The Impact of Demonetisation in India

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Abstract

The decision to demonetise high value currency notes was in continuation of a series of measures taken by the Government of India which is steadfast in correcting the deviations in the financial system to improve the welfare of the state. In this paper an attempt has been made to record the mixed effects of demonetisation in Indian economy. While the quarterly average GDP before demonetisation during FY 2015-16 and 2016-17 was seven percent, it slipped to 6.1 % and further to 5.7% during following two quarters of post demonetisation. The short term impact of demonetisation in terms of contraction in GDP continues unabated in the current FY2017-18. Further, found that due to squeeze on demand the IIP growth in respect of consumer durables segment has evidenced a negative growth since November 2016. Nevertheless, on electronic payment's front the impact is highly positive. The debit card usage at point of sale terminals has more than doubled post demonetisation period. Digital payments such as NEFT, IMPS etc., have witnessed marginal increase in terms of volume of transactions during post demonetisation. Hence it can be claimed that the demonetisation exercise has resulted in increased digitalization of payments in the country that helps achieve formalisation of economy. It helps the financial system leapfrog into a cashless state to some extent. Other effects of demonetisation like elimination of corruption, black money, counterfeit currency and terror funding remains skeptical.

Key Words: Demonetisation, Economic growth, Digital Payments

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Every economic system strives to allocate resources evenly among various units and improve overall welfare the state. Indeed, the result of distribution of goods and services is mixed over time. The ills in the economic system are to be corrected and overcome by means of appropriate economic policies of the state. The demonetisation is one such policy measure of the state to correct the deviations and channelise the resources to improve the welfare of the state. The act of stripping a currency unit of its status as legal tender is called demonetisation. The currency unit that has been demonetised is withdrawn from circulation. "On November 8, 2016, it was decided to demonetise high value currency notes of denomination of Rs. 1000 and Rs.500. Such notes, valued at Rs. 15.4 trillion, constituted 86.9 per cent of the value of total currency in circulation. The decision was in continuation of a series of measures taken by the Government of India during last two years aimed at eliminating corruption, black money, counterfeit currency and terror funding" (RBI, 2017). India has traditionally been a cash intensive economy. According to an estimate, about 78 per cent of all consumer payments in India are effected in cash (Ratan Watal, 2016).

1. Objectives of the Study

The purpose of this paper is to examine the impact of Demonetisation of high value currency notes in India. Nevertheless it specifically intends;

1. To study the effects of demonetisation on Indian economy
2. To analyse the impact on the industrial production in India

3. To examine the effects of demonetisation on plastic money.

Besides, attempts have also been made to record other consequences of this exercise in the banking and investment fronts.

2. Materials And Methods

This article is a descriptive research intended to record the effects of demonetisation. The impact assessment has been carried out from the secondary data gathered from published sources. In order to study the impact on economy the quarterly Gross Domestic Products (GDP) figures and the monthly growth rate in Index of Industrial Production (IIP) have been culled out from the Central Statistical Organisation, Ministry of Statistics and Programme Implementation, Govt. of India and RBI respectively. The data on electronic payments were sourced from Reserve Bank of India's online data base "Payment System Indicator", Annual bulletin and reports. The GDP growth rate represents the value addition made during the quarter in comparison to the same period in the previous year. The payments data are available in terms of volume and value of transactions. Since the volume of transactions mirrors the technology adoption by the public the changes in the number of transactions are reckoned with in this paper. For the purpose of analysis the period of study spans from November 2016 to May 2017.

3. Data Analysis & Discussion

The demonetisation was carried out with various goals in mind such as eradicating the use of fake currency, bringing unaccounted money back into the banking system, reduction of illegal activities, to encourage digital payment modes to reach the target of a cashless society etc., On account of this, bank deposits with RBI reached a record high of Rs.6 trillion (Attorney general Mukul Rohatgi told the Supreme Court, livemint, 2016) which is considered to a surplus liquidity in the system. State Bank of India's economic research unit estimates that Rs 1.7 lakh crore in permanent liquidity will be added to the banking sector post demonetisation. It can supplement banks to have more money at their disposal for lending at a very competitive rate of interest. It can also cause increased bank lending to corporate India at minimum cost and augment productive resources in the economy which in turn boost corporate investment and earnings. Despite all these benefits, the negative externalities of demonetisation cannot be overlooked.

