

Demonetization and its consequences on Indian economy

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Abstract: *Demonetization is a process by which a series of currency will not be legal tender. Indian government has taken a bold decision to demonetized money on November 08, 2016. India is amongst the highest level of currencies in circulation. A significant portion of the household cash in hand is generated by economic transactions that are not reported to tax authorities or is generated through corruption. Scrapping the higher denomination money would either result in these being brought into the system or the money just disappearing. The present paper highlights the probable consequences of this decision on various economic variables and entities. This study is based on secondary data, which is collected from news papers, magazines, internet, some useful books related to topic etc.*

Key Words: *demonetization, legal tender, corruption, economic variables.*

1. INTRODUCTION:

Demonetization is the withdrawal of a particular form of currency from circulation. Through demonetization the old currency is replaced by the new currency or a currency circulation is blocked. There are various reasons why a country demonetizes its currency; some reasons include checking the black money, checking the inflation, to curb the corruption and to promote the cashless transactions. Demonetization is a major decision and it impacts all the citizens of the country because overnight all the money you have become a piece of paper which has no value until you do not exchange it with new currency units or deposit it in the banks. The series of currency will not acceptable as valid currency.

As per RBI, 87% transactions in India are cash transactions and this loophole is used by corrupt people to build a parallel economy with unaccounted money. This parallel economy helps in terror financing which in turn hampers the growth and development of country. Currently high- values notes account for total value of 86% of the notes in circulation in India. It is expected that this step of Demonetization will help in reducing the fiscal deficit of India and promote the cashless economy in India which can be easily monitored. This move will also be useful in controlling NPAs of banks.

2. OBJECTIVES OF THE STUDY :

- 1) To examine the causes of demonetization in India.
- 2) To know the possible consequences of demonetization in India.

Demonetization History and Background in India?

This is not the first time when currency is demonetized in India. The glimpse of history of demonetization in India is:

- On 12th January 1946, 500, Rs. 1,000 and Rs. 10,000 notes were declared invalid as legal tender.
- New notes of Rs. 1000, Rs. 5000 and Rs. 10,000 came into economy in 1954.
- On 16th January 1978, the Morarji Desai led *Janata Party* demonetized banknotes of Rs. 1000, 5000 and 10000.
- RBI introduced a new banknote of Rs. 500 into the economy in 1987 to control inflation.
- On 8th November 2016, the old banknotes of Rs. 500 and Rs. 1000 were barred from being legal tender and new notes of Rs. 500 and Rs. 2000 were introduced.

However, the 2016 demonetization efforts cover 86% of the total currency in circulation (11% of GDP).

Demonetization is potentially: An aggregate demand shock, because it reduces the supply of money and affects private wealth.

- Impact on informal economy: informal economy depends heavily on bank notes for its transactions and there have been reports of job losses, declines in farm incomes, and social disruption.

- Impact on formal economy: little direct impact on the formal economy, which depends instead on the banking system, where liquidity has actually improved. An aggregate supply shock to the extent that cash is a necessary input for economic activity (for example if agricultural producers require cash to pay labor)
- If cash and other forms are substitutable, the impact will be relatively muted;
- If cash is not substitutable the impact will be greater. An uncertainty shock because economic agents face uncertainty in decision making:
- Uncertainty caused consumers to postpone purchases and firms to put off investments in the third quarter.
- There was clearly a wealth shock in the initial months, as cash assets were turned into the banks.

What are the causes of Demonetization?

According to economics survey 2016-17, the aim of the demonetization was fourfold:

- To curb corruption;
- Counterfeiting;
- The use of high denomination notes for terrorist activities; and
- Accumulation of “black money”, generated by income that has not been declared to the tax authorities.

Watal Committee has recently estimated that cash accounts for about 78 percent of all consumer payments. This is because: Cash has many advantages:

- It is convenient,
- Accepted everywhere, and
- Its use is costless
- Cash transactions are also anonymous, helping to preserve privacy.

Digital transactions face significant impediments. They require:

- special equipment, cell phones for customers
- Point-Of-Sale (POS) machines for merchants,
- internet connectivity
- costly to users, since e-payment firms need to recoup their costs
- Inter-operability of the payments system- the decline rate for transactions was nearly 56 per cent in cases where the transactions were carried out between two different banks, almost double the rate in case of intra-bank transactions.

India being a vast, multi-terrain country, with the uneven presence of banking facilities, there are many regions with poor access to banking facilities. The transaction cost is quite high as a percentage of a household's income. People living in remote villages in hilly areas rely on others to get notes exchanged, and taking losses in the process. So, for a subset of the poor living in remote locations, the costs may be even larger.

In India poor people are more vulnerable to frauds and swindles that are thriving in the present environment of enormous uncertainty. The unbanked are likely to be mainly the poor, and the unexpected ban on exchange of notes has created a worst situation for them. It is easy to say that they should open bank accounts. Farmers in particular were most affected. They had to stand in a long queue in front of banks leaving behind their jobs. It is quite likely that the costs of this decision on the poor will be significant, and some poor people might suffer disproportionately. Poor households have no black money and did nothing to deserve this.

