



# STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

*To kindle interest in economic affairs...  
To empower the student community...*

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December 2016

Theme 301

## DEMONETISATION



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Theme No: 301: Demonetisation

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A well informed customer will make the policy makers as well as organizations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of goods and services produced.

The “SIB Students’ Economic forum” is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the “Forum”. This month, we will discuss “Demonetisation” a tool used by government to curb the black money.

**1. What is “Demonetisation”?**

Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as an official mode of payment.

**2. Demonetisation in India**

The first instance was in 1946 and the second in 1978, when an ordinance was promulgated to phase out notes with denomination of Rs 1000, Rs 5,000 and Rs 10,000. The high-denomination notes were facilitating the illegal transfer of money for financing transactions which were harmful to the national economy or which were for illegal purposes. The third was on 9<sup>th</sup> November 2016, to curb the black money from the economy.

**3. What is the Objective of current Demonetisation?**

The objective is to curb the following activity:-

- i) The unaccounted income or black money in the form of currency
- ii) Financing terrorism through cash dispensation
- iii) Making fake currency.

**4. Why demonetise Rs 500 and Rs 1000?**

The above two denominations accounted for 86.4 per cent\* of all currency value. Scrapping and replacing these with new ones would largely take care of all the black money stored in the form of cash. Bank notes in circulation of different denomination are given in the table below:-

Denomination (Rs)	Volume (million pieces)		Value (Rs billion)	
	Mar - 15	Mar - 16	Mar - 15	Mar - 16
100	15,026	15,778	1,503	1,578
% to total	(18.0)	(17.5)	(10.5)	(9.6)
500	13,128	15,707	6,564	7,854
% to total	(15.7)	(17.4)	(46.0)	(47.8)*
1000	5,612	6,326	5,612	6,326
% to total	(6.7)	(7.0)	(39.3)	(38.6)*

Source – RBI Annual Report

### 5. Who is going to benefit from the demonetisation – RBI or Government?

Demonetisation is likely to give the government a fiscal windfall of Rs. 2.5-lakh crore or more. But, for the RBI, the exercise will lead to a net loss of seigniorage (Seigniorage is the difference between the value of money and the cost to produce and distribute it) of Rs. 2,800 crore. Going by the experience of the 1978 demonetisation, there may be a cash payout against the extra notes printed by the RBI to the government. As the RBI will issue notes only against the old ones, there has to be a decline of an equivalent amount from the RBI's asset side/cash payouts.

### 6. What is the likely outcome of demonetisation Scheme?

- i) **Surge in Banks CASA** – Rs 3 lakh crore worth of the old high denominated notes - Rs 500 and Rs 1,000 has been deposited in the banking system. “About Rs 50,000 crore has been dispensed to customers. Within four days of demonetisation, the banking system has handled about 18 crore (180 million) transactions. Bank will receive, about Rs 15 lakh crore in currency. Even if only 10 per cent remains with the banks, it means an incremental Rs 1.5 lakh crore of current and savings account balance (CASA).
- ii) **Rate cut** – An indicator of the southward movement of interest rates can be seen by looking at the money market operations and the behaviour of the daily weighted average call money rate (WACR). The reduction in currency will be a deflationary shock, with certain asset markets declining sharply and economic activity weak for the next two quarters at least. Inflation as measured by the Consumer Price Index had come down to 4.2 per cent by October-end itself. It is a no-brainer that the November CPI is likely to be below 4 per cent, as consumer demand has been adversely affected by the de-legalisation of the old high value notes giving the RBI the space to cut the rate.
- iii) **Reduction in high end-discretionary consumption** – Black money that is either simply burned, or loses 30-40 per cent as the cost of conversion to legitimate money. Wealth destruction is also inevitable in property, as prices fall and markets freeze. Hence there will be a significant negative wealth effect.

## 7. How the MSMEs (Micro, Small and Medium enterprises) are impacted by the demonetisation scheme?

There are 3.6 crore MSMEs across the country employing 8.6 crore people. With the cash economy hit by demonetisation, uncertainty hangs over the fortunes of many micro, small and medium enterprises (MSMEs) who are doing business entirely in cash. Most small manufacturers keep 50 per cent of their working capital in cash though their current accounts are maintained in banks. Hence, the businesses are facing issues related to salary payments to employees/factory workers, which are usually made in cash.