3.1 Impact on Banking Services: In view of increased supply of money into the banking system bankers reduced the rate of interest on deposits. India's largest bank, SBI whose deposit rate was steady at 4 per cent for six years, cut interest rate on saving deposits up to one crore from 4% to 3.50 per cent. Other banks such as HDFC Bank, Punjab National Bank and YES Bank have taken a cue from the recent move by SBI to lower their savings bank deposit rates. As a result of this banks could save on interest outgoes. SBI could save about Rs. 4,000 crore from the 50 basis points cut (Business Line, 2017). The reduction in interest rate would not only discourage household saving but also reduces interest income of household especially senior citizens who depend on income by way of bank interest on their deposits. German poet and playwright Bertolt Brecht once said "It is easier to rob by setting up a bank than by holding up a bank clerk". Demonetisation compelled bank customers to deposit cash into the banking system. But banks have come out with norms on the minimum balance to be maintained, upwardly modified bank charges, imposed new limits on cash withdrawals and resort to charging customers who exceed limits. This has put more stress on the poor and middle income group as they have to forgo the best possible use of the increased minimum balance. So Customers end up paying more to banks. This amounts to conducting banking company in a manner that is detrimental to the interest of depositors and hurt customers. In addition, increased money supply in the banking system may induce banks to look for newer customers to park this money in loan products. Sloppy additional lending targets may lead to chasing sub-prime borrowers and be a cause to strain the bank's balance sheet in the long run.

3.2 Effects on Mutual Fund Investments

RBI's paper on Financialisation of savings into non-banking Financial Intermediaries by Manoranjan Dash et al. (2017) states that reduction in interest rates on bank deposits after demonetisation and decline in gold price enhanced the relative attractiveness of both debt and equity oriented mutual funds. As a result of this, assets under management by mutual funds (AUM) touched an all-time high of more than 17.5 trillion by end-March 2017 and further increased to 20 trillion at end-July 2017. Table 1 portrays the resource mobilisation under equity schemes post demonetisation period from November 2016 to June 2017 which has increased by 1.85 times over the same period before. It is found that higher resource mobilisation by mutual funds after demonetisation has mainly been driven by retail and high net worth individual (HNI) investors. The total investments made by HNIs and retail investors for the year ending March 2017 has been 39.2% and 15.2% respectively more compared with the year ending March 2016.

Table 1: Net inflows/outflows in mutual funds (in billion)

Category	Nov 2015 - June 2016	Nov 2016 - June 2017	2015-16	2016-17	April-June 2017-18
Income / Debt Schemes	-328.6	386.2	330.1	2131.5	407.4
Equity Schemes	235.7	670.7	740.3	703.7	283.3
Balanced Schemes	111.4	436.5	197.4	366.1	222.6
Exchange Traded Fund	75.5	203.8	78.2	232.8	21.9
Fund of Funds Investing Overseas	-2.4	-1.9	-4.2	-3.6	-1.1
Total	91.6	1695.5	1341.8	3430.5	934.0

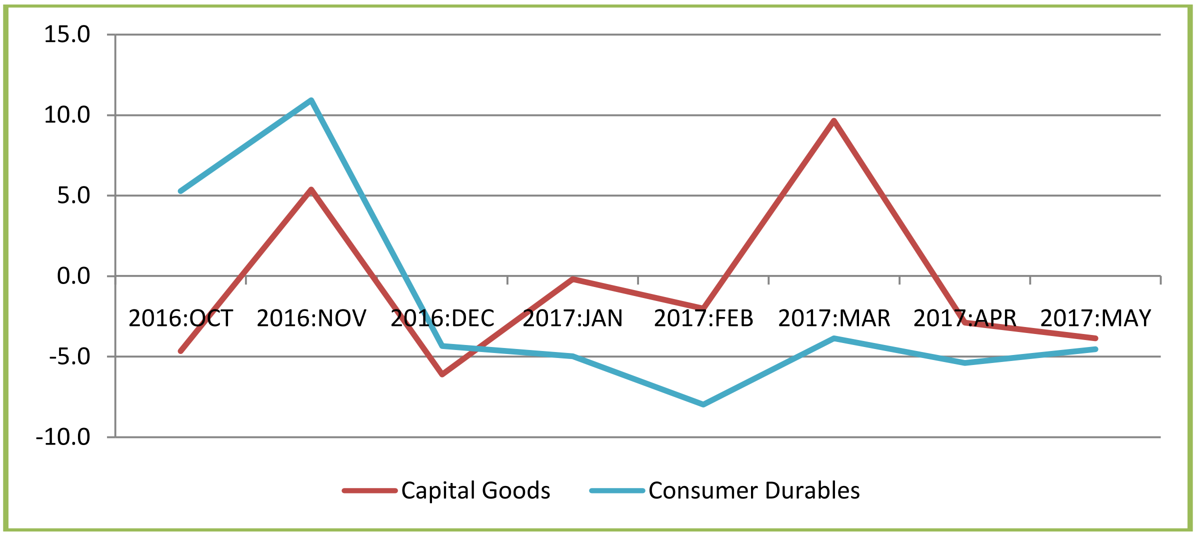
Source: Securities and Exchange Board of India
Available at https://rbi.org.in/Scripts/MSM_FinancialisationofSavings.aspx

From Table 1 it appears that demonetisation have led to acceleration in the financialisation of savings especially in mutual investments. But the argument that the demonetisation has paved the way for the movement of household savings from physical assets to financial assets, and will help boost economic growth, is skeptical as overwhelming majority of individual/retail investors are not financial literate. Retail investors who cannot comprehend with the complex nature of financial products may systematically lose out to other categories of players in the market especially if one chooses to invest in stock market. The middle class who are vulnerable to such shocks may end up losing out significant portions of their savings.

3.3 Impact on Index of Industrial Production (IIP)

The priori - expectations and the widespread presumption of the radical demonetisation exercise was that it would lead to fall down in domestic demand induced by the cash crunch and knock industrial activities. Figure 1 attest such a slowdown in demand for goods. Figure 1 gives the monthly growth rate in IIP that reveals the segments that are worst affected by the squeeze on demand. The instant impact of demonetisation move is so evident on consumer durables segment which has recorded a negative growth in the IIP numbers since Nov. 2016. The sector continues to experience unfavourable growth in industrial production. The growth rate in infrastructure and construction sector is reduced to 0.1 percent as against the 7.4 percent recorded growth in October 2016.

