

IMPACT OF DEMONETIZATION ON INDIAN ECONOMY

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Abstract:

India has come a long way in modernizing its economy through fiscal and monetary policy along with banking sector reforms in order to improve living standards for a huge fragment of its population. India's economy has been one of the largest contributors to global growth over the last decade, accounting for about 10% of the world's increase in economic activity since 2005, while GDP per capita in purchasing power parity terms is today three times as high as in 2000. In the light of the importance of GDP, it is important to look at the recent changes in the money and financial sector. Demonetization has put several changes in which money is used and has a profound effect on the economy. This paper delves need of demonetization and the way ahead for common man and government. The article is also an attempt to discuss and predict impact of demonetization on parallel economy, money supply, effect on demand and price, effect on diverse economic entities, banks, GDP and effect on e-transactions and alternative modes of payments. It is too early to conclude the comprehensive impact of demonetization but overall economy is expected to benefit from a decrease in unaccounted cash transactions and an elimination of counterfeit currency notes. The present government brought a pertinent monetary reform i.e. demonetization which can be viewed as milestone for the development of the Indian economy and its impact is expected to be positive for overall growth of the country.

Keyword: Denomination, Digital transaction, Parallel economy, Credit rating, Plastic money.

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1. Demonetization in Indian Economy

Economic and financial reforms have proved their significance on various walks of life. In recent past, banking and financial markets of India have experienced a profound change. The Government of India declared notification no. 2652 dated November 8, 2016 and withdrew the legal tender status of Rs.500 and Rs.1,000 denominations of banknotes of the Mahatma Gandhi series issued by the Reserve Bank of India till November 8, 2016. After the notification, the Prime Minister while addressing to the nation announced demonetization of current series of Rs.500 and Rs.1000 notes from mid-night of November 8, 2016. This means that these notes will not be acceptable for future money transaction. As per the Weekly Statistical Supplement (WSS, RBI, 2016), the notes in circulation as on November 4, 2016 stood at Rs.17, 74,187/- crore. Roughly 86% of this value, i.e., Rs.15, 25,800/- crore comprised notes of denominations Rs.500/- and Rs.1000/-, which have been demonetized. It is difficult to find out what percentage of this value won't be tendered for exchange for new notes and thus will be written off from the system.

2. History of Demonetization in the World

In fact, In India alone Rs.1,000 and Rs.10,000 currency notes were demonetized in 1946, re-introduced in 1954 and then demonetized again in 1978. Again in 2014, Reserve Bank of India announced that it would withdraw all banknotes printed before 2005 so demonetization is not a new crunch to Indian economy. On the flipside, initiation of demonetization was a big disaster to country like Soviet Union in the year 1991, Ghana in 1982, Myanmar in 1987, Nigeria in 1984, North Korea in 2010. In recent past, Venezuelan also demonetized its currency with the same thought of end of black money and corruption in December 2016 but after strong agitation the bill was taken back within 72 hours and so, demonetization came to an end.

On the other side, USA has not demonetized its currency ever. Their tax compliance system is robust and being a developed country people are comparatively well off to not to think about stealing taxes always (www.quora.com).

3. Need of Demonetization in India

The present Government had promised to combat the menace of black money, pledging to crack down of parallel economy in India which has seen tax to GDP ratio being abnormally low. While

the Indian economy grew by 30% during 2011 and 2016, the circulation of money in the economy increased by 40%. However circulation of Rs 500 notes increased by 76% and of Rs.1000 notes by an astounding 109% which means the demand for high denomination notes grew at a faster rate, causing suspicion that much of this was being hoarded as black money. Demonetization is a move which had been suggested by several housing. The move will also check fake notes flows, a bane which has been dogging the Indian financial markets for years. The Reserve Bank of India said while the Indian currency's security features have not been breached. The fake notes being pushed by some spy agencies were similar to legal tender and were causing excessive flow of notes in the market. Currently, there are 16.5 billion legal Rs.500 notes and 6.7 billion Rs.1000 notes. But estimates point to larger numbers of high denomination notes circulating in the market that clearly pointing to fake currency being pushed into India in large numbers (WSS, RBI, 2016).

The decision of the government to demonetize currency notes of Rs 500 and Rs 1000 will also drive India towards a cashless economy. This is a kind of resolution that will change the system the people spend and keep their money. The Government has been trying to push the country's cash dependent economy towards cashless transactions. The Government has made outline papers of offering and incentives, which may be considered for those opting for e-transaction and plastic money. However, the move has remained nascent at best till now.

High denomination banknotes account for 86% of the 1, 64,000 crore rupees of currency in circulation. With inflation raising prices, most people preferred higher denomination notes. However, by now taking steps to discourage high value notes, the government could push more people to opt for e-commerce and plastic money. Analysts believe the move to scrap high denomination notes will now force people to use their accounts and financial technology for transactions (Charles Roth, 2016). Estimates say the mobile commerce market in India will grow from a current \$2 billion to \$19 billion by 2019. Officials point out that studies by Mckinsey suggest large-scale adoption of digital finance by emerging economies could boost their GDP by up to 6%. The study says India could see a boost of \$700 billion, an 11.80% increase by 2025. The idea is to move society towards electronic transactions and away from

cash, as this helps to monitor money flow and check black money in economy (Choudhary, R. J, 2016).

4. The Way Ahead for the Common Man

The old Rs.500 and Rs.1000 notes are being exchanged at post office and banks till December 30 with any valid ID such. Those who are unable to exchange their notes by December 30 will be allowed to declare them with the Reserve Bank of India till March 31, 2016. However, with valid source, there will be no limits on the amount of old money that can be deposited in a bank account. Tourists and Indians returning from abroad can change these notes at airport up to the value of Rs.5000.

