



DEMONITIZATION IN INDIA: ITS GOALS AND IMPACT ON THE INDIAN ECONOMY

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Abstract

Demonization of currency is a radical step in which the currency unit is declared invalid as a legal remedy. This usually happens if you change your national currency, replacing the old one with a new one. Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes, there occurred huge gap in the currency composition as after Rs 100; Rs 2000 is the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination. Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce following short term/long term, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts. This study is an attempt at getting to know the Demonization in India, its purposes and its effects. The purpose of this paper is also to explain the impact of such black money traffic.

Keywords: *Demonetization, Objectives, Effects, Impact, Black Money GDP.*

Introduction

When a note of a nominated currency ceases to be a legal tender, it is called a Demonization. It Occurs when there is a change in national currency. The current form or form of money is collected from circulation and retired, often replaced by new notes or coins, and sometimes the country completely replaces the old currency with a new currency. For example, such a step was taken when, in 2002, the European Monetary Association decided to adopt the euro. However, the old currency could have been converted to euros for some time to provide a smooth transition through demonization. In 2015, the Zimbabwean government demonstrated its dollar as a way to fight the hyperinflation of the country, which amounted to 231,000,000¹. The ongoing process included the removal of the Zimbabwean dollar from the country's financial system and the intensification of the US dollar, Botswana pool and South African rand as a legal tender to stabilize the economy. Fiji, Singapore and the Philippines were other countries that had opted for a currency Demonization. Demonetization for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as an official mode of payment. Demonetization is the act of stripping a currency unit of its status as legal tender. In India's case, the move has been taken to curb the menace of the black money and fake notes by reducing the amount of cash available in the system. It is also interesting to note that this was not the first time the government of India has gone for the demonization of high value currency. I was first time implemented in 1946 when the Reserve Bank of India demonetized the then circulated Rs 1,000 and Rs 10,000 notes, The government then introduced higher demonetization bank notes Rs 1000, Rs 5000 and Rs 10000 in a fresh avatar eight years later in 1954 before the Morarji Desai government demonetized these notes in 1978. The government's move to demonetize, even then, was to tackle the issue of black money economy, which was quite substantial t that point of time. The move was enacted under the High Demonetization Bank Note (Demonetization) Act, 1978. Under the law all 'high denomination bank notes' ceased to be legal tender after January 16, 1978. People who possessed these notes were given till January 24 the same year a week's time to exchange any high denomination bank notes. On 28 October 2016, the total currency in circulation in India was Rs. 17.77 lakh crore (US\$260 billion). In terms of value, the annual report of Reserve Bank of India of 31 March 2016 stated that total bank notes in circulation valued to Rs. 16.42 lakh crore (US\$240 billion) of which nearly 86% (i.e. Rs. 14.18 lakh crore (US\$210 billion)) was 500 and 1000 rupee notes. In terms of volume, the report stated that 24% (i.e. 2,203 crore) of the total 9,026.6 crore banknotes were in circulation. In an important move, the Prime Minister of India Mr. Narendra Modi hit hard on corrupt bureaucrats, politicians, and business class, terrorist groups, smugglers, drug traffickers, black marketers and many others engaged in unlawful activities declared that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The people were given a chance either to exchange the old currency with new one through banks, post offices or deposit the same in their accounts upon December 30, 2016. According to the government of India, the RBI will issue Two thousand rupee notes and new notes of Five hundred

rupees which will be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. The main difference between previous drives of demonetization and the current one is that currency of higher denomination was barely in circulation in 1948 or 1978, unlike the Rs 500 and 1000 notes in 2016².

Objectives of the Study

1. To study the Demonetization Policy in Indian economy.
2. To study the various objectives and effects of the Demonetisation in India.

Research Methodology

Keeping in view of the objectives, in the present study secondary data has been used. Data has been collected from various research papers, magazines and articles. In addition to this study, data have also been collected from various journals, economic and political weekly and the research is also based on the referred sources- published, unpublished and electronic.

