

Demonetisation's Effect on Indian Economy: A Critical Analysis

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ABSTRACT

Demonetization is the act of taking away a currency unit of its legal tender status. It was the most critical action taken to get black money targeted. India's government demonetized the currency as an tool to counter corruption and black money, which are Indian economy's main problems. The change was an attempt to deal with the danger of illegal money, corruption, terror financing and fake currency. Black money and fake currencies are contributing to more extremism, violence and corruption. A total of Rs. 16.42 lakh crore worth of currency was in circulation as of the 2015-2016 statistics shown by Reserve Bank of India's rulebook as of the end of April 2016. For this, Rs. 14,18 lakh crore was in Rs. 500 and Rs 1,000 denomination notes represented about 2300 crore notes, which accounted for about 26 percent of the total circulating notes.

The paper attempts to explain the meaning and reasons of demonetisation, the effect of demonetisation on a sectoral level. This paper also offers insight into the demonