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IMPACT OF DEMONETIZATION ON INDIAN ECONOMY

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Abstract
Demonetization is the act of stripping a currency unit of its status as legal tender.

Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit. Declaration of 86 percent of currency notes as illegal tender in just a blink of time on eve of 8th November 2016 mandated the creation of immediate interruption in daily lives. The chaos was created in every strata of the society whether upper, middle or lower. This was not for the first time before this currency was demonetized first time in 1946 and second time in 1978. The demonetization was done in an effort to stop the counterfeiting of the current banknotes alleged to be used for funding terrorism and for cracking down on black money in the country. On 8 November 2016, India's Prime Minister Narendra Modi announced the Government of India's decision to cancel the legal tender character of 500 and 1,000 banknotes with effect from 9 November 2016. He also announced the issuance of new 500 and 2,000 banknotes in exchange for the old banknotes. In this paper I want to discuss the impact of recent demonetization on the Indian system.

Keywords: Demonetization, Black Money, Government, RBI, Exchange of Currency.

Introduction

Demonetization for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as an official mode of payment.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. Demonetization rendered everyone surprised as this was momentous decision and unexpected one which was declared without any prior information in the evening at 8:15 p.m. addressed by our honorable Prime Minister Shri Narendra Modi. This concept of demonetization is not new. This move is targeted for flushing the stocks of "black money" out of our economy and getting them legitimate, banked and taxable so that it becomes a part of our economy. While the announcement essentially rendered the 500 and 1,000 banknotes invalid from 9 November 2016, the Ministry of Finance has been monitoring the implementation of these measures in a number of ways:

- Exchange of old currency notes for new 500 and 2,000 currency notes has been permitted until 31 December 2016 (i.e. 50 days from the date of the announcement)
- Such currency exchanges have been limited to certain specified amounts announced from time to time and excess amounts are required to be deposited with banks subject to applicable KYC requirements.
- Cash withdrawals have been limited to ensure adequate supply of new currency notes.
- Usage of old currency notes has been permitted for certain specified periods and purposes, such as at hospitals and pharmacies, gas stations and foreign currency exchange for tourists.

The demonetization of the highest denomination currency notes is part of several measures undertaken by the government to address tax evasion, counterfeit currency and funding of illegal activities. The requirement to deposit currency notes in excess of specified limits directly into bank accounts has resulted in the declaration of hitherto unaccounted income, subject to higher tax and other penalties. 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 reasons of it are as under:

- To tackle black money in the economy;
- To lower the cash circulation in the country which is directly related to corruption in our country;
- To eliminate fake currency and dodgy funds which have been used by terror groups to fund terrorism in India;
- The move is estimated to scoop out more than more than Rs 5 lakh crore black money from the economy.

Demonetization in India

1. 1946: Rs1,000, Rs5,000, and Rs10,000 notes were taken out of circulation in January 1946. The Rs10,000 notes were the largest currency denomination ever printed by the Reserve Bank of India, introduced for the first time in 1938. All three notes were reintroduced in 1954.
2. Historically, previous Indian governments had demonetized bank notes. In January 1946, banknotes of Rs1,000, Rs5,000, and Rs10,000 notes were taken out of circulation. The Rs10,000 notes were the largest currency denomination ever printed by the Reserve Bank of India, introduced for the first time in 1938. In the year 1945 all three notes were reintroduced.
3. In 1977 Wanchoo committee (set up in 1970s), a direct tax inquiry committee, suggested demonetization as a measure to unearth and counter the spread of black money.

4. On 28 October 2016 the total banknotes in circulation in India was Rs.17.77 trillion (US$260 billion). In terms of value, the annual report of Reserve Bank of India (RBI) of 31 March 2016 stated that total bank notes in circulation valued to Rs.16.42 trillion (US$240 billion) of which nearly 86% (around Rs.14.18 trillion (US$210 billion)) were Rs.500 and Rs.1,000 banknotes. They were taken out of circulation from 2016.

Objectives

- To study the past experience of demonetization in various countries
- To analyze the impact of demonetization on Indian economy;
- To study impact of demonetization on growth and inflation.