Figure 1: Sectoral IIP



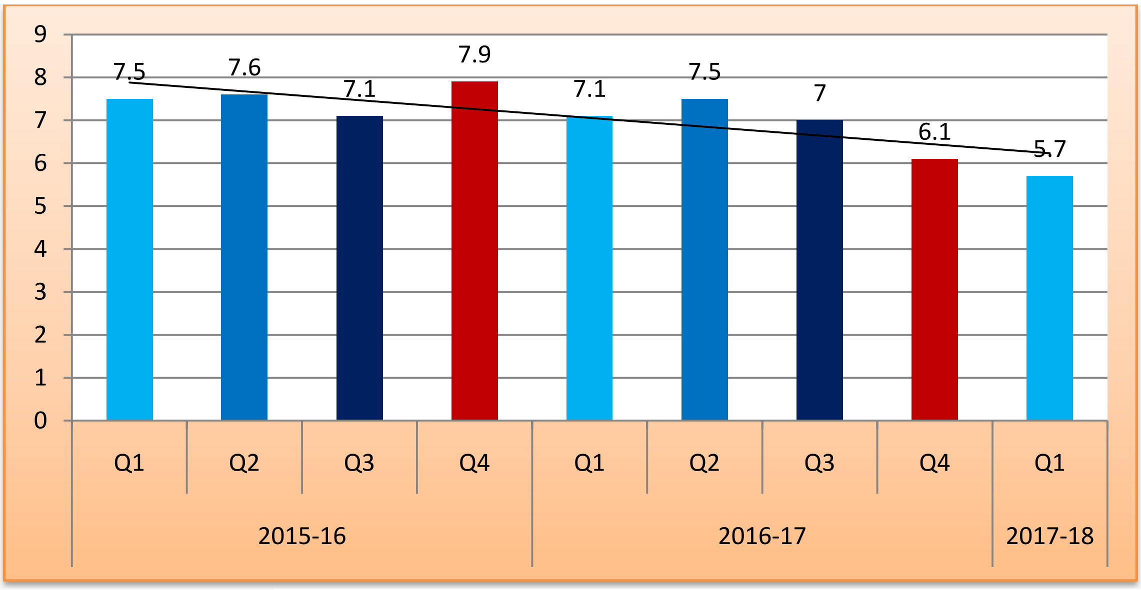
Source: RBI

The other industry groups that have witnessed fall in the growth of IIP are manufacture of beverages, electrical equipments, motor vehicles, food products, wearing apparels etc., Food products group have been showing an absolute decline from August 2016 (-4%), but the decline deteriorated further from December 2016 at minus 7.9%, March 2017 with minus 10.2% and continued till the most recent month, June 2017 at minus 1.7%. The capital goods segment has been more volatile. "But the most telling indicator of the impact on demand may be what is happening to cement production. This is significant, since cement output essentially reflects construction activity, which happens to be the largest non-agricultural employer. The collapse of cement production in the organised sector may therefore be an indication not only of depressed informal sector demand but also depressed employment conditions in the economy" (Chandrasekhar & Jayati Ghosh, 2017).

3.4 Impact on GDP

The very purpose of economic and financial sector reforms is to achieve higher economic growth in the country. The demonetisation move by the state during the third quarter of fiscal 2016-17 has altered the gross value added to the GDP of the country.

