Growth pangs of demonetisation

The ease at which the currency is replaced is key

WITH the not-so-encouraging response to its Income Declaration Scheme-2016, which unearthed just about 0.5% of GDP, the government came out with the policy-surprise of discontinuing 500- and 1,000-rupee notes. As the government is determined to curb terrorism financing, counterfeiting as well as unaccounted income, the demonetisation measure is clearly a bold one and expected to be effective. However, as many analysts pointed out, given the share of the value of these currency notes is about 86.3% of currency in circulation at the end of FY16, the success of this policy depends heavily on the speed and smoothness at which the existing currency in circulation is replaced with new currency.

At a macro level, it would be interesting to know what could be impact of demonetisation policy on the growth, inflation, government revenues, and so on. In this small note, we try to empirically look at these issues. However, *ex ante*, at this stage, given it is difficult to ascertain the degree of replacement, the figures derived here are at best based on partial analysis and indicative that is subjective to key assumptions.

Here, following the quantity theory of money framework that explains the long-run relationship between money supply, output and prices, simulations are carried out to understand the impact on output and inflation. At present (FY16), 'currency with public' is estimated to be about 13.2% of broad money, at a whopping 75% of reserve money stock with the money multiplier being largest at about 5.7. Most risky for this analysis is the assumption about the extent of unaccounted money in the economy. While the media provided various unauthenticated estimates about the extent of unaccounted incomes in the country, following the currency-demand approach (by Friedrich Schneider), India's unaccounted incomes is estimated to be about 23-26% of GDP and this could be in the form of currency (domestic and foreign), gold and precious metals, immovable assets, etc.

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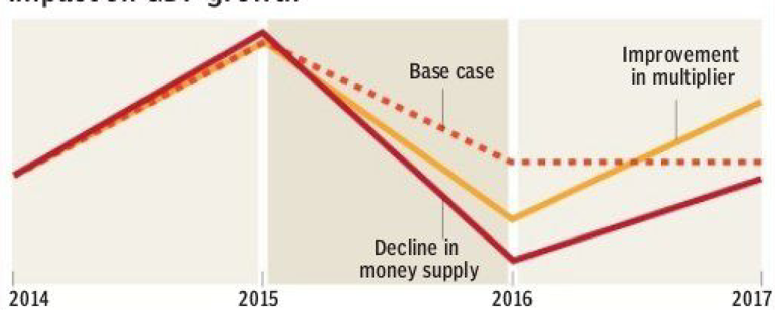
Following demonetisation, what is generally expected is that a major part of the currency with the public will be exchanged and some part of it will end up as deposits as well. This, through money multiplier, could enhance economic activity substantially. However, due to unaccounted incomes, the replacement might not be complete and the extent of currency that could not be part of the replacement depends on the extent of black money and might be substantial. This would have a differential impact on GDP growth and inflation in different times. As per theory, the impact of change in money-supply is expected to be significant on output in the short-run. However, in the long-run, its impact could be highest on prices but less on output. This can be explained through the accompanying graph.

As demonetisation would reduce the money supply due to incomplete replacement in the system, this is expected to reduce the GDP growth not only in the shock year but also in the t+1 period. However, as some of the currency that was not part of the financial system earlier comes back to the banking system and there are policies to increase the cashless transaction in the economy, one should expect the improvement in the money multiplier. This should have positive impact on growth and expected to result in higher growth than in the base case. There are other channels through which positive impact on growth can occur. They are fiscal channel (through increase in the government revenues) and the banking channel (through downward pressure on the interest rates). Similar channels and their differential effects can also be seen on inflation.

Illustratively, assume that out of the 'currency with the public', 25% (close to Schnider's estimates) is unaccounted money. Further from this if half of it comes back to the banking system, with half of the money out of circulation, this could reduce the GDP by 1.1% in the current year. However, due to increase in money multiplier, the drop in GDP is expected to be about 0.6%. What is interesting is that the positive impact of such improvement in multiplier is much more in FY18, where the GDP is expected to be higher than that of in base case, by 0.7%. In the same scenario, while the inflation also decline, the decline in inflation in FY18 is higher compared to decline in FY17.

As discussed earlier, what determines the impact of demonetisation is the ease at which the replacement of currency takes place so that there is no significant disruption to normal transactions. Going by the reports that suggest compatibility problems of existing ATMs with the new notes as well as doing away with 1,000-rupee notes during the crucial transition period (although, as an afterthought, the government announced that it could bring new 1,000-rupee notes soon) imply that replacement process could be prolonged and painful.

Impact on GDP growth



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LETTERS TO THE EDITOR

Simultaneous polls a bad idea

This refers to the editorial 'Demonetising politics' (*FE*, November 17). During the debate that took place in the Constituent Assembly, professor KT Shah was critical of the "heavy cost of seeking representation" which inevitably led to the failure of democracy in actual practice. He suggested that all election expenses be paid out of the public treasury and that anyone who fails to secure less than 10 percentage of votes should not be entitled to claim such expenses. To ensure that candidates who for lack of funds would otherwise not be able to come forward for public service, he suggested that the scale of expenditure should be laid down so that there is "no abuse of this privilege". It is unfortunate that even today elections in India are influenced more by the personality of the candidates contesting the elections than larger electoral issues. This leads to creation of votebanks in the country and voters of the same hue are swept by "waves" into donning a particular political outfit. Parties with large party funds carry on election campaigns, extending over months perhaps, and involving hundreds of workers to canvas votes. The Constituent Assembly did not explicitly lay down any provision for simultaneous elections to panchayats, local bodies, state assemblies and Parliament. However, Syed Muhammad Sa'adulla did express his views on the objection raised against simultaneous elections—"the bogey of expenditure". While the idea of simultaneous elections sounds promising in letter, in spirit, it could be a political hara-kiri for a diverse nation like India. In a politically charged electoral atmosphere, the election of a common regime to office, though highly improbable, could prove to be a Constitutional nightmare. Therefore, sacrificing representative democracy at the altar of administrative convenience is not a prudent idea.

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