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Expectation and Unexpected Policy Change; Demonetisation

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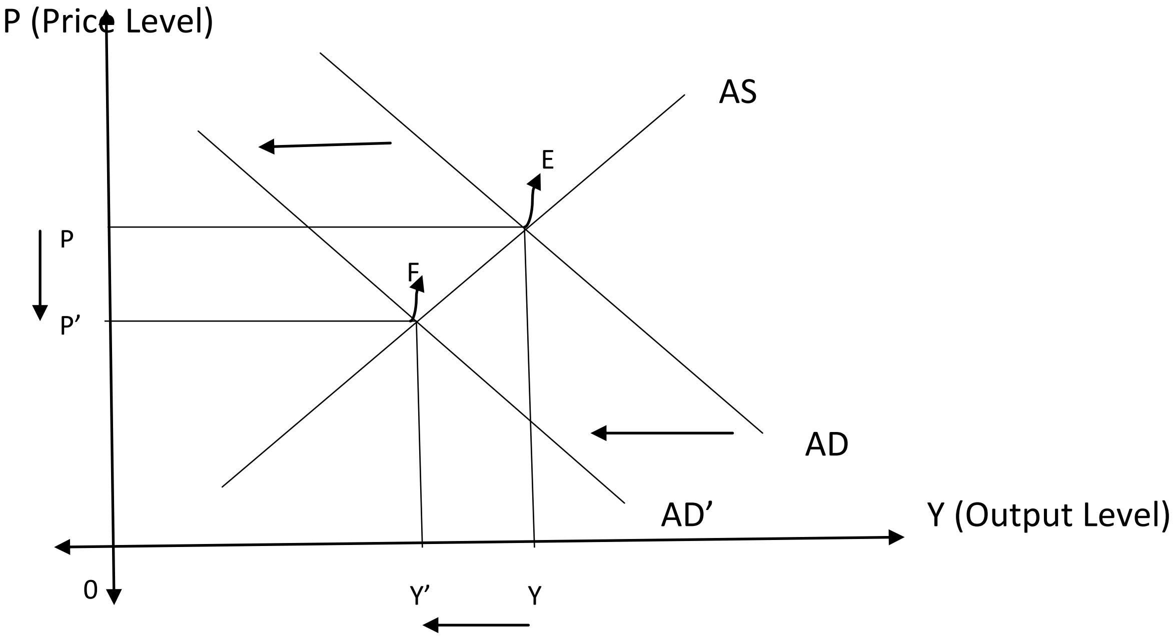
Abstract: In this paper, the policy of demonetization, which was a sudden and unexpected move the authority, will be evaluated based on the theory of expectation. Evidence will be presented to justify the impact of unexpected policy change.

Expectations play an essential role in economic decision making. Every economic player has to make some decisions to maximize their future utility. At the beginning of any period, every economic player has to make decisions about the upcoming period; while making decisions, they have to form expectations about the variables, e.g., future income, future consumption, future interest rate, etc.. Households and private investors are the two important economic players in the economy. Both of them have to maximize their satisfaction level by making a better decision with the given constraint. In their decision-making process, they have to accommodate the formed expectations about the variables. In maximizing their utility level with the given constraint, households, as a consumer, have to forecast their future income to make their consumption pattern smooth. They will also have to consider the expected interest rate to make an appropriate decision about consumption and saving, and better trade off can be done between these two. Private investors have to consider two things in their decision-making process: their investment decision's future profitability and the expected rate of interest. It can be learnt that both households and private investors have to form expectations for their decision-making process.

There are various ways of forming expectations. Generally, the variable's past behaviour is observed, and all the available information are taken into account to form expectation in a better manner. Any discrepancy in the above process or ignoring any information can lead to an error in expectation, defined as the gap between the expected value and actual value. Expectation error can also be the result of an unexpected policy change. The magnitude of error depends upon the degree of an unexpected change of policy. Any expected change in policy will not impact the variable, like output/income level, because the economic players would have already taken the expected policy change to form the expectation.

