

Demonetization and Its Impact on the Indian Economy

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Abstract

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 during the liquidity side. Its effect will be a telling one because nearly 86 percent of currency value in circulation was withdrawn without replacing bulk of it. Demonetization is the most important and necessary when there is a change of national currency. The old unit of currency must be removed and substituted with a new currency unit. The currency was demonetized first time in 1946 and second time in 1978. In November 2016, The Indian government has taken a bold step to demonetize the 500 and 1000 Rs (fully ban).

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.

Introduction:

Demonetization is the most important and necessary when there is a change of national currency. The old unit of currency replaced with new currency. Demonetization is the process where government declares the currently running currency notes illegal to be tender after the declaration is made. There are both pro and cons of demonetization in the Indian economy. The reasons for demonetization are to control fake notes that could be contributing to violence, and to challenge or remove the "black economy".

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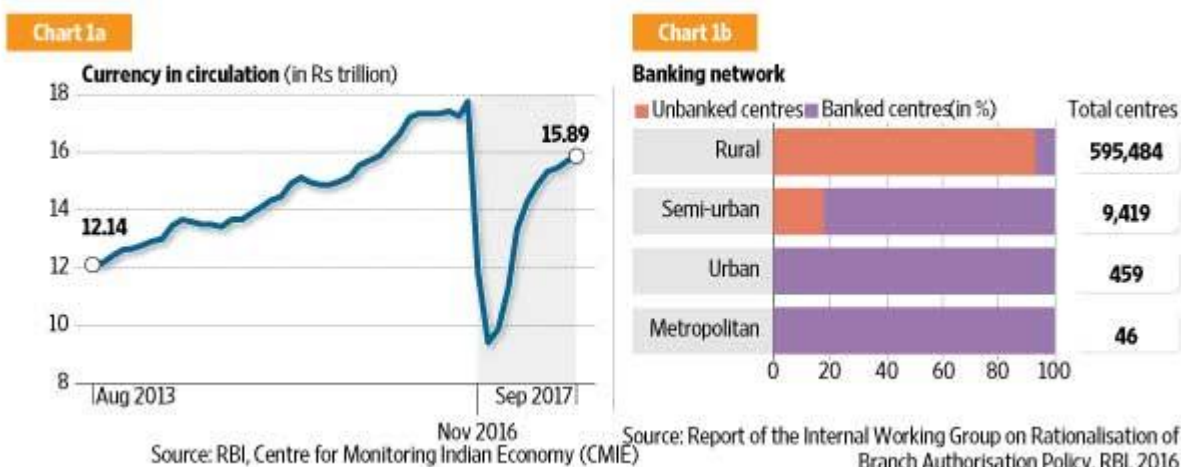
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Example: The Coinage Act of 1873 demonetized silver in favor of adopting the gold standard as the legal tender of the United States. The withdrawal of silver from the economy resulted in a contraction of the money supply, which subsequently led to a 5-year economic depression in the country. In response to the dire situation and pressure from silver miners and farmers, the Bland-Allison Act remonetized silver as legal tender in 1878.

The main objective of this paper is to study the impact of demonetization on 8th Nov. 2016 by the present government on Indian economy and system.

The costs were scarred by currencies, however, quite severe, at least in the short term, upsetting ordinary life.

The hardest-hit were those in rural areas, where access to banking and the internet are quite low. Reserve Bank of India (RBI) report on branch authorization policy classified 93 percent of rural centres in the country as unbanked, with the population dependent on roving banking correspondents and on remote urban or semi-urban branches. Access to the internet is equally irregular, with only 3 percent of households in underdeveloped rural areas reporting contact to internet in a 2016 consumer economic survey.