Figure 2: Quarterly GDP Growth



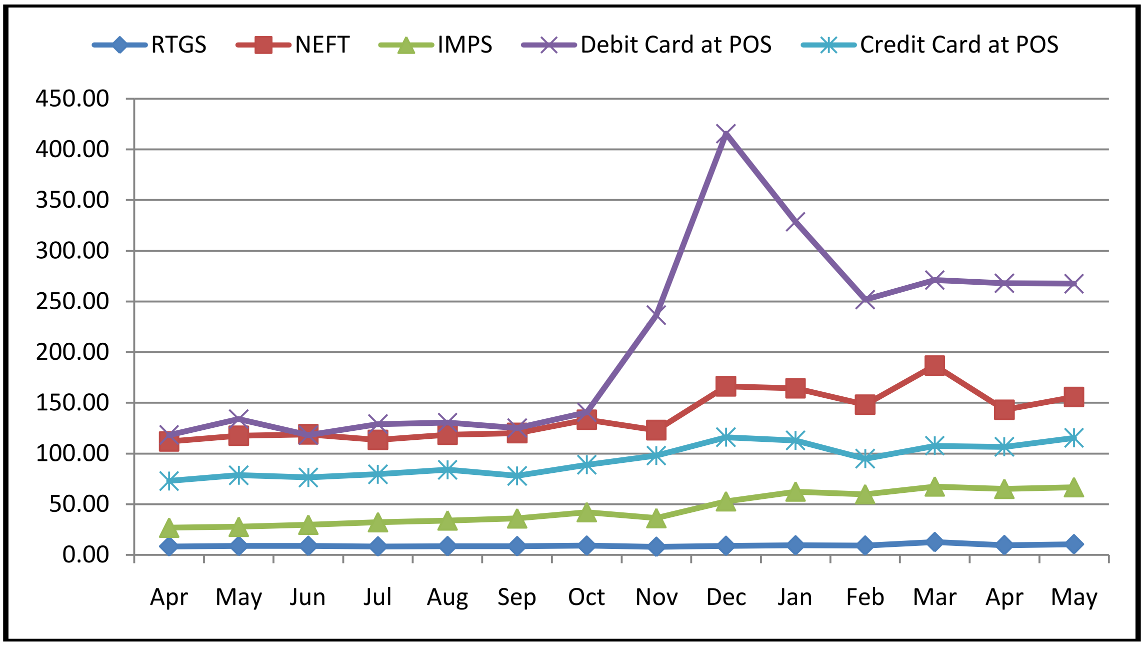
Source: CSO_MOSPI

The economic growth during the first, second and third quarter of the financial year 2016-17 was impressive and reflected the similar growth rate in the same period of the previous financial year. But, in view of demonetisation exercise, the growth rate in the fourth quarter post demonetisation Jan-March 2017 has fallen to 6.1 percent as against 7.9 percent growth in the same period of the previous year. The impact of demonetisation on the contraction in GDP continues unabated in the current financial year 2017-18 too. The growth rate slipped further in the first quarter ending June 2017 to 5.7 percent as against a growth of 7.1 percent recorded during the same period last year. It is evident from figure 2 that gross value addition to the GDP which mirrors the economic growth is slowing down due the demonetisation move. As far as economic growth is concerned the buzz words "short-term pain for long-term gain" is inconclusive. The long term impact of demonetisation on the economy requires wait and watch approach.

3.5 Effects on Digital Payments

One of the important goals of demonetisation is to encourage digital payment modes to reach the target of a cashless society. When the legal tender of the existing high value currency is withdrawn it takes time to exchange the new currency for old one. This lead time is expected induce public to adopt newer payment methods especially electronic medium such as National Electronic Fund Transfer (NEFT), Real Time Gross Settlement (RTGS), Immediate Fund Transfer Service (IMPS) Debit Cards, Credit cards etc., when bank customers tread in to the digital modes and gain confidence in the system, they are more likely to continue with the experience in digital payments.

Figure 3: Digital Payments during 2016-17



Source: RBI

As per the priori expectations, after the demonetisation on November 8, 2016 the debit card usage at Point of Sale (POS) terminal in the retail outlets witnessed sudden surge. The surge in card usage at POS terminals at merchant locations reflects a positive for the economy as more people start using their debit cards for payments rather than for withdrawing cash at ATMs. The acceptance infrastructure of the country has expanded significantly, which allowed card transactions to report the biggest growth post demonetisation. The volume of debit card transactions at POS pre-demonetisation period in October was 140 million and this has gone up to 415 million in December 2016 recording a growth of over 195%. This record high usage debit card was considered as a success of the exercise. Although it recorded a sharp pick-up in December, the growth moderated in January and further in February with progressive remonetisation. Immediately after the normalisation of new currency distribution, the same debit card usage at POS started falling nearly by half within two months of post demonetisation growth in February 2017 meaning return of cash economy. But in spite of the fall, it can be observed that compared to pre demonetisation period in the same fiscal, the debit card usage at POS terminals during post demonetisation period has recorded an impressive growth of over 106%. This trend continues even beyond 31st march 2017. Hence it can be claimed that this demonetisation exercise has resulted in increased digitalization of payments in the country. Other payment methods too have witnessed marginal increase in volume of transactions during post demonetisation. While digital transactions had been consistently growing over the years, demonetisation gave it an additional leg up. However, factoring in the trend in IMPS, the growth in debit card volumes may be challenged in the future as immediate payments are increasingly adopted which are considered a potential alternative to cheques and cash for retail and corporate customers. Upgrading of merchant and corporate infrastructure and education of all stakeholders are required to boost immediate payment service.

