

# IMPACT OF DEMONITIZATION ON INDIAN ECONOMY – A STUDY

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## ABSTRACT:

The Indian Economy which was billed as the “fastest growing major economy” in the world and the “only bright spot” among Emerging Markets seems to have slowed down even before the latest “shock therapy” of “demonetization”. Indeed, the recently released growth figures from the CSO or the Central Statistical Office considered to be the official department that releases projected, and actual growth figures (apart from the RBI or the Reserve Bank of India and the Finance Ministry) hints at a slowdown in the Indian economy even during the quarter before demonetization happened.

While this is indeed cause for concern with projected growth figures revised downwards from 7.6 % to 7.1% for the financial year ending March 2017, what is cause for greater worry and even alarm is the view among some economists including the former Prime Minister Dr. Manmohan Singh (who is a reputed economist in his own right) that the current and ongoing attempt to flush out black money would shave a good 2% of the GDP or the Gross Domestic Product.

Indeed, some think tanks and research institutes such as Ambit Research have given even more dire assessments with their projections of growth figures tending to be in the less than 3% range. Of course, the consensus view among many economists is that while there would be indeed a noticeable slowdown in the economy for a “quarter or two”, most of them seem to agree that growth would indeed bounce back and the Indian economy would regain its momentum as well as turnaround with a renewed sense of vigour due to higher tax revenues.

Key words : Indian Economy which was billed as the “fastest growing major economy

## Introduction

Having said that, one must keep in mind the fact that as per the recent estimates by some economists, **nearly 90% of the total cash in circulation has come back into the banking system** and hence, the stated purpose of the Demonetization exercise which was to “extinguish” black money and enable the RBI to lower its liabilities thereby providing the government with a huge dividend seems to have been belied. Of course, there are some who now argue that the Indian Banking System is now “flush with cash” and this has enabled the government to “nudge” the RBI to cut rates as well as to allow banks to pass on the benefit of ample liquidity to consumers by lowering lending rates.

However, the flip side of this has been that banks have cut their deposit rates as well which is natural considering that any cuts to lending rates have to be accompanied by cuts to deposit rates. This has resulted in a situation

where banks with enough deposits seem to be encouraging spending more than saving and this can indeed create demand in the system since more money with consumers means more spending thereby leading to an uptick in sales of goods and services and which has the “multiplier effect” of resulting in more growth.

On the other hand, **with more taxes being collected due to higher deposits in banks that can be taxable as well as increased compliance due to greater scrutiny and oversight by the IT (Income Tax) Department**, the government too might be tempted to announce lower rates for taxes and other aspects of what are known as fiscal measures. In this context, it is worth remembering that fiscal stimulus which is by lowering taxes and providing more incentives to consumers as well as producers by boosting supply can be complemented and supplemented by the monetary stimulus which is by boosting demand for goods and services by lowering lending rates thereby putting more money in the hands of consumers.

As economic theory states, both fiscal and monetary stimulus can be implemented in isolation or taken together and hence, the Demonetization or the DeMo as it is being called might indeed act as a catalyst for growth. Having said that, one must remember that India is primarily a cash transaction based economy and hence, removing 86% of the money in circulation is indeed a “brave” move since there are reports that large sections of the informal economy have come to a grinding halt.

Moreover, **there are also reports of farming sector taking a hit due to lack of cash as well as sales of automobiles and other capital goods falling even though inventories are building up**. Thus, it remains to be seen as to how the growth figures for the next quarter and the overall financial year turn out to be. Given that mainstream economists tend to debate and argue both sides with equal passion and vigour, it is the case that as the cliché goes, the “proof of the pudding is in the eating” and hence, the actual growth figures have to be watched.

Of course, there are other indicators to keep track of as well in the form of various Indices such as the PMI or the Purchasing Managers Index which tracks industrial activity as well as the rates of investment and the credit pickup as well as the Inflation figures. Having said that, one must also note that given the lack of communication about some of the economic indicators from the government is indeed worrying given that Demonetization has been billed as the “Biggest Monetary Experiment” in recent times in the entire world.

The point here is that any such “disruption” must be both communicated and implemented well and given some of the concerns expressed in this regard by many commentators, one must indeed look for “straws in the wind” to make sense of the economic impact of Demonetization on the country.

In recent months, all of us have heard extensively about the “war on cash”, the move to make India and other countries “**cashless economies**” and the general trend among policymakers worldwide to move the economies of the world to a digital and information enabled paradigm.

In this context, it is worth noting that the emphasis laid on digital payments and the digitization of commerce has implications for individuals, businesspersons, governments, and anyone and everyone who is a participant in the economy.

Thus, it is important to understand what digital payments and how they work and how they benefit the economy as well as the associated problems that accrue from using such modes of transactions and commercial dealings.

**Digital Payments are payments that are conducted over the internet and mobile channels** and hence, any payment that is sent online or through mobile computing and internet-enabled devices can be called such.