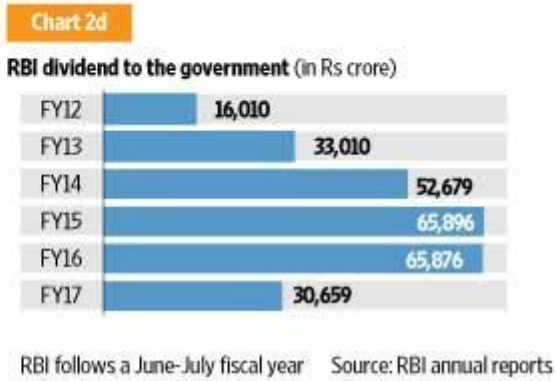
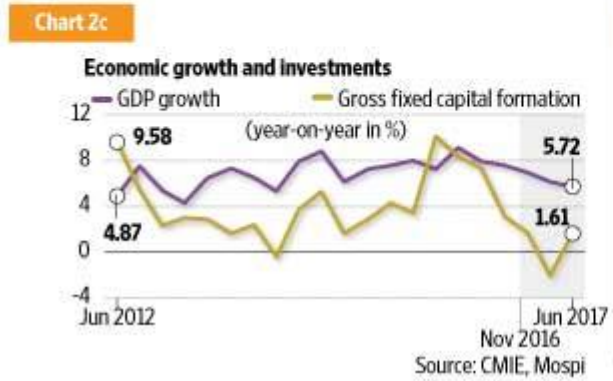
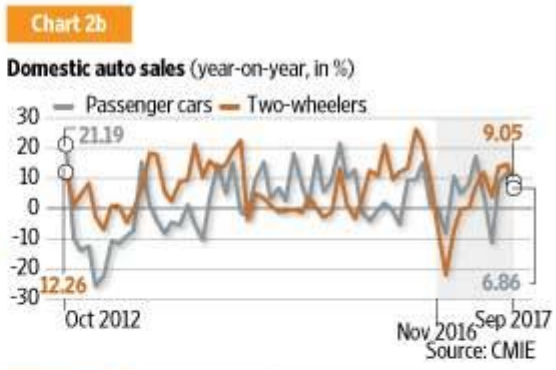
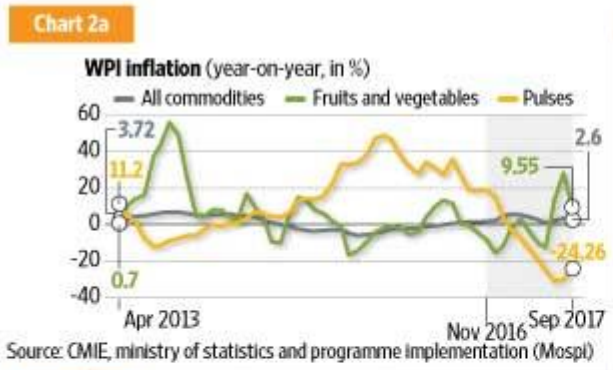


Economic costs

The rural and informal economy suffered unreasonably because most transactions are cash-based. The liquidity compress led to a pile-up at wholesale markets, leading to a sharp decline in the Wholesale Price Index (WPI) of perishables such as fruits and vegetables in the urgent outcome of demonetization. By turning farm markets into buyers markets, demonetization may have also contributed to the decline in prices of pulses. Rural consumer sentiment too took a hit, with domestic sales of two-wheelers plunging sharply. Car sales also declined but the decline was less severe than in the case of two-wheelers.

The slowdown in the economy, which started before demonetization, also seems to have been exacerbated by demonetization. New project announcements declined sharply in the come around of demonetization, a Centre for Monitoring Indian Economy (CMIE) analysis showed, hurting the capital expenditure (capex) cycle.

Some economists predicted to opposite, the payment from RBI to the government was lower because of demonetization. RBI’s domestic earnings declined as it had to pay interest of Rs17,426 crore after it mopped up excess liquidity in the banking system following demonetization. The previous year, the central bank had earned interest of Rs 506 crore in its liquidity management operations. RBI’s printing costs also went up because of the move.

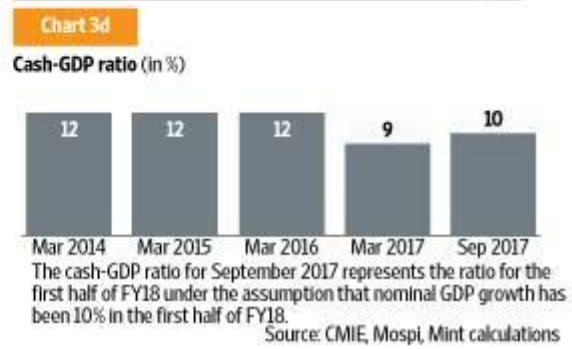
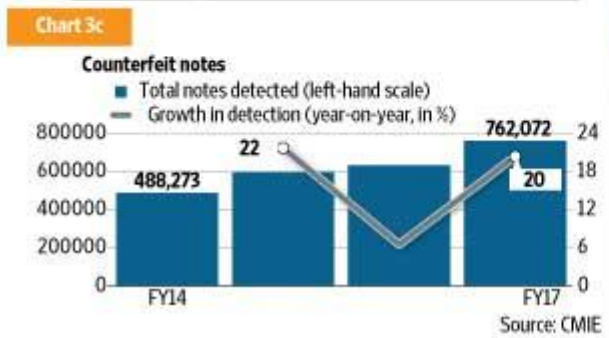
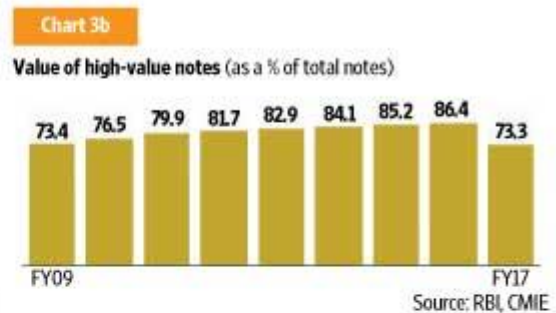
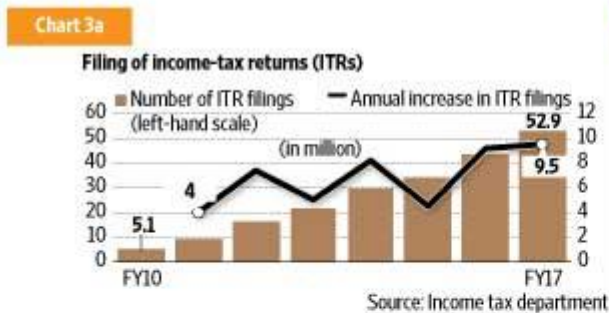