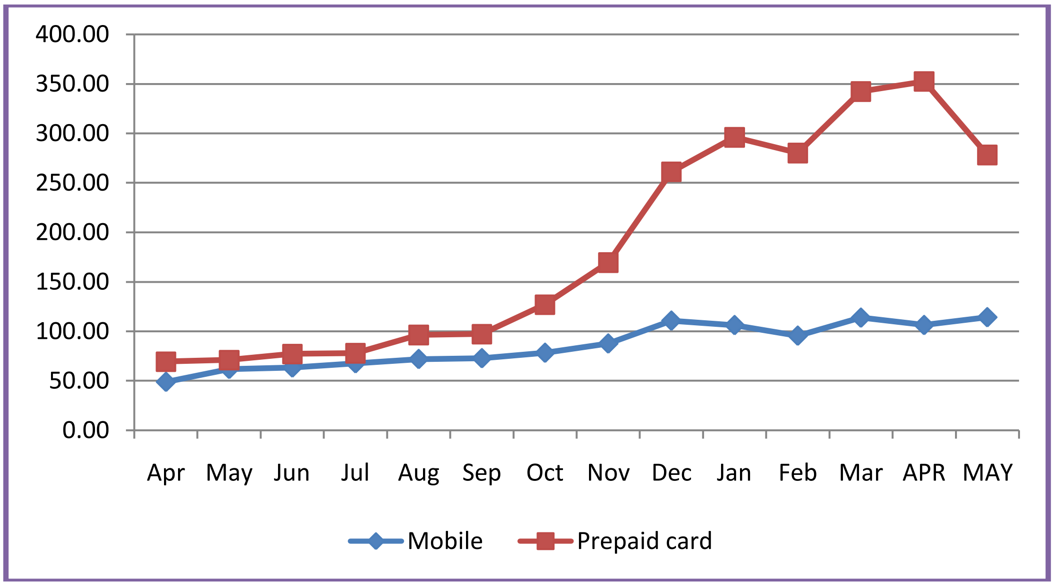
Table 2: Usage of Debit Card

Financial Year	Usage at ATMs	Usage at POS
2014-15	89.64 %	10.35 %
2015-16	87.31 %	12.69 %
2016-17	78.11 %	21.89 %

Source: RBI

It can be learnt from table 2 that the demonetisation has positively altered the pattern of usage of debit cards which have hitherto been predominantly used for cash withdrawals at ATMs. The usage has fallen by about 10% from 89.64% to 78.11% between 2015 and 2017. The usage rate at POS was 7.82% and 9.23% for the year ending 2012-13 and 2013-14 and as a reflective of demonetisation, the share of debit card usage at POS for purchases have doubled during the period ending March 2017.