This means that for digital payments to take place, the sender of the payment must have a bank account, an online banking method, a device from which he or she can make the payment, and a medium of transmission meaning that either he or she should have signed up to a provider or an intermediary such as a bank or a service provider. We will come to the last part in a bit.

Apart from the sender having such means, the receiver of the payment too must have these ways to accept payments. This means that there must be a medium of transmission between the sender and the receiver wherein the former instead of paying the latter in cash and physical format pays in digital format meaning that the transaction happens over eCommerce or mCommerce modes of transmission.

Thus, what is important in any digital payment is the “via media” through which the payments happen which means that the intermediary and the modes of transmission are indeed the keys to making the transaction or the digital payment successful.

Coming to the intermediary, let us first think about what happens when we pay cash in the physical format. We first need to withdraw the cash from the bank or get it from someone who is likewise using cash obtained from the bank.

Thus, without banks and banking channels, there is no way we can access cash or transact for commercial dealings. Similarly, the digital payments need the intermediary as well and considering the fact that the payment still involves money though not in physical format and in digital format means that there must be infrastructure that connects the flow of digital cash across the payment value chain.

Remember that the payment value chain begins with the sender punching in the details in the Point of Sale devices at the merchant who in turn, uses the POS to connect to his or her bank account and thus, remits the money in such accounts. This means that the “digital backbone” is indeed important.

Now, while in developed countries, almost everyone has a bank account or has access to credit and debit cards in addition to most merchants having POS machines in their establishments means that the job of digital payments is infinitely easier than in developing countries where such infrastructure either does not exist or in basic form.

Thus, for countries such as India to move to the digital payment paradigm means that there is a massive need and demand to bring in all the players in the payment value chain into the digital backbone.

Further, when the Indian economy is predominantly cash-based one; this means that there is a massive effort to transition all the stakeholders in the payment value chain onto the digital paradigm. Considering that banking

channels and access to banking services are mostly in urban areas, this means that there are huge challenges in migrating all the people into the digital network.

Moreover, as explained earlier, most merchants lack POS devices, and this is where service providers such as PayTM and the newly launched BHIM App from the government can do the trick.

In addition, as most of the country has already been covered under the Aadhar cards, it is easier for the government to create a digital backbone using such biometric models. Thus, while the road to a digital economy is indeed challenging, there exist the basic ingredients to smoothen the journey and all it needs is vision and dedicated effort from all stakeholders including the willingness of the people to make the journey.

Having said that, one must also caution that while a digital economy sounds like Utopia because black money, criminal activities, and corruption are supposed to (there is no tangible evidence from developed countries that they actually do) reduce, there are also pitfalls here since digital models are susceptible to hacking, identity theft, and cybercrime which raise pertinent questions about data integrity and data protection.

Moreover, in countries where the law enforcers are yet to come to terms with the digital paradigm, one must be realistic in expectations about the benefits.

Finally, digital payments are an evolutionary step towards the “**business at the speed of thought**” model that pioneers such as Bill Gates have always predicted would be the next step in our move from physical to digital and hence, despite the challenges and doubts, one must indeed take steps to move towards it.

Having said that, there is also a case to be made for proceeding gradually instead of the “shock thera

### The Promise and Peril of the Digital Economy

Much is being said and written about the emerging digital economy with all its promise of techno-utopia and the perils of technology taking control of our lives. Indeed, while some experts have cautioned against surmising that technology would solve all the problems of humankind and lead us into a future of abundance, the mainstream view seems to be that technology can indeed liberate humanity.

While the case for pessimism might be overblown, there is also the fear that relying too much on the Internet and the digital technologies might lead us to a situation where we become slaves to technology rather than technology serving us. Thus, there needs to be a considered debate on how technology can benefit us as well as fail us.

First, let us consider the promise of the digital economy. The techno-utopians (or the cheerleaders pioneering new technologies and propelling inventions of new tools and apps) point to the “**business at the speed of thought**” paradigm where we can all harness technology to operate 24/7 and ensure that real value is created by all stakeholders and in the process, create wealth and prosperity for humankind. Indeed, one cannot deny that millions of people in Asia and especially in India and China have prospered due to the converging trends of technology and globalization and parallelly have also helped the West to reap the rewards of outsourcing and focusing on higher value-adding activities.

Second, the argument that technology is inherently democratizing can be seen from the way in which anyone with an internet connection or a Smartphone can login to the worldwide web irrespective of race, class, gender, and nationality and participate in what essentially is a “flat world” should give us a reason for embracing the digital economy. Indeed, the fact that more than a Billion people are on Facebook and nearly twice that number have Smartphones means that digital technologies have the potential to eliminate or if not reduce the gross inequalities and inequities in the modern world.