Experience of Demonetization by Various Countries

- **Nigeria:** During the government of Muhammadu Buhari in 1984, Nigeria introduced new currency and banned the old notes. However, the debt-ridden and inflation hit country did not take the change well and the economy collapsed.
- **Ghana:** In 1982, Ghana ditched their 50 cedis note to tackle tax evasion and excess liquidity. This made the people of the country support the black market and they started investing in physical assets which obviously made the economy weak.
- **Pakistan:** From December 2016, Pakistan will phase out the old notes as it will bring in new designs. Pakistan legally issued the tender a year and a half back, and therefore, the citizens had time to exchange the old notes and get newly designed notes.
- **Zimbabwe:** Zimbabwe used to have hundred trillion dollar note. The Zimbabwean economy went for a toss when President Robert Mugabe issued edicts to ban inflation through laughable value notes. After demonetization, the value of trillion dollars dropped to $0.5 dollar.
- **North Korea:** The demonetization that happened in North Korea in 2010 left people with no food and shelter. Kim Jong II introduced a reform the face value of the old currency in order to banish black market.
- **Soviet Union:** Mikhail Gorbachev ordered to withdraw large- ruble bills from circulation to take over the black market. The move didn’t go well with the citizens which resulted into a coup attempt which brought down his authority and the led to soviet breakup.
- **Australia:** Australia became the first country to release polymer (plastic) notes to stop widespread counterfeiting. Since the purpose was to replace paper with plastic and only the material changed, it did not had any side effects on the economy.
- **Myanmar:** In 1987, myanmar’s military invalidated around 80% value of money to curb black market. The decision led to economic disruption which in turn led to mass protests that killed many people.
- **Zaire:** Dictator Mobutu Sese Seko faced increasing economic disruptions in the early 1990s, when his administration mounted successive banknote reforms. A plan to withdraw obsolescent currency from the system in 1993 saw a surge in inflation and a collapse in the exchange rate against the dollar. After a civil war, Mobutu was ousted in 1997.

Impact of Demonetization on Indian Economy

1) Black Money and Corruption: By demonetization, Black money will be taken out of Indian system. As predicted by ICICI Securities Primary Dealership the government's plan to remove INR 500 and INR 1,000 notes from circulation will disclose up to INR 4.6 lakh crore in black money. Corruption will also be automatically reduced by removing black money from economy.

2) Funding: Funding for smuggling and terrorism will take a blow since all the money will get back to bank and from there it is easy to identify the fake currency. Demonetization thus affects the funding of terror networks in Jammu and Kashmir, North-eastern states and the other areas.

3) Real Estate: Another impact of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable. In the short term, prices of real estate would come down for the same reason above. There will be fewer suitcases moving.

4) Elections: Demonetization has shocked political parties. Many states like Punjab and Uttar Pradesh, cash donations are a huge part of "election management". Political parties will find themselves helpless as cash hoards are often undeclared money. So upcoming elections 2017 will be transparent to the some extent.

5) Gold/Silver and Jewellery: After demonetization the demand for gold and other precious metals rise greatly. Because people are trying to invest their black money in gold to make it white in short period. But demand for gems and jewellery to decline in the next two to three quarters.

6) Digital Payments: People adopting online payments system such as Paytm etc. after ban for high denomination currency in India. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit

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and Credit Cards), etc. will definitely see substantial increases in demand. This behavioural change could be a game changer for India in the near future.

7) Fake Currency: The impact on the fake currency would be more significant. Many dealers with the existing counterfeit notes would be trapped as they would have to take the notes to the bank and have better chances of getting their racket exposed. Thus, they have only option to destroy their notes and incur losses.

8) GDP: The sudden decline in money supply and increase in bank deposits is going to adversely
impact consumption demand in the economy in the short term. This coupled with the adverse impact on real estate and informal sectors may lead to lowering of GDP growth.

9) Markets: There will be positive move in markets in long run that could bring confidence of overseas investors in Indian stock markets. Market goes a bit down in the short and medium term. Indiais still a very attractive destination on a long term basis. It is not the best market in the next three months.

10) Decease in Interest Rates: We will see a lowering interest rates for education loans, home loans and medical loans very soon. It will make higher education and medical facilities more accessible. This change is hard to undo because if any subsequent government increases loan it will suffer huge backlash.

11) Lower Inflation: As the black money goes out of the system the money supply will shrink to some degree. This will reduce inflation rate in the absence of any open market interventions by the Reserve Bank of India.

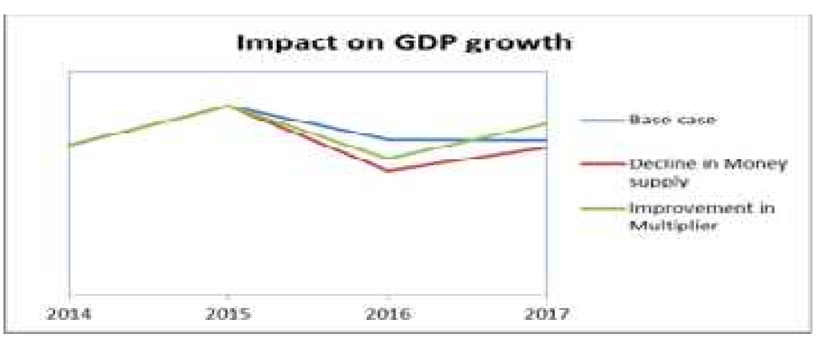
Impact of Demonetization on Growth and Inflation

With not so encouraging response from its Income Declaration Scheme, 2016, which could unearth just about 0.5% of GDP, the government came out with a surprise policy of discontinuing Rs 500 and Rs 1000 notes from circulation. As the government is determined to curb terrorism financing, counterfeiting as well as the unaccounted incomes, the demonetization measure is clearly a bold one and expected to be effective. However, as many analysts pointed out, since the share of the value of these currencies is about 86.3% by the end of 2015-16, the success of this policy depends heavily on the speed and smoothness at which the existing currency in circulation is replaced with new currency.