GDP growth

India's GDP, which grew by 7.6% in fiscal year 2015-16, is likely to slow down by 0.5% to 1.5% according to reports from several agencies. This is due to the lower availability of cash-intensive sectors such as manufacturing and real estate. Even the rapidly growing car industry has seen a contraction in the October-December quarter of 2016. Consumers' purchasing power has been negatively affected because cash is not available. We need to remember that India's economy is largely cash driven with more than 90% of transactions taking place in cash and digital transactions accounting for only the remaining 10%. Banks have also focused on the sole task of deposit and withdrawals, with the result that their primary role of issuing loans has been adversely affected. Also current account clients, who are largely business owners, need large amounts of cash in the short term have not been able to access cash and credit due to restrictions on withdrawals and the inability of banks to focus on the task of issuing loans³. In the short run, however, the cash crunch should have sizeable negative effects. First of all, India has a substantial informal economy, contributing 46% to non-agricultural Indian GDP and encompassing 84% of the non-agriculture jobs. The informal sector is very cash-dependent and the liquidity squeeze should have put a brake on transactions, especially in sectors such as retail, agricultural and commodities. Many entrepreneurs in the agricultural and retail sector do not have bank accounts, do not pay taxes and run their daily business solely based on cash transactions. During the note ban, these parties were not able to pay their workers in cash, buy intermediate goods in cash and sell their products and services for cash. Second, the crackdown on black money, which has been hoarded in the real estate sector, will most likely result in lower house prices and, hence, negative wealth effects. This is also detrimental for private consumption and housing investment. In response to the demonetization operation, many analysts have revised their growth expectations for the fiscal 2016/2017.

Many institutes revised FY2016/2017

	Original 2017	Revised 2017	2018
RBI	7.6%	7.1%	--
World Bank	7.6%	7.0%	7.6%
IMF	7.6%	6.6%	7.2%
Rabobank	7.0%	5.5%	8.2%

Source: IMF, World Bank, RBI, Rabobank

About tax compliance

India's tax rate in India is relatively low of 16.6% compared to emerging economies. It is estimated that since more money, including black money will be settled, this will lead to better tax compliance through better revenue orientation. The positive effect may be lower tax rates as the tax base grows and more people start paying taxes. The digital pressure of the government will also lead to an increase in indirect tax revenues for the government. In the form of service tax. In addition, companies that have previously reported their income will need to make appropriate disclosures, in particular income received through digital or non-cash.

For small and medium-sized enterprises (SMEs)

The SME sector, as we understand it, is a large part of the economy, contributing to 8 percent of GDP, with more than 80 million people employed each year. Wages in this sector are largely paid in cash and wages are adversely affected by

demonization. Unemployment has also been observed in relation to the decrease in the demand for goods for SMEs, as the purchasing power of consumers has decreased in the short term. Other sectors of the SME sector, such as restaurants and transport companies, have also been negatively affected, as business activity has declined, and there is a strong tendency in the segment to accept payments only through cash. Vegetable wholesalers observe declining demand and prices of tomatoes and other foodstuffs are declining considerably, making farmers economically unproductive. Which brings us to the next point⁴.

On Agriculture

This is one sector where all transactions are in cash and, given the values involved, involve the higher denomination notes. The withdrawal of the old currency notes has put pressure on the mandis; farmers are having problems in selling their produce as both the parties have to agree on the mode of payment. Also since there is acute shortage of Rs 500 denomination notes presently, change for the high denomination Rs 2000 notes is not readily available with the vegetable and fruit vendors. This is also taking the buyers away from these vendors to big retail markets thus impacting the livelihood of the unorganised sector.