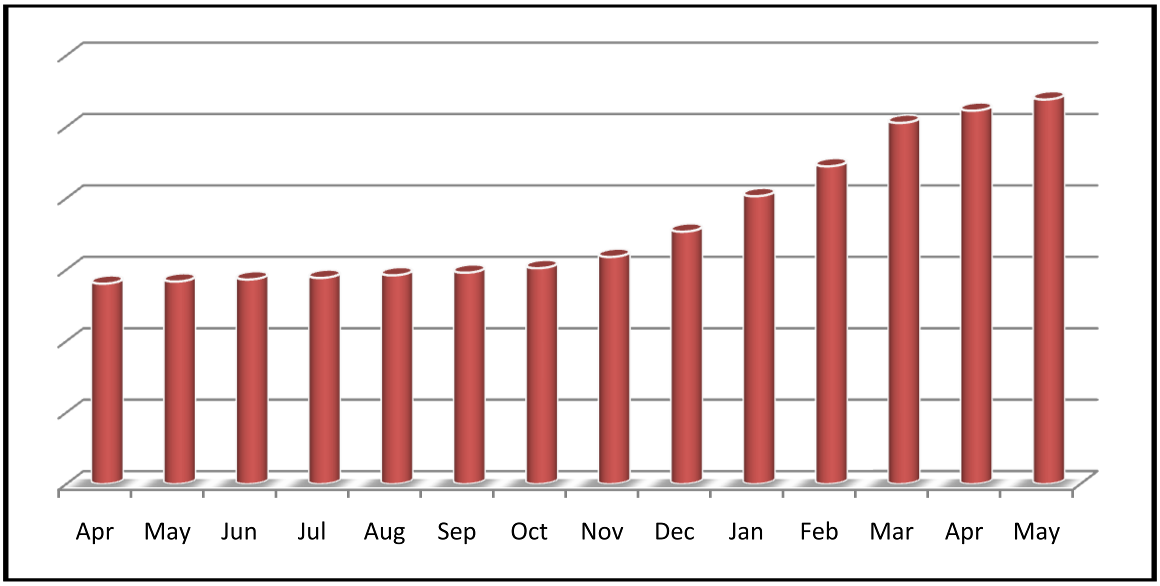
Figure 4: Mobile and Prepaid Card payments during 2016-17



Source: RBI

The demand for prepaid card has increased steadily during pre demonetisation period up to October 2016 in the current fiscal. However as shown in figure 4 the prepaid card payments have witnessed an impressive growth over 100% post the demonetisation period. But volatile trend is observed in its usage and it appears to be reverting back to pre demonetisation levels in the next fiscal. On the other hand mobile payments seem to be stepping up to record a sustainable level of growth in the future. It is learnt that tech savvy bank customers will continue with mobile payments as it is convenient and cost effective.

Figure 5: Growth in Number of POS during 2016-17



Source: RBI

The objective of achieving less-cash economy with the use of plastic cards can materialise if only card swiping machine are installed at the point of sales in merchant establishments. As the demonetisation exercise has induced public to embrace card payments the merchants too have taken cue to increase the number of POS installations in their business establishments.

4. Conclusion

The outcome of demonetisation has been mixed. It is impeccably clear that the demonetisation exercise, which had started with tall claims like flushing out black money, eliminating fake currency, striking at the root of terror financing, converting non-formal economy into formal one to expand tax base and digitisation of payments to make India a less-cash economy, had slowed economic activity as evidenced by low GDP numbers and put the depositors at much inconvenience with more restrictions. "The growth in returns filed by individuals is 25.3 per cent in the corresponding period of 2016-2017. This is a clear indication that a substantial number of new tax payers have been brought into the tax net subsequent to demonetisation (*Indian Express, 2017*). The RBI had mentioned in its annual report for 2016-17 released on 30 August that Rs.15.28 trillion, or 99% of the demonetised Rs 500 and Rs 1000 notes, have returned to the banking system. Hence the impact of demonetisation on elimination of corruption, black money, counterfeit currency and terror funding remains skeptical in the light of fake currencies confiscated in the country during remonetisation. It is a common knowledge that Indians spend less when we use cash than payment by cards. At this juncture, demonetisation aimed at reducing cash transactions and prod people towards cashless society, substantial progress has been made in this regard post demonetisation which has encouraged the use of electronic medium for payments. The digital payment methods have seen impressive growth after demonetisation and appear to be contributing to less-cash economy initiatives. Subsequently, Carrot approach with incentive to boost card payments will take this trend forward together with the increase in the number of point of sales terminals in all merchant establishments. NEFT and Prepaid payment cards demand appropriate attention as they have delivered encouraging results. Undoubtedly push towards digital India will help achieve formalisation of economy with increased use of digital payments. In this regard the central bank's proactive role in bringing awareness on debit card usage among merchants and cardholders through focused financial education drives involving commercial banks will pay rich dividend in the future.

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