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Guest Opinion:

Credit FAQ: The How And Why Of India's Demonetization

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*(**Editor's Note:** The views expressed in this article are those of CRISIL Ltd., the India-based subsidiary of S&P Global Inc.)*

In a surprise move at 8 pm on Nov. 8, 2016, the government of India announced the withdrawal of bank notes in denominations of Indian rupee (INR) 500 and INR1,000. Although the Reserve Bank of India (RBI; the central bank) did not explicitly call this "demonetization," the term is now widely used to refer to the move.

The long-term aim of the policy is to improve economic and public administrative conditions in India by forcing black markets and cash-based sectors of the economy to operate in the formal economy. However, the immediate impact of the move has been stunningly disruptive, with cash shortages roiling business plans and curbing individual consumption.

In this article, CRISIL Ltd., S&P Global's subsidiary in India, reviews some of the most frequently asked questions on India's radical policy move.

Frequently Asked Questions

What was the Indian government trying to achieve with demonetization?

The objective is to curb corruption, reveal the amount of "black money" made on the black market, and to stamp out illegal funding activities, including the funding of terrorism. Policymakers believe all of these activities are facilitated by high-denomination notes, which make good targets for counterfeiting. Another component of the move is to break the Indian economy away from its dependence on cash transactions, which allows for a large informal economy and tax avoidance. By promoting electronic payments India's policymakers are seeking a "less-cash," and perhaps eventually a cashless economy.

Another major aim of the policy is to bring more Indians into the formal financial system. According to a 2013 study carried out by the Institute for Business in the Global Context at Tufts University ("Cash Outlook: India"), the value of cash transactions in India as a percentage of total consumer payments was approximately 86% in 2012. This number might have fallen in the past few years led by some pick-up in electronic transactions, but would still be significantly high. Significantly, less than half of India's population has a bank account or uses the financial system for monetary transactions. Demonetization is aimed at forcing more Indians to keep their money in banks.

How is such a major currency-swap program being implemented?

Holders of the demonetized INR500 and INR1,000 bills have been given little time to adjust to the new reality. In the first stage of the currency-swap implementation, the government permitted an exchange of existing notes at banks and post offices until Nov. 24, if accompanied with proof of identity. However, limits were set. For each exchange, the government set a limit of INR4,000 per person per day (about US$59).

In addition to the exchange of notes until Nov. 24, holders of the discontinued notes can deposit any amount of them at banks until Dec. 30. However, total cash withdrawals remain limited and are constantly under review, with the current limit set at INR24,000 per week on savings accounts, and INR50,000 per week on current accounts. Withdrawals from ATMs are restricted to INR2,500 per day. The withdrawal limit is only on cash, there is no restriction on making check/digital payments.

Some relaxations on cash withdrawals and use of old currency notes have been permitted on a case-to-case basis for farmers, traders, and for weddings. Moreover, for a specified period, the government is allowing the existing currency notes to be used for certain essential purposes such as transactions at government hospitals, pharmacies, and gas stations.

Meanwhile, the RBI is printing more smaller-denomination notes to meet supply, and the government also announced the launch of a new INR2,000 note and a redesigned INR500 note. Between Nov. 10 and Dec. 13, 2016, the RBI issued 21.8 billion notes of various denominations of which 20.1 billion pieces belonged to small denominations of INR 10, 20, 50, and 100 and 1.7 billion belonged to higher denominations of 2000 and 500.

The process has been rocky. What went wrong?

Inadequate planning is to blame. The government has not been unable to ramp up bank note production to meet demand. And there is not much scope to speed up the process due to printing capacity constraints. The high denomination notes withdrawn amounted to more than INR14 trillion by value, tantamount to 86% of the value of cash in circulation. As of Dec. 10, the public had deposited INR12.44 trillion of the demonetized currency notes with banks, but authorities have been able to print only 4.6 trillion worth of new notes. In short, so far only about 37% of the old currency has been replaced. As a result, there is a large shortage of physical legal-tender currency.