Impact of Demonetisation on Black Money

As outlined in the first post on What is Demonetization of Currency, fighting black money rampant in the economy was one of the foremost objectives of this entire exercise and we will discuss in detail whether this objective was realised or not. If you read the above post, you will know that cash component forms just 6% of the black money in the Indian economy and currency demonetization will target just this 6% black income. If various reports are anything to go by, most of this black income has been converted into white by depositing it in Jan Dhan accounts, depositing in individuals own accounts by breaking into smaller chunks, by exchanging for new currency notes through hawala dealers, by buying last-minute luxury items like jewellery and high priced mobiles, by paying advance wages to employees etc. This is supported by the fact that almost the entire amount of Rs 14.18 lac crores in Rs 500 and Rs 1000 currency denominations lying with the public has returned to the banks at the time of writing this post. This implies that the dividend which the govt⁵. has been hoping for by way of 2-3 lac crores not returning to the banking system (since it is black money and/or counterfeit currency) has turned out to be a mirage. Also as per various announcements by the govt. from time to time that deposits by housewives and those exempt from tax will not be scrutinized has provided a way out for black money hoarders to convert their money into white. However there have also been some positive impacts like one time removal of counterfeit or fake currency from the economic system. Some people argue that since black money has reduced, prices of black money intensive sectors like real estate and gold jewellery will go down. This remains to be seen. But demonetisation cannot and will not prevent future generation of black money since black money problem is more of a cultural mindset in India than a legal problem. It will also be easier for the corrupt and black money hoarders to deal in Rs 2000 currency notes as compared to Rs 500 and Rs 1000 notes since higher currency value can now be carried with greater ease. A total of Rs 3185 crores in black money of which Rs 86 crores in new notes has been seized by the Income Tax authorities since the launch of the demonetisation drive on 8th November. This implies that on the one hand black money is getting unearthed and on the other leakage of new currency notes is taking place; most probably through the banking system itself.

Impact of Demonetisation on Terror Funding and Fake Currency

This was another stated objective of the currency demonetization drive of the government. While initial reports suggest that terror related activities in J&K witnessed a noticeable halt in the days following the demonetisation drive, including, stone pelting by misguided youths; the recent Nagrota attack shows that terrorism is continuing in the valley. Although the availability of cash has surely declined among the terror groups presently. The govt. also claimed that the new currency notes contain very high security features and are almost impossible to replicate⁶. But this claim does not seem to be true since many stories of counterfeit currency have come to light since the note ban was announced on November 8th. However in the short term, circulation of fake currency has definitely slowed down considerably since the infrastructure set up to print fake currency notes in neighbouring countries like Pakistan has been rendered useless by the demonetisation drive.

Impact of Demonetisation on Cashless Transactions

As already explained above that cashless transactions account for only 10% of all transactions on daily basis. The government in order to divert some of the blame for the poor implementation of this demonetization exercise announced mid-way that making India a cashless or less cash economy was one of the important objectives of this demonetization drive.



Towards this end, the Finance ministry, RBI and NITI Aayog announced a host of incentives to boost cashless transactions. This was also done to ease some of the problems that have resulted due to acute shortage of cash in the economy.

Effects of Demonetization in India

In an important move, the Government of India declared that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI has issued Two thousand rupee notes and new notes of Five hundred rupees which have been placed in circulation from 10th November 2016. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. The present study highlighted the probable consequences of this decision on various economic variables and entities⁷.

Effect on parallel economy

The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee Notes is expected to remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks, Temporarily stall the circulation of large volume of counterfeit currency and Curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

Effect on Money Supply: With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to reduce in the short run. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money and hence money supply will decrease permanently. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.

Effect on Demand: The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly; the nature, frequency and amounts of the commercial transactions involved with these sections of the economy necessitate cash transactions on more frequent basis. Thus, these segments are expected to have the most significant impact post this demonetization process and the introduction of new notes in circulation⁸.

Effect on Prices: Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

Consumer goods: Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.

Real Estate and Property: Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheque transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices (probably charging more on cheque payment).

Conclusion

The Demonetisation undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be “black money” and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetisation on the economy and its agents. It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. So, this highly impact-full step has both sorts of effects (i.e. positive and negative) over the economic as well as social atmosphere of the country. But, as per our impartial evaluation, the conclusion is that, the bad effects would be only short term and the country will regain its growth momentum in one or two years’ time, depending mainly over the government’s future course of actions. On the other hand, the positive effects will continue to contribute in the improvement of the economy as well as socio-political scenario of the country.



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