Uncertain benefits

The one big promise of demonetization was a rapid expansion in the tax base but the actual results have been quite diffident. According to the finance ministry’s estimates published in the latest Economic Survey, the tax base expansion attributable to demonetization was Rs 10,600 crore, lower than what RBI spent on interest expenses, and equal to only 0.1 percent of India’s gross domestic product (GDP). The full effect on tax collections “will materialize gradually” as reported income of new taxpayers grows, said the survey.

Another stated aim of demonetization was to notice and reduce fake notes. The growth in detected fake notes after demonetization has not been unusually large, shows RBI data, even as counterfeits of the freshly issued notes have already emerged in the system.

Demonetization provided a boost to non-cash payments in the short term but that effect may be diminishing, with the cash-to-GDP ratio back to double-digits. There seems to have been some impact on the stock of black money (rather than the flow), given that the construction sector has been hit hard. But this may also have led to large-scale job losses. The proportion of high-value notes (Rs 500 and above) often viewed as conduits of black money has also been rising as new notes have entered the system. At the end of fiscal year 2017 (FY17), the proportion of high-value notes stood at 74 percent, considerably lower than that in FY16. But this figure may rise significantly by the end of FY18.



Impacts

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

Advantage of Demonetization:

There are some benefits of demonetization has given, which describes the how many people are getting the benefit after banning the currency notes.

Controlling inflation: When inflation really gets out of hand, one explanation can be to totally change the currency and to start afresh. With increase in cash available for government expenditure and reduced state borrowing, inflation will fall for the short term and thus prices of necessary produce will also fall.

Reducing criminal activities: Money used to fund criminal activities such as terrorism and drug trafficking will be rendered useless. Hence, the government can use demonetization policy to copy money that has been made from illegal activities such as drug trafficking and robbery since such individuals are faced with only two options: either deposit the money with the bank or be left with currency that has no value.

The move to digital exchange: Some commentators dispute that in the future, we will all be using digital exchange, such as bitcoins. If this is true, then one advantage of demonetization is that it will help to propel us into the future

Improved deposits and savings in financial institutions: Parallel economies make it difficult for banks and other financial institutions to move up deposits. Demonetization reduces the size of the parallel economy and boosts savings and deposits. Demonetization can also be used to get false money out of circulation in a country's economy since such moneys cannot be deposited in banks and other financial institutions.

Large sum of unaccounted cash: The biggest advantage of demonetization is that it helps the government to track people who are having large sums of unaccounted cash or cash on which no income tax has been paid because many people who earn black money keep that money as cash in their houses or in some secret place which is very difficult to find and when demonetization happens all that cash is of no value and such people have two options one is to deposit the money in bank accounts and pay taxes on such amount and second option is to let the value of that cash reduced to zero.

Introducing new bank note designs: Demonetization is also a good opportunity to redesign bank notes. This might involve making them more durable, for example. Several countries have switched from paper notes (which tore or got worn very quickly) to more durable plastic notes, which have made their monetary system more secure in several ways.

Paying tax honestly: Demonetization has control over on those people, who are not paying of tax proper. This policy forced to people to pay income tax returns. Those people are trouncing their income now required to come forward to declare their income and pay tax on the same.

Deposit of proper tax: Under demonetization, those people even though deposits up to Rs. 2.5 lacs will not come under income tax analysis, individuals are required to submit PAN for any deposit of above Rs. 50,000 in case. It will help the income tax department to follow persons with high denominations money.