The cash crunch has led to demand contraction in the economy. The shortage is worse in areas where cash takes time to reach, because of the logistics involved in transferring currency across the length and breadth of the country. Distribution has been lowest in remote villages, hilly terrains, and conflict-ridden regions, where the country's vulnerable populations lie, affecting them the most.

There has been speculation that currency notes that do not get exchanged before the deadline will reduce the liabilities of the RBI (extinguished currency) and this, in the form of dividend, can become a fiscal bonanza for the government. Is this the case?

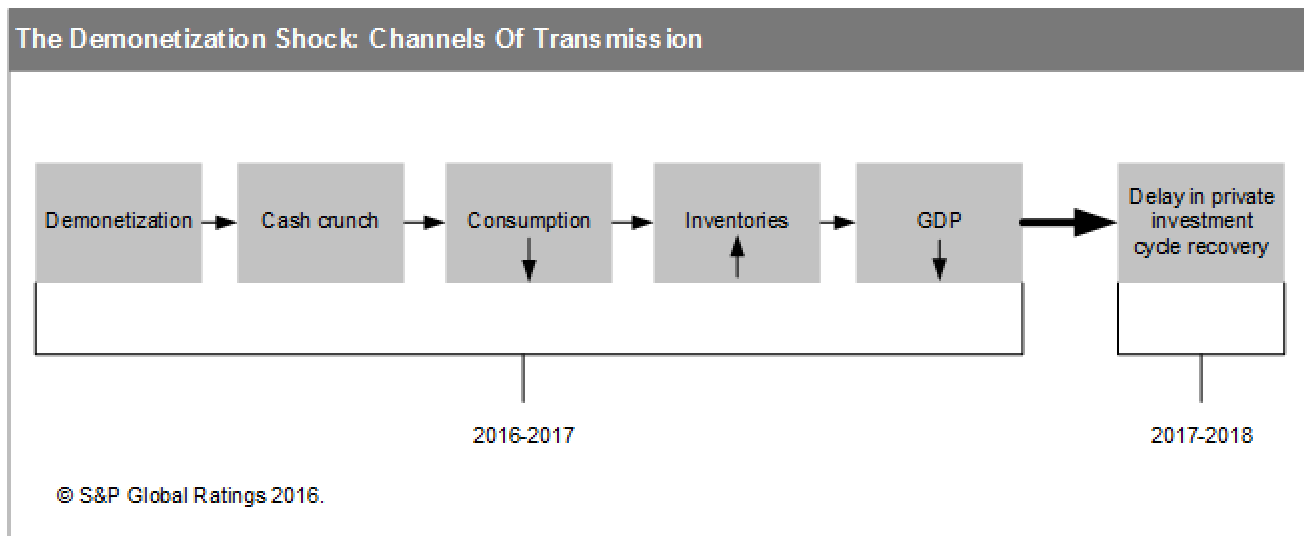
As such, there is no question of special dividend to the government now just by "the withdrawal of legal tender status of currency" that has been currently done. As RBI governor Urjit Patel explained recently, the central bank's liabilities remained unchanged as a result of the withdrawal of INR1,000 and INR500 notes.

What will be the impact on the economy?

Based on our assumption that it will take at least a couple of more months for the situation to normalize, we have sliced 100 basis points off this fiscal's earlier estimated GDP growth of 7.9%, to 6.9%. That translates into a GDP growth of 6.6% for the second half of the fiscal year ending March 31, compared with 7.2% in the first half. The jolt to demand will also pull inflation down. We now expect the Consumer Price Index (CPI)-based inflation to be pegged lower at 4.7% in fiscal 2017, compared with our earlier forecast of 5%.

If the adjustment takes more than two to three months, GDP growth might very well slip below 6.9% for the full fiscal

year 2017, and delay economic recovery in fiscal 2018. The RBI has cut India's growth outlook by 50 basis points to 7.1% for fiscal 2017.