Reports of stress in agriculture have begun to appear because of demonetization. Cash is the primary mode of transaction in agriculture sector which contributes 15% to India's total output. Formal financing in many parts, especially Punjab, Uttar Pradesh, Odisha, Maharashtra, Gujarat and Kerala is significantly from cooperative banks, which are barred from exchange-deposit of demonetized currency. Notably, this is a time of kharif harvest and start of rabi sowing, partly explaining why this period is dubbed the 'busy season' from a standpoint of credit demand, the other being bunching of festivals and weddings.

According to Indian express, Professor Amartya Sen (leading economist) said that millions of innocent people have deprived from their money and being suffered to get their own money back.

Kaushik Basu (Leading economist; Senior VicePresident and Chief Economist at The World Bank) According to Indian express, he said that government of India made policy that any person who deposits money beyond the limit of 250000, have to pay huge penalty. This policy created a new black market, in which large amount of illicit cash broken in to smaller parts and deposited by the members of team; which is a legal way of illegal activity. Mr. Basu said this move is hurting innocent people who has no illegal money but they have built up cash reserve over a long period of time.

On the other hand, Arun Jaitley (Finance Minister of India) gives his opinion that the demonetization is good for economy, Indian banks were facing NPA problem since last many years, now banks will have more money to lend for many sectors of the economy.

3. SIGNIFICANCE OF DEMONETIZATION MOVE:

- In effect, the tax on all illicit activities, as well as legal activities that were not disclosed to the tax authorities, was sought to be permanently and punitively increased.
- Demonetization was aimed at signaling a regime change, emphasizing the government's determination to penalize illicit activities.
- India's demonetization is unprecedented in international economic history, in that it combined secrecy and suddenness amidst normal economic and political conditions.
- Also India's action is not unprecedented in its own national history (for ex: 1946 and 1978), But the recent action had large, albeit temporary, currency consequences

4. CONSEQUENCES OF DEMONETIZATION ON INDIAN ECONOMY:

4.1 On GDP Growth

India's GDP which grew at 7.6% in FY 2015-16 is likely to **slow down by 0.5% to 1.5%** as per reports of various agencies. This is due to less availability of cash in **cash-intensive sectors like manufacturing and real estate**. Even the automobile industry which was growing rapidly earlier has seen a contraction in the October-December quarter of 2016. Purchasing power of consumers has been negatively affected due to cash not being readily available.

We need to remember that Indian economy is largely cash driven with **more than 90% transactions taking place in cash** and digital transactions accounting for just the remaining 10 percent.

Banks have also been focusing on the single task of deposit and withdrawals with the result that their **core function of issuing loans has been adversely affected**. Also current account customers, who are largely business owners, need large amounts of cash at short notice have not been able to access cash and credit owing to restrictions on withdrawals and inability of banks to focus on the task of issuing loans.

4.2 On Tax Compliance

India's **tax-to-GDP ratio is quite low at 16.6%** compared to other emerging economies. It is estimated that since more money, including black money, gets accounted for this will lead to **better tax compliance** owing to better targeting of income. The positive impact could be **lower tax rates as the tax base widens** and more people start paying taxes. The digital push of the government will also result in **higher indirect tax revenue** for the govt. in the form of service tax. Moreover businesses that under-reported their revenue earlier, will have to make proper disclosure, especially, of revenue received through digital or cashless means.

4.3 On Small and Medium-sized Enterprises (SMEs)

The small and medium-sized enterprise (SME) sector, as we understand, is a big chunk of the economy, contributing to eight percent of the GDP whilst employing more than 80 million people year on year.

The labor wages in this sector are largely paid in cash and **wages have been adversely affected** by the demonetization move. Unemployment has also been reported owing to decline in demand of SME goods as the purchasing power of the consumers has contracted in the short term. Other sectors within the SME space like **restaurants and transport operators have also been negatively impacted** since economic activity has declined and also due to the fact that there is high tendency in this segment to accept payments through cash only.

4.4 On Black Money

People who possess huge amounts of black money in hard cash are at a complete loss now .Their black money in hard cash is now a pile of trash.Now If a Black money holder Want to Deposit Money in Bank Account Than he/she Has to Show ID .There Will Be 200 % Penalty On Income tax Amount .

4.5 End of Huge Donations

Huge amounts of donation that is taken in the private education and healthcare sectors would be stopped.Schools, engineering and medical colleges and hospitals (private ones) used to take huge amounts of money as donations especially in the form of hard cash .These money-minded people running these institutions won't be able to make any easy money now .Same applies to the real estate sector.

4.6 Effects 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, it would curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

4.7 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 unorganized sector.

4.8 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 demonetization 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 replicate. 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 neighboring countries like Pakistan has been rendered useless by the demonetization drive.

5. CONCLUSION:

Demonetization of old currency notes surely has had some positive impact like reducing the cash flow to terror organizations, dismantling of counterfeit currency infrastructure, better income tax and indirect taxation, boost to digital economy. However, it has come at a huge social and economic cost. Demonetization costs are estimated at Rs 1.28 lakh crore to the economy for the 50-day time period till the end of depositing period of old currency. This includes a cost of Rs 17,000 crore towards the government and the RBI for implementing the demonetization process in India.

It is imperative that the effort to collect taxes on newly disclosed (and undisclosed) wealth does not lead to tax harassment by officials. There must be a shift to greater use of data through greater information sharing between direct and indirect tax departments, smarter evidence-based scrutiny and audit, greater reliance on on-line assessments with correspondingly less interaction between tax payers and tax officials.

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