A new series of Rs.500 and Rs.2000 notes are initially accessible with all commercial banks and post offices of India. All who want to exchange old notes will have to produce valid ID cards and the exchange would be recorded. Moreover, all cashless transaction such as cheques, plastics card and demand drafts will continue as usual.

The real estate sector in India has involved a momentous level of informal funding in the form of cash transactions. As the demonetization measures are expected to result in decreased informal funding sources, the real estate sector is expected to be adversely affected. Cash transactions are most common in secondary sales, and resale transactions are expected to decline. While these measures are expected to in the long term promote transparent pricing in the real estate sector, decreased liquidity resulting from lower informal funding sources is expected to significantly weaken the demand for resale properties (Chatterjee & Anandee, 2016).

5. The Way Ahead for the Government

The present Government pursues to use more and more e-transaction and to give consumers easy credit term and higher credit flows. Tax collections in medium term will increase and bank deposits are also expected to rise. The Government will monitor all cash deposit of over Rs 2.5 lakh. If a huge amount of cash is deposited which does not match with income declared, would be treated as the case of tax evasion and the tax amount plus a penalty of 200% of the tax payable would be levied as per the sections 270(A) of the income tax Act. Section 270(A) of the

Income tax act provides that in case of under-reporting of income flowing from deliberate misreporting, the penalty which may be imposed can be 200% of the amount under-reported.

Nevertheless, cash deposits of up to Rs.2.5 lakh will not be examined and the people who make such deposits will not be hassled. A common man need not worry about small amount of deposits and simultaneously there will be no harassment by Income Tax department for such small deposits made.

Furthermore, all denominations of currency notes, beginning with Rs 1000 notes will be reintroduced with a new color combination, design and improved security features in the due course.

6. Common Impact of Demonetization

Expected outcomes of demonetization on various economic variables and entities will be underline in following points:

6.1 Effect on Parallel Economy

New currency of Rs. 500 and 2000 rupee notes is anticipated

- a. To remove black money from the economy because the owners won't be in a position to deposit the black money in the banks,
- b. To transitory stall the circulation of large volume of fake currency and
- c. To curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

6.2 Effect on Money Supply

The Government is trying its best to circulate new 500 and 2000 rupees notes in the market but not in position to fulfill the demand of market. Hence, 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 and hence money supply will diminish for short period of time. However, progressively as the new notes get circulated in the market and the disparity gets corrected, money supply will pick up in due course.

6.3 Effect on Demand

The overall demand is expected to be curbed to some extent. The demand in following areas is to be impacted particularly:

- a. Consumer goods
- b. Gold and luxury goods
- c. Automobiles (only in short run)
- d. Tourism

All these mentioned sectors are likely to face certain moderation in demand from the consumer side, owing to the significant amount of cash transactions involved in these sectors.

6.4 Effect on Prices

Price level is also expected to be lesser due to moderation from demand side. This demand driven fall in prices can be understood as follows:

- a. Consumer goods: Prices are anticipated to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
- b. Real Estate and Property: Prices in this sector are mostly expected to fall, especially for sales of properties where major part of the operation is cash based, rather than based on banks transfer or cheque transactions. In the medium and long term, the prices in this sector will get back as developers rebalance their prices.

6.5 Effect on Diverse Economic Entities

With cash transaction lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- a. Agriculture and related sector
- b. Small traders
- c. SME
- d. Services Sector
- e. Households
- f. Retail outlets

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 due to demonetization process and the introduction of new notes in circulation.

6.6 Effect on Gross Domestic Product

The GDP formation could be impacted by this measure, with reduction in the consumption demand. However, with the recent rise in festival demand is expected to offset this fall in overall impact. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and re-enter the stream once the cash situation becomes normal.

6.7 Effect on Banks

As directed by the Government, the 500 and 1000 rupee notes which now cease to be legal tender are to be deposited or exchanged in banks. This will automatically lead to more amounts being deposited in Current Account and Saving Account (CASA) of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. Further deposit of money would be subject to declaration of source of income and service can be availed till 31 March, 2017.

6.8 Effect on e-Transactions and Alternative Modes of Payment

With cash transactions facing a reduction, alternative forms of payment will see a flow in demand. Digital transaction systems, E wallets and apps (BHIM), UPI, online transactions using e-banking, usage of Plastic money (Debit and Credit Cards) etc. will definitely see substantial increase in demand. This should eventually lead to strengthening of economic environment (CARE, 2016).

While rating agency Fitch Rating has projected a decrease in India's GDP growth by approximately 50 basis points, other projection peg India's GDP growth rate for fiscal years ending March 31, 2018 and 2019 lower by approximately 30 basis points. These forecasts indicate that India's credit rating for the next two years remains improbable (Chatterjee Biswajit & Banerji Anandee, 2016).

7. Conclusion

The comprehensive long term impact of demonetization measures cannot be fully ascertained at this stage, the overall economy is expected to benefit from a decrease in unaccounted cash transactions and an elimination of counterfeit currency notes. Demonetization is also intended to combat untaxed black money, rampant corruption, encourage cashless transactions, terrorism and to bring more accountability and transparency in the informal sector of the economy. An increase in transparency is also likely to improve attractiveness for foreign investors, while higher bank deposits and formalizing large hitherto unaccounted for income streams is expected to improve the fiscal deficit of India. Monetary reform demonetization can be treated as milestone for the development of the Indian economy and their impact is expected to be positive for overall growth of the country.

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