



# **Impact of demonetisation**

**15<sup>th</sup> November, 2016**



## Background

On the midnight of 8th November 2016, the Government decided to eliminate the existing Rs 500 and Rs 1000 notes from circulation and gradually introduce a new set of notes. Essentially, demonetisation is a radical monetary step in which a currency unit's status as a legal tender is declared invalid.

The primary objectives of demonetisation are:

- Control the counterfeit notes that could be contributing to terrorism
- To undermine or eliminate the black economy
- To lower the cash circulation in the economy which is directly related to corruption in the country

## Short-term Impact

- **Severe contraction in money supply**
  - With 86 percent of the currency in circulation removed, a severe contraction in the economy has been observed
  - This would affect individuals who earn incomes in cash and spend it in cash
  - To a lesser extent, it would impact individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes
- **Demand- based sectors to face compression**
  - The sectors where the demand is backed by cashed, especially those not with organised retailing, to be adversely impacted
  - A slow-down in the spending is highly probable
  - Transport vehicles, fruits and vegetables and all perishable goods will experience a negative impact since they are backed by purchasing power
  - This will eventually lead to excess supply over demand, which basically would lead to a fall in prices
  - However, if supply too gets curtailed for want of a medium of exchange, prices may rise
- **Increase in credit transactions**
  - Both the retailers and other agents in the economy might take recourse to credit in the hope that when the liquidity status is corrected, the payments can be realized
  - In these cases, the price of commodities might rise instead of falling
- **Decrease in demand for non-essentials**
  - In the face of uncertainty in the availability of cash, the demand from segments which have access to digital medium of exchange would remain unaffected, but that from the rest of the economy would get compressed
  - This would transmit the effect to the rest of the sectors in the economy as well
- **Impact on the real estate**
  - Agents who have earned unaccounted incomes and placed them in the real estate would see a fall within this segment or a cease in the transactions

- Where this in itself is a positive development, it could lead to a compression in the investment rate in the construction sector
- This will further adverse income and employment consequences for the economy
- **Impact on the demand for gold**
  - With the ban on Rs 500 and Rs 1000 notes, the gold market has seen a sharp decline
  - The sales have gone down since and are not likely to grow in the short-term
  - There has not been a drastic increase in the gold rates as well
- **Increase in the tax collection in the short-term**
  - People in the attempt to get rid of unaccounted cash balances through purchase of goods and services, or payment of property taxes, a spurt in the indirect taxes as well as property tax collections is expected
  - This would mean a higher tax net and a better tax to GDP ratio

## Long-term impact

- **Changes in spending behavior**
  - There is a possibility of changes in spending behavior as a result of moving to instruments other than cash
  - Substitutes for cash, such as cheques, debit cards, credit cards, mobile wallets, will see increase in the level of its usage
  - With frequent use of debit cards, the consumption levels are expected to increase
  - This will encourage spending on non-essentials
  - In the long-run it is expected to have an impact on the lifestyles as well as the budgets and priorities of the agents of economy
  - If not suitably managed, it could channel towards consumer debt with a lower saving in the economy and adversely impact the investment within the domestic economy
- **The asset quality of banks will improve**
  - This drastic currency step will improve the asset quality of the banks as the cash coming in will lead to higher CASA (current account, savings account), in turn de-clogging the system
  - It will no longer hold up the flow of bank credit for private sector investment in the country
  - It will lead to increase in the current account and savings account deposits
- **Formalisation of the economy**
  - In the long term, combined with the GST legislation, it will help propel economic growth as more of the informal economy becomes formal
- **Rate cuts**
  - Monetary stimulus to be observed in the form of rate cuts and liquidity infusion in the formal system
  - Demonetisation will also lead to lower inflation, leading to reduced interest rates
  - Higher deposit growth and continuing weak credit growth would create opportunities for lending rate cuts and investment activities to pick up

- **Current Account Deficit**
  - In the long term, the current account deficit may be financed through borrowing
  - This is considered to be unsustainable since in the long-term the economy will be burdened with high interest payments
  - Additionally, a current account deficit may also imply that the economy is relying largely on consumer spending and the market is becoming uncompetitive
  - This will eventually dampen the export sector
  - Overall long term impact is expected to be neutral as demonetized currency is also being replaced with higher value denominations

### Demonetisation's impact on the automobile industry

- **Vehicle sales to be affected**
  - The rural market vehicles sales is highly driven on cash and demonetisation will be a temporary disruption in the auto industry
  - Sales of luxury cars and premium SUVs, along with the unorganized used car market could also witness a temporary slump
  - Small cars sales are not expected to take decline as purchase of such cars is largely supported by EMIs, bank financing and loans
  - In the long term the consumer demand is expected to revive which will cause the auto sector to bounce back rapidly

Hence, this move will prove to be marginally negative for the auto industry.

### Conclusions

- The impact of the bold move taken by the Government 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 interpreting the phenomenon, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes
- However, with this step, the poor will be the most impacted, both in the rural and urban areas who work in the vast informal sector of the country
- The possibility of recouping black money by its hoarders is not unachievable, fake money may be pushed out of the economic cycle, but black money may continue to remain

Variables	Immediate impact	Medium/ Long-term impact	Over-all-term impact
GDP	Negative	Net positive	Positive
Inflation	Downward pressure on prices	Neutral	Neutral
Liquidity	Positive	Neutral	Neutral
Currency circulation	Negative	Neutral	Neutral
Fiscal deficit	Neutral	Positive	Positive
Current Account Deficit	Positive	Negative	Negative
Digital payments	Positive	Positive	Positive