

Demand for currency could rise despite digitisation finds RBI study

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Anup Roy | Mumbai July 19, 2020 Last Updated at 14:36 IST



A Reserve Bank of India (RBI) staff study has found that demand for currencies rises in a low interest rate environment and falls when the rates are high. As a result, the country will have to adjust with higher currency in circulation in the coming days despite higher acceptance of digital transactions.

According to the latest RBI data, the value of card and mobile payments of Rs 10.57 trillion was more than ATM withdrawals of Rs 9.12 trillion in the fourth quarter of fiscal 2018-19, for the first time ever.

In the months of lockdown, the gap may have widened even further as people did not want to touch public ATM machines for fear of contracting virus, say experts, but cash could be back in vogue once the situation normalises.

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The RBI paper, titled 'Modelling and Forecasting Currency Demand in India: A Heterodox Approach'

If the slowdown persists for long, the impact will slowly reflect in currency demand

has been authored by former executive director and member of the monetary policy committee (MPC)

Janak Raj, Indranil Bhattacharyya, Samir Ranjan Behera, Joice John and Bhimappa Arjun Talwar.

The authors argue that digital transactions should be widely used to counter the ‘dash for cash’ as governor Shaktikanta Das recently put it, but the tone of the paper suggests that the outcome is unlikely to be realised in the immediate future.

To start with, the authors argue that income continues to be a key determinant of currency demand. "Therefore, currency demand in the foreseeable future is expected to grow broadly at the same rate as nominal income, which serves as an important guide for policy making."

Analysts are predicting that the nominal GDP growth rate could be negative in the present financial year, but that doesn't mean that the currency in circulation would fall. Despite a fall in economic growth, the CIC in the first four months of calendar 2020 was higher than the entire year of 2019, as reported by Business Standard earlier. The CIC between January and May 1 was Rs 2.66 trillion. In comparison, it increased by Rs 2.40 trillion in the entire 2019 (January to December).

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According to the latest Weekly Statistical Supplement (WSS) released by the Reserve Bank, currency in circulation increased by Rs 2.31 trillion in 2020-21 (up to July 10) which is more than three times that of the last year. At the same time, payments on Unified Payments Interface (UPI) reached an all-time high of 1.34 billion transactions in June, growing 9 per cent from May's 1.23 billion. In April, transactions had fallen to 999 million due to strict lockdown measures. The value was up 18 per cent in June to Rs 2.62 trillion, from Rs 2.18 trillion in May.

"It needs to be recognised that the Covid-19 situation is unprecedented (a tail event) which cannot be predicted by any model. Moreover, the estimates in the paper are long period average impact, which cannot be juxtaposed on a tail event like Covid-19; hence, it may be misleading to derive conclusions from the paper," said a senior economist, considered to be an expert in RBI matters. The study also implies that it will take many quarters to reflect the full effect of a current GDP slowdown on currency demand.

If the slowdown persists for long, the impact will slowly reflect in currency demand. "Thus, a sharp decline in currency to the magnitude of the GDP slowdown is not imminent in the current context," said the expert.

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But the growth of currency could be moderated by sustained usage of digital transactions, especially credit and debit cards and therefore, the thrust on these should continue, the paper argued.

Currency demand is higher in the festive season, especially during Diwali, while lower during the monsoons. The demand increases by about 1 per cent during general elections spanning about five weeks. The impact depends on the nature of elections – size of states, or nationwide Lok Sabha elections, it said.

While policy-induced measures such as demonetisation had lowered the trajectory of currency significantly, increasing sophistication of financial markets are also bringing forward several alternative investment avenues for economic agents instead of relying solely on bank deposits.

“Therefore, the opportunity cost of currency holding has shifted from bank deposits to new instruments ,” the paper said.