Having said that, it must also be said that **too much reliance on technology can lead us to a digital dystopia** as can be seen from the way in which Smartphone addiction and obsessive gaming via video and virtual reality apps are making an entire generation of youth slaves to technology and creating societal problems as well as personal problems. Indeed, the main concern of many parents in these times are about how to restrict their children’s access to digital tools.

Further, given the anonymity offered by the digital technologies, the potential for abuse and misuse is growing. As can be seen from cyber stalking and online bullying as well as the so-called “**dark web**” where everything from drugs to guns is traded, many point to the potential for a new kind of crime and breakdown.

Thus, to summarize, digital technologies are value-neutral, and they can be used for both good and bad. It is ultimately up to us to use them for promoting societal welfare instead of going down dark alleys.

What are the impacts of Demonetisation on Indian Economy?

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.

1. Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.
2. **Liquidity crunch (short term effect):** liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Current reports indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 mn Rs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.
3. **Welfare loss for the currency using population:** Most active segments of the population who constitute the 'base of the pyramid' uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class.

There will be a trickle up effect of the liquidity chaos to the higher income people with time.

**4. Consumption will be hit:** When liquidity shortage strikes, it is consumption that is going to be adversely affected first.

Consumption ↓ → Production ↓ → Employment ↓ → Growth ↓ → Tax revenue ↓

**5. Loss of Growth momentum–** India risks its position of being the fastest growing largest economy: reduced consumption, income, investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.

**6. Impact on bank deposits and interest rate:** Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply take place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization will produce big savings in the banking system in the medium term.



Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

**7. Impact on black money:** Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depend upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. such a nationwide awareness and urge will encourage government to come out with even strong measures.

**8. Impact on counterfeit currency:** the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the unmeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

### How demonetisation impacted the Indian economy

**Mumbai:** Reserve Bank of India's (RBI's) confirmation that most [demonetised notes were returned](#) to the central bank finally confirms the long-held suspicion that the unilateral executive decision to ban specified notes not only failed in its stated objective of flushing out hidden wealth but also ended up causing some damage to the economy. The [RBI annual report for 2017-18](#), released on Wednesday, shows that almost all the banned banknotes, or 99.3% of the notes withdrawn, were returned to the central bank.

The government had on 8 November 2016 abruptly withdrawn currency notes of ₹ 500 and ₹ 1000 denominations without providing for adequate replenishment. All economic agents were given a limited time window to deposit their existing notes with banks and replace those with new notes. This created a huge pressure on the banking system, marked by lengthening queues outside banks for about two months.

The sudden decision had a two-fold impact on the Indian economy: an aggregate demand shock by reducing the supply of money, and, an aggregate supply shock by constraining availability of cash as a critical input for specified economic activities, such as purchase of inputs in the agriculture sector. Growth slowed down to a four-year low of 6.7%.

Kavita Chacko, senior economist with Care ratings agency, says: "Demonetisation led to disruptions in economic and industrial activity. [The lower domestic GDP growth in the past two years](#) is largely on account of demonetisation and GST implementation led turbulence."

At the same time, RBI data indicates that the desired effect of a substantial reduction in frequency of cash transactions remains largely unfulfilled.

Immediately after demonetisation (November-December 2016), sales of consumer durables and appliances slipped by 40%. The effect of demonetisation was more pronounced in Tier-II towns and beyond, generally referred to as up-country markets. The impact on the durables and appliances segment was palpable as this market still operates 80% on cash.

Schemes encouraging digital payments, special discount offers and promotions did not ease demonetisation's impact on consumer durables market.

That year, companies in the sector were expecting a 30% growth on improved household income, backed by a good monsoon and the 7th Pay Commission. But that did not materialize.

The after-effects have also taken some time to feed through the system. In its latest Article IV Consultation report on India, released in August 2018, the International Monetary Fund (IMF) has said: "The impact on growth appears to have been more severe and longer-lasting than anticipated at the time of the 2017 Article IV Consultation with a disproportionate impact on the informal sector."

The negative impact of demonetisation was felt across the all segments of economy, especially agriculture and industry. The worst impacted were segments that relied on high-volume cash transaction, such as organized and unorganized retail. The impact was felt at both the firm level as well as at the consumer level. The IMF report quoted above also states that the disruption caused by cash shortages dampened consumer and business sentiments, leading to a decline in high-frequency consumption and production indicators, such as sales of two-wheelers and cement output, respectively.

**Conclusion:** Praveen Khandelwal, secretary general of the Confederation of All India Traders (CAIT), said: "In the first four months after demonetisation, business was down by as much as 50% for small traders. It took about six months for the situation, currency flow and business to normalize."

Even in agriculture, demonetisation aggravated the sector's existing stress points by creating new choke points within the supply-chain. Cash is a critical input in the agricultural production process and its unexpected shortage had an impact at many levels, including a slowdown in employment of labour and a dip in overall farm incomes. The Economic Survey for 2016-17, authored under the stewardship of former chief economic adviser Arvind Subramanian and released in January

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