending increases.

3.5 GDP Estimates

Since consumption is a major component of GDP, the cash crunch due to demonetization has negatively affected the consumption level and hence the GDP growth rate. In this context, the International credit rating agencies have also cut down their forecast for GDP of India post demonetization. The Reserve Bank of India (RBI) has cut its GDP growth forecast for this financial year from 7.6% to 7.1%, citing the government's demonetization exercise.

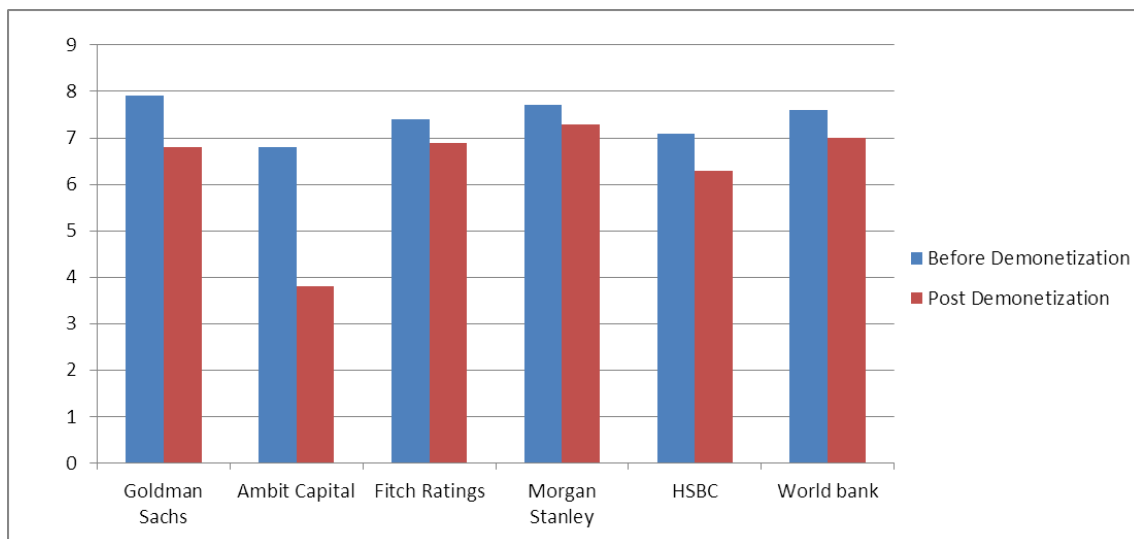


Fig 1: GDP estimates by Global Analysts

Fitch Ratings lowered its GDP growth forecast for India to 6.9% from 7.4% for this financial year. The rating agency, which reaffirmed its negative outlook on the Indian banking sector, said: "The move (demonetization) has the potential to raise government revenue and encourage bank lending, but Fitch Ratings believes the positive effects are unlikely to be strong and sufficiently enduring to support credit profiles." Moreover, The World Bank's Global Economic Prospects January 2017 report has also lowered the GDP growth estimates from 7.6% to 7% post demonetization. "In the short term, 'demonetization' could continue to disrupt business and household economic activities, weighing on growth," and "a benefit in the medium term may be liquidity expansion in the banking system helping to lower lending rates and lift economic activity." It further added that the Indian economy is subsequently set to recover its growth momentum, with

growth rising to 7.6 per cent in FY18 and further strengthening to 7.8 per cent in FY20. Ultimately for long run it can be asserted that with a widening of tax net GDP is likely to get a boost.

4. Conclusion

We cannot deny from this fact that demonetization has caused sufferings and hardships for public but for a policy measure to be effective the emphasis must be on maximizing its benefits while minimizing its costs. So we can conclude that even after observing a fall in the growth rate of Agriculture production, Purchasing Managers' Index, Employment, Inflation and GDP forecasts, these indicators are expected to retain their growth rates in the near future according to the reports.

Dr. B.R. Ambedkar in his thesis "the problem of Indian rupee" suggested that the notes should be demonetized after

every 10 years to curb corruption. But is it feasible and accurate for an economy like India to have policies like demonetization and digitalization prior to the achievement of basic amenities even in the remotest areas? There are still many places with no banks and ATMs so; at the initial level the policies must be formulated to rectify the grass root problems. Moreover, until or unless the revenue generated through demonetization is not adequately allocated and if the increased liquidity in the banks is not properly utilized, the lucrative objectives which were undertaken by the government like to deal with black money, tax evasion and eradicate counterfeit currency would be worthless and on the other hand the hardships of public caused by demonetization would be in vain.

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