Simple to explore income tax: The ban on high-value money will also control the menace of money laundering. Now such activity can easily be tracked and income tax department can take such people who are in the business of money laundering.

Growth in a country's GDP: Due to low lending rates, improved revenue collection, and growth in savings and deposits, a country that has demonetized is likely to see an improvement in the growth of its GDP. The move has generated interest among those people who had opened Jan Dhan accounts under the Prime Minister's Jan Dhan Yojana. They can now deposit their cash under this scheme, and this money can use for the developmental activity of the country.

Catch black money: Demonetization is very essential for the government to follow the black money from India. Those persons, who have unaccounted cash, are now required to show income and submit PAN card for any legal monetary transactions. The government can get income tax return for the income on which tax has not paid.

Disadvantages of demonetization

Demonetization is not all beneficial and even proponents of demonetization acknowledge that it does have its disadvantages. A few of them are outlined below.

Slowdown in economic growth: The country registered a growth rate of 6.1 per cent in the March quarter. This growth rate is below the GDP growth of 8% in 2015-16, 7.5 per cent in the previous year and the expected growth of 7.1 per cent the current year. Demonetization seems to be the sole cause for the slowing down e GDP growth rate. Some observers also believe that the reason for the decline growth cloud be that as a proportion of GDP, investment has trended downwards for same time, with very few investors and companies following up with actual money after having promised to invest in India. Investment is believed to have shrunk in absolute terms by 30 per cent in 2016-17.

Problems with paying bills: If someone has sent some bank notes in the post in order to pay a bill, or if there is any important delay in processing a bill payment, and demonetization hits in the mean time, the money set aside to pay the bill can become invalid. This is more common that you might think in highly bureaucratic systems.

Inconvenience and annoyance to the public: Sometimes, demonetization can be very inconvenient. For example, sometimes the government will remove certain denominations of bank notes from circulation but keep others. It can be annoying when smaller coins are removed from circulation and you do not have enough change. Further, queuing up in banks to deposit money or exchange currency can be inconveniencing.

Cash crisis: Due to demonetization, availability of cash in the market will be very less because every currency should be deposited in the respective bank and till the time bank reissue the new currency against old, so ultimately the new currency will be very less in the market. This will affect the major industries in order to run efficiently without enough cash.

Re-calibration of ATM's: Re-calibration of ATM's is not done at rapid it should be done, which lead to long line and take more time to get our money back. Due to very slow system many people experience serious problem. Everyone has their own job and problem so they have deal with it anyhow.

Short term financial crisis for poor people: If people adopt a new currency and this currency is not a successful one, then it can cause a financial crisis for everyone who is involved. Even a small change in the value of everyday items, or even a small amount of confusion about whether a currency is valid can mean a lot of hardship. As such, demonetization can increase and exacerbate inequalities within society, at-least in the short term

Job losses

There was a loss of jobs due to demonetization, particularly in the unorganised and informal sector and in small enterprises. Labour union jobs were not working.

Stock market decline: as a combined effect of demonetization and US presidential election, the stock market indices dropped to an around six-month low in the week following the announcement. The day after the demonetization announcement, BSE SENSEX crashed nearly 1,689 points and NIFTY 50 plunged by over 541 points. By the end of the intraday trading session on 15 November 2016, the BSE SENSEX index was lower by 565 points and the NIFTY 50 index was below 8100 intraday.

Conclusion

There are both positive and negative impacts of demonetization on different sectors. Demonetization would have a bad impact on small traders, real estate, transport sector, consumer durable goods industry and agriculture. The demand of gold and luxury items was increased in the beginning period of demonetization. There is no doubt that demonetization is a great move for a better future of India and its economy. In the short term, GDP will be down for at least a 1-2 quarters before recovering. A lot of black money will be converted to white and be deposited into the banks which will in turn help in the NPA problem that banks are facing. In the longer term, reducing of black money economy in the future should bring more people in the tax net and hence lower taxes as well as interest rates which will bode well for the overall economy. The overall retail demand for goods and services have taken a hit owing to demonetization.

Demonetization method is like a two faces of a currency because one side it will benefit the nation and other side it's going to make some provisional and long term problems, Most of the business in India has money deal with less than 2 per cent business deals taking place electronically. Demonetization can be a chance for a fresh new start, or it can be something that causes unnecessary confusion for a country. There are only advantages of demonetization in the long term. The government is taking all the necessary steps and actions to meet the currency demand and make sure the smooth flow of new money. The real picture of India will positively change and Indian economy will appear as one of the strongest economy in the world in medium to long time only as forecasted by our PM. So, the Indian citizens will have to wait more for the good days and need to strongly support the PM great move of demonetization.

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