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## Insights – ‘Demonetization’ and its implications

The demonetization drive initiated by the Indian Government is going to have far reaching impact on the Indian Economy. It is being considered as one of the most significant step in tackling the black money issue that has gripped our country since many years.

Some of the effects of the demonetization measure are:

- a) The total currency in circulation as on Oct 28, 2016 was INR 17.54 lakh crores. According to the Reserve Bank of India (RBI), 86% of this component is in currency notes of INR 500 and INR 1000 denomination. Therefore, the currency that is being attempted to be demonetized is around Rs. 15 lakh crores. It is being estimated (internal estimates) that around 20% of this currency is in black. We believe that this money either will not come back into the system for exchange for new notes or will be surrendered as black money and taxes thereon will be paid.
- b) The deposit of these notes with the Commercial Banks ends on December 30<sup>th</sup>, 2016. Thereafter, currency notes will have to be deposited with RBI till Mar 31<sup>st</sup>, 2017.

We believe that after this date, the RBI will reduce Notes in Circulation to the extent of the money not deposited. To match its liability, it will have to reduce its asset or increase its liability. Increasing its liability would mean increase in its Net Non-Monetary Liabilities (or reserves) and declare special dividend (just an accounting entry) to the Government. The Government, in turn can reduce its bonds on the RBI's balance sheet by buying its bonds back from the reserves transferred by the RBI. The government will have multiple options about what it could do with this special dividend. It may reduce domestic outstanding debt, prepay external debt, reduce fiscal deficit as interest cost drops, and reduce its borrowing for following years. Improvement in debt/Gross Domestic Product (GDP) ratio should also help improve the country's sovereign rating by the International Agencies. RBI's balance sheet also frees up for supporting liquidity requirements of the banking system.

- c) On the other hand, the banking sector is going to see a surge of liquidity as deposits get collected. Based on our assumption (internal estimates) that (20% of currency will not be tendered back), there is going to be tendering of currency from the public to the tune of Rs. 12 lakh crores (80% of Rs. 15 lakh crores). Due to the temporary restrictions on withdrawing cash, our internal estimate is that at least 50% of the cash will remain within the banking system, i.e. of Rs. 6 lakh crores. This sudden surge in

deposit of 6% of current aggregate deposits will help in improvement of liquidity. This will lead to demand for fixed income securities, particularly government securities.

- d) According to a World Bank estimate in 2007, around 20-25 % of India's GDP is the size of the parallel black economy. The steps taken by the Indian Government has led to a scare in the parallel black economy and should lead to better tax compliance going ahead. This will have a telling effect on the other heavens of black money i.e. real estate and gold. Both these sectors are going to witness reduced demand. Lower demand for gold resulting ultimately in lower import of gold is expected to improve the current account balances. The Indian rupee should remain stable and display appreciating bias against hard currencies, as the current account improves and may also move into surplus.
- e) The sudden change due to reduced cash transaction will lead to reduction in economic activity. We believe that the services sector growth will be majorly affected. This will lead to lowering of inflation expectation and moderation of headline inflation too. However, the effect on inflation would depend on the moderation in economic activity in those sectors that have heavy cash transactions. RBI will find larger room to reduce repo rates with moderation in inflation.
- f) There are some other positives expected over the medium to long term. A more compliant economy should increase tax collections and tax to GDP ratio should improve from both direct and indirect tax. In future, an increase in use of plastic money rather than hard currency would also lead to higher money multiplier which will be more productive.

To sum up, the fight against corruption, terror funding, counterfeit currency and the black economy should result in,

- Increased systemic liquidity leading to higher demand for bonds
- Rate reductions due to lower inflation and inflationary expectations
- Stable to appreciating INR as Current account deficit improves due to lower demand for gold
- Higher tax to GDP
- RBI freeing up balance sheet as liability declines
- Government would be able to bring down its outstanding debt liability and improve fiscal deficit
- Immediate near term impact – decline in cash transactions may lead to reduction in consumption demand leading to some decline in the GDP growth.

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