At a macro level, it would be interesting to know what could be the impact of demonetization policy on the growth, inflation, government revenues, and so on. In this small note, we try to empirically look at these issues. However, ex ante, as at this stage, it is difficult to ascertain the degree of replacement, the figures derived here are at best based on partial analysis and indicative, that is subjective to key assumptions.

Here, following the quantity theory of money framework that explains the long run relationship between money supply, output and prices, simulations are carried out to understand the impact on output and inflation. At present (2015-16), ‘currency with public’ is estimated to be about 13.2% of broad money while at a whopping 75% of reserve money stock, the money multiplier is the largest at about 5.7. Most risky for this analysis is the assumption about the extent of unaccounted money in the economy. While the media provided various unauthenticated estimates about the extent of unaccounted incomes in the country, following currency demand approach (by Friedrich Schneider), India’s unaccounted incomes is estimated to be about 23% to 26% of GDP and this could be in the form currency (domestic and foreign), gold & precious metals, immovable assets, etc.

Following demonetization, what is generally expected is that a major part of currency with the public will be exchanged with new notes and some part of it ends up as deposits as well. This, through money multiplier, could enhance the economic activity substantially. However, due to unaccounted incomes, the replacement might not be complete and the extent of currency that could not be part of the replacement depends on the extent of black money and might be substantial. This would have differential impact on GDP growth and inflation in different times. As per theory, the impact of change in money supply is expected to be significant on output in the short run. However, in the long run its impact could be highest on the prices but less on the output. This can be explained through the graph below.



As demonetization would reduce the money supply due to incomplete replacement in the system, this is expected to reduce the GDP growth not only in the shock year but also in the t+1 period. However, as some of the currency, which was not part of the financial system earlier, comes back to the banking system and there are policies to increase the cashless transaction in the economy, one should expect the improvement in the money multiplier. This should have a positive impact on growth and expected to result in higher growth than in the base case. There are other channels through which positive impact on growth can occur. They are fiscal channel (through increase in the government revenues) and the banking channel (through downward pressure on the interest rates). Similar channels and its differential effects can also be seen on inflation.

Illustratively, assuming that out of the 'currency with the public', 25% (close to Schnider's estimates) is unaccounted money. Further from this if half of it comes back to the banking system, with half of the money out of circulation, this could reduce the GDP by 1.1% in the current year. However, due to increase in money multiplier, the drop in GDP is expected to be about 0.6%. What is interesting is that the positive impact of such improvement in multiplier is much more in 2017-18, where the GDP is expected to be higher than that of in base case, by 0.7%. In the same scenario, while the inflation also decline, the decline in inflation in 2017-18 is higher compared to decline in 2016-17.

As discussed earlier, what determines the impact of demonetization is the ease at which the replacement of currency takes place so that there is no significant disruption to normal transactions. Going by the reports that suggest compatibility problems of existing ATMs with the new notes as well as doing away with Rs 1000 notes during the crucial transition period (although as an afterthought, government announced that it could bring back new Rs 1000 notes soon) imply that replacement process could be prolonged and painful.

Challenges Ahead

1. The government should come up with additional economic stimulus to offset the dampening effect:
   - Accelerated reduction in corporate income tax along with withdrawal of exemptions;
   - Ending uncertainty on GAAR and retrospective taxation or any other blockbuster measure that they might be working on, that would offset the initial adverse economic impact.
2. Assess Black Money better: There's no good estimate for how much of India's black money is in forms other than currency/physical notes such as gold, jewellery, land or any other form of wealth. Therefore, while banning Rs 500 and Rs 1,000 notes will tackle the black money that is in the form of hard cold cash, it won't affect other forms of black money.
3. Prepare for the challenges of cashless economy: The UPI (unified payment interface) system is likely to be fully operationalised only by January 2017. India was recently hit by one of its biggest financial security breaches compromising hundreds of thousands of debit cards.

Conclusion

The demonetization of the highest denomination note undertaken by the government is a big shock to the Indian. The demonetization is taken for several measures such as tax evasion, counterfeit currency and funding of illegal activities. Alternative payment methods, such as e-wallets, online transactions using e-banking, debit and credit card usage have been increased and this will shift an efficient cashless infrastructure. However experiences from different countries shows that the move was one of the series that failed to fix a debt-burdened and inflation-ridden economy. Demonetization though it has created some positive and some negative impacts on different sectors but in long run it definitely will have positive impact in controlling black money and fake money.

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