## 8. Demonetisation scheme impact on the current account deficit (CAD)?

As rates of interest in India decline, we can expect an outflow of funds from India into more lucrative emerging markets, as also towards advanced economies which have been experiencing a rising trend in their bond yields. Thus, while the 10-year G-sec yield on Indian government bonds declined by 30 basis points in the last month, yields on other emerging market bonds have shot up by at least 30 basis points in the same time, with Brazilian yields going up by 68 basis points. Further, US 10-year bonds have risen by 56 bps in the same period. Such a bearish bond trend exhibited by India in the face of a global bullish bond trend, will lead to capital outflows from India and difficulties in financing our current account deficit (CAD).

## 9. Demonetisation impact on the economy?

- i) **Informal Sector** : The informal sector in rural and urban India (proprietary and partnership enterprises employing less than 10 workers) accounting for 45 per cent of the GDP and 80 per cent of total employment, has been badly hurt by the withdrawal of 86 per cent of the value of currency in circulation. Informal sector accounts for 48 per cent of India's total output (Chart – 1). This share might go down to 20 per cent between Q3 FY17 and Q4 FY 19.

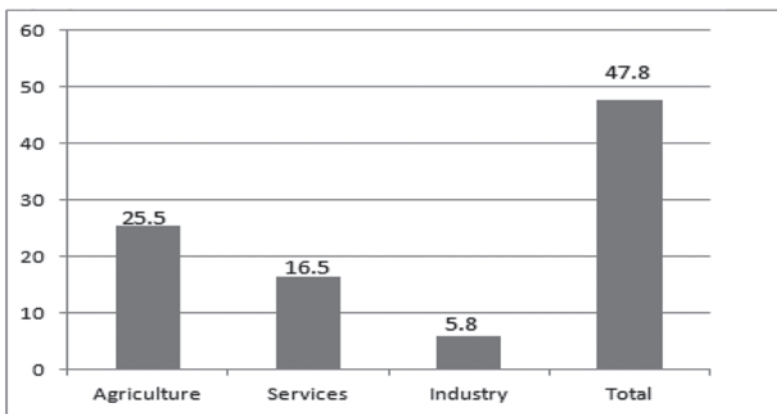


Chart - 1

**ii) Increase in saving**

The big benefit of demonetisation will be the bump-up in white savings ratio, at the cost of black savings ratio, over the next few years.

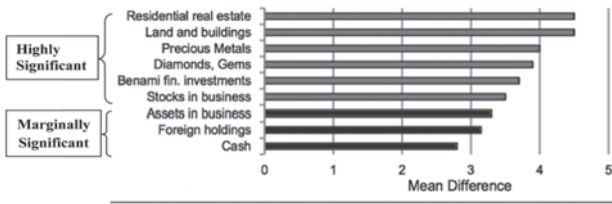
	FY 14	FY 15	FY 16	FY 17E	FY 18E
Investment ratio(% of GDP)	34.7	34.1	33.3	32.8	32.8
White saving ratio(% of GDP)	26.3	26.2	27.4	28.1	28.8
Black saving ratio(% of GDP)	6.8	6.8	6.2	5.6	4.9
Nominal GDP growth rate (y-o-y in %)	13.0	11.0	9.0	11.0	11.0
Saving & Investment gap (Rs lakh crore)	6.0	5.0	4.0	4.0	5.0

**10. Whether the demonetisation scheme is an effective tool to curb the black money in the economy.**

Over a period of time the black money scope has widened through the following activity.

- i) **Hawala deals:** The unaccounted money is held in foreign bank accounts, domestic and foreign real estate and in gold and jewellery. Unaccounted money can also be laundered into “white” money through “hawala” mechanism. Hawala takes the unaccounted money as cash and smuggles it overseas to safe havens where it is converted into foreign currency and invested in different ways including in bank accounts. The cash returns to India by a similar route. It is now available for investment in “black” assets which could be real estate & gold.
- ii) **Offshore havens:** Send the money to countries like Mauritius which have no capital gains tax. The money goes there and is then legally sent to be invested in say, stock exchanges in India, and when the shares are sold, the proceeds that are remitted back to Mauritius are now whiter. This happens with a few other countries like Cyprus.

Cash is the least preferred instrument for storing undeclared assets. It is real estate, followed by precious metals and jewellery that is used to launder most of the black money.



Source: NIFM, Credit Suisse estimates

The demonetisation of high value currency is an important step. To reduce the role of black money, we need the government to make most approvals clear and automatic. We need far less hurdles on the path of doing business. We need much more bank than cash transactions (now 12 per cent of GDP). We need more use of plastic money, though not with the high debt component that has drastically reduced savings rates in the US.





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