

India's currency in circulation conundrum

Higher despite rising digital payments

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Economics - India

- ◆ The recent rise in currency in circulation sits oddly with rising digital payments and weak rural demand
- ◆ Inflation explains only part of the puzzle; we believe the main driver is the distress in the informal sector, pushing it more towards cash-based activities outside the tax net
- ◆ For now, the RBI may welcome this fall in INR liquidity, but eventually, informal sector distress needs to be addressed

After normalising post the demonetisation and pandemic spurts, there has been a rise once again in currency in circulation since early 2022. This sits oddly with the ongoing surge in digital payments. What's going on? Traditionally, rural demand has been a key driver of currency in circulation. But this time around real rural wages are falling. Inflation raises the demand for cash in hand to meet regular expenses. But we find that rising inflation explains only 40% of the rise in cash demand. Something else is at play.

We believe that distress in India's informal sector is a contributing factor. Let us explain. India's large informal sector has suffered back-to-back blows in recent years. We believe that the distress in the informal sector is pushing it increasingly towards cash-based activities, especially those activities that end up falling outside the tax net.

One might ask why goods and services tax (GST) revenue is on the rise when we are claiming that certain activities are more cash-based than before. We believe a growing formal sector can co-exist with a weaker informal sector. In fact, India is in the midst of a two-speed recovery. As for GST revenue, true that it has risen recently. But, once we scale it with GDP, the rise is not dramatic – and, if the informal sector had not been as disrupted, GST revenue may have been higher.

We go on to test our hypothesis with an ordinary least squares (OLS) regression. We find that, indeed, digital payments lower the currency in circulation (though the overall impact is small), while higher rural demand and GST revenue tend to raise it. GST revenue has risen on the back of formalisation. But the simultaneous disruption in the informal sector has pushed some informal activity deep into the cash economy. On net, the latter has dominated, leading to a rise in currency in circulation.

What does all this mean? If the rise in currency in circulation continues, it would lead to a meaningful fall in banking sector liquidity. This would come as a silver lining for the RBI, which is trying to drain INR liquidity in a bid to control inflation, but may also need to buy government bonds later in the year if it aims to keep bond yields contained. The rise in currency in circulation leakage may help it to buy bonds without significantly adding to outstanding liquidity. But, a word of caution here. The ongoing rise in currency in circulation comes on the back of informal sector distress. Eventually, this needs to be addressed. And the fiscal deficit needs to fall so that its funding is not too dependent on the RBI's helping hand. The policymakers have a task cut out for themselves.

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Chart 1: Currency in circulation dipped during demonetisation, recovered thereafter, soared during the pandemic, normalised soon after, before inching up again in 2022

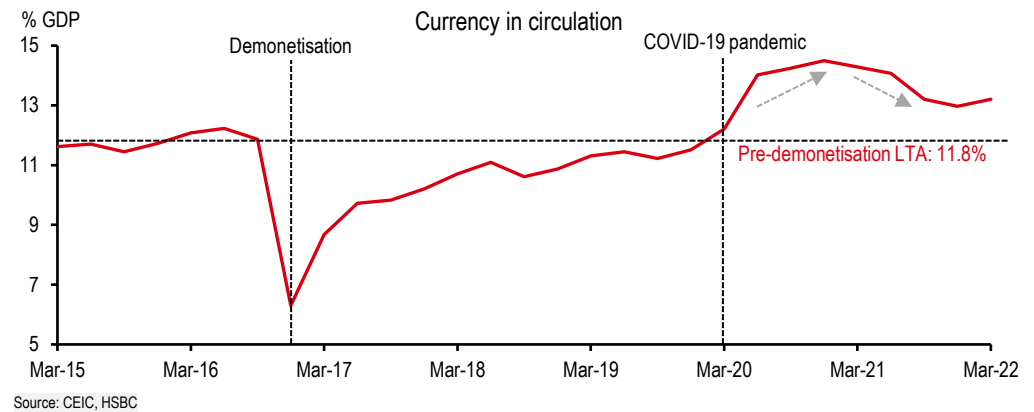


Chart 2: There has been another spurt in currency in circulation in 2022 ...

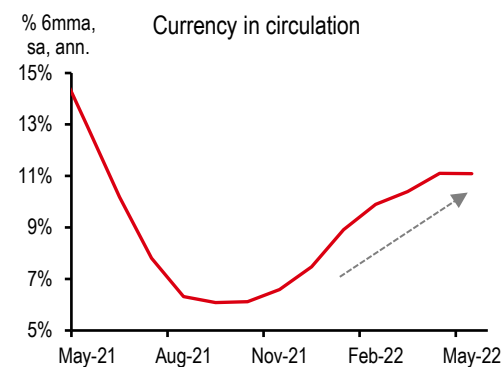


Chart 3: ... despite a pick-up in digital payments

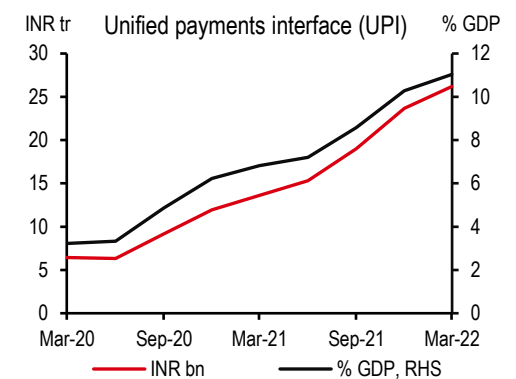


Chart 4: Real rural wages are slowing since the start of the year

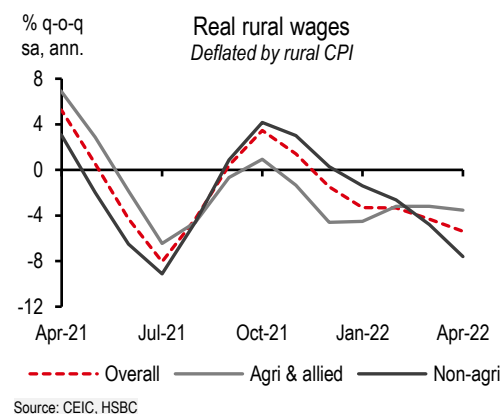
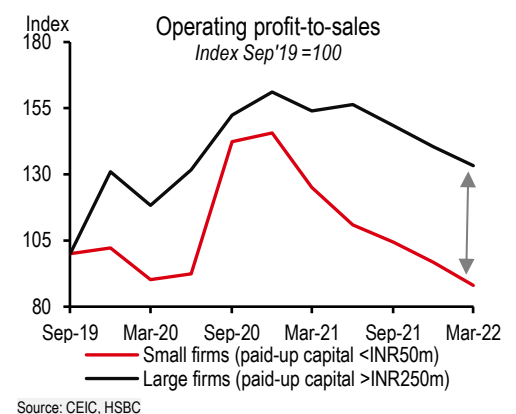


Chart 5: Small firm profitability has fallen rather sharply in early 2022



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