Role of Expectation and Demonetisation:

A sudden announcement about the demonetisation was made on 8th of November, 2016, which can be considered an unexpected monetary policy change. This policy was sudden, as well as unpredictable. The demonetisation process led to invalidate of the currency notes of Rs. 500 and Rs. 1000. It was nothing but an unexpected contractionary monetary policy that was implemented. The proportion of these currency notes in circulation was around 86%. Such a high degree of sudden withdrawal of currency notes from circulation, which was unexpected, can substantially impact the economy.



The above diagram explains the impact of an unexpected change in monetary policy. Since the demonetisation suddenly reduced a large number of currencies from the economy, this AD curve is shown to be shifted backward from AD to AD'. The unexpected withdrawal of currency from the economy did not allow all economic players to change their expectations. If their expectation remains at the same level, there would be no change in AS function, and AS curve remains in the same position. The downward shift of the AD curve shifted the equilibrium point from E to F. In achieving a new equilibrium point, F, which results from the unexpected policy change, the equilibrium price decreased from P to P', and it also reduced the output level from Y to Y'. The final result, as per the theory, will be the low level of output. In the diagram, it can be observed that in this case of sudden and unexpected policy change, the output level will remain at a low level, at Y'. And it would be difficult for an economy to converge at the initial natural level of output (Y). In other words, the impact of unexpected policy change will remain for a longer period.

Since output level and employment level is directly related (this can comfortably be assumed as per theory), an unexpected decrease in output level would also decrease the economy's employment level. The degree of job loss would directly be related to the degree of vulnerability associated with the nature of jobs. Since, in India, a large number of labour-forces are working in the informal sector and are employed in informal employment. Their degree of vulnerability is too high; it can be expected that many workforces would lose their jobs due to such a sudden demonetisation policy.

Pieces of Evidence:

A large number of work-forces work in the unorganized sectors, which is generally assumed as the cash intensive sectors; where large number of transactions are done in cash. Many newspapers reported that during the period of demonetisation, it became difficult to do transactions in cash. These sectors would undoubtedly have faced a problem. Due to the unavailability of cash, the firms (particularly in the unorganized sectors) faced difficulties making payments to workers. According to Himanshu, most of the small and medium units' employees met a very challenging time. The situation was made to force them to close their units, which led to many unemployed workers. The estimation of Srivastava (2011) shows that the number of short-term circular migrants was 40 million in 2011. The number is too high, and these short-term circular migrants are assumed to be highly vulnerable. The Centre for Monitoring Indian Economy (CMIE) reported that about 15 lakh workers lost their jobs post demonetisation (during January-April, 2017). They were forced to migrate back to their origin. It can also be noticed that reverse migration increased after demonetisation; this led to a decrease in the remittances sent back to the origin (Mishra, 2016). In some states, reverse migration puts pressure on rural labour markets, and demand for work has increased under the scheme of MGNREGA (Maji&Saha, 2017). UP and Bihar are the states which contribute a large number of the inter-states migrant population. So, these states are going to face a considerable burden.

Conclusion:

According to the expectation theory, any unexpected change of policy can deviate the output level from the natural (desired) level of output; this is also true with the level of employment. The policy of demonetisation was a sudden and unexpected policy change and can be considered an unexpected contractionary monetary policy. As per the expectation theory, this unexpected and sudden policy change can decrease output level and employment level from the desired level. It is challenging for the economy to reach the desired level again because a large part of the economy consists of unorganized sectors, and a large workforce consists of informal workers. The evidence post-demonetisation also shows that many firms went for closure, which led to an increase in the number of unemployed workers. Many states experienced a considerable reduction of remittances from out-migrants. Those who became unemployed during the period of demonetisation, are forced to go back to their origin. The origin states have seen an increased burden on the rural economy, and demand for work under the scheme of MGNREGA has increased post-demonetisation.

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