Quantifying the impact of demonetization on GDP is tough, given its unprecedented nature and the continuously evolving scenario. While the channels through which it will work on GDP are understood, it is not clear how long the cash crunch will endure. The large and cash-dependent informal sector is not accurately measured, so this accentuates the problem of forecasting.

Moreover, this comes at a time when the business cycle was accelerating on the back of a number of recent tailwinds, including a good monsoon season, which boosted the country's large agricultural sector. Moreover, consumption was enjoying a boost from a recent hike in government-employee salaries and an expansion of the pension scheme for veterans. Shortages of cash have interrupted these benign trends.

That said, we believe that over the medium run, this process will strengthen the government's fiscal position as tax compliance improves. Broader revenue collection will in turn provide an opportunity to cut tax rates. As a result, private consumption (the biggest contributor to India's GDP with a 55% weight) should get a boost. This, combined with pent-up demand that will be exercised once India has adjusted to the new system, makes us believe the country can return to its previous GDP-growth trajectory.

Which business sectors are most impacted?

Sectors that transact a high proportion of business in cash transactions will face disruption. This includes real estate, jewelry, retailing, restaurants/quick service restaurants, logistics, consumer durables, and luxury brands, and some segments in retail and small and midsize enterprises (SME). The cement sector will feel the pinch indirectly, given that more than 60% of production goes into real estate.

While short-term liquidity issues will get evened out, we expect headwinds in the medium term for a few sectors such as real estate, jewelry, and high-end consumer goods, particularly if the cash crunch persists longer than expected.

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While the current winter sowing season seems to be progressing well, the agriculture sector will nonetheless bear the brunt of demonetization. That's because farmers are finding it tough to sell their produce in the Agricultural Produce Marketing Committee markets and prices for perishables have come down sharply. Therefore, despite a good harvest, there is unlikely to be a commensurate improvement in rural demand.

Will the government ultimately achieve its objectives?

The demonetization shock will be instrumental in helping India reduce the size of the shadow economy, which the World Bank estimates to comprise 20%-25% of total GDP. A "less-cash" economy will allow for better cash flow trails and stamp out black-market activities. Corruption is another drag on economic performance, and better-tracked money flows should help fight corrupt activities.

To be sure, problems of corruption and black money are deeply entrenched, and will not be magically cured with one policy action, no matter how radical. Demonetization should be viewed as part of the process of cleaning up the system, and must be accompanied by other steps. These would be a simplification of the tax system, greater accountability systems in government, and fixing issues related to funding of political parties and elections.

Having said that, a bold move of such a scale, we believe, will instill some fear among wrongdoers and act as a deterrent against future illegal activities.

What are the main takeaways from this episode?

It is too early to know. Theoretically, there are many benefits to reducing large-currency bills. The economist Kenneth Rogoff in his book, The Curse of Cash, recommended their removal in advanced countries to curb illegal activities, and also suggested that such a process should be gradual. India is neither an advanced country, nor did it initiate a gradual phasing out. The suddenness of this policy is ascribed to the secrecy needed to make such a move effective.

Demonetizing roughly 86% of currency in circulation, and rendering such a large proportion as illegal tender in one go is a courageous step. Yet discretion is the better part of valor. It seems the government went grossly off the mark while evaluating and preparing for such a major shake-up. Moreover, a number of inconsistencies have not been addressed. For example, if the idea is to follow Rogoff's advice and eliminate large currency notes, then why is the government introducing a new, even larger note (INR2,000)? This is a conundrum. Apparently, the government expects to speed up the process of cash replacement. However, unless these big notes are also eventually demonetized, we could be back to square one.

The long-run question, of course, is whether a change in currency composition can solve broader issues of corruption, tax avoidance, counterfeiting, and black market activities. If the answer is yes, the Indian demonetization will be marked down in the annals of economic history as a major success story.

The coin has been flipped, but we do not yet know on which side it will land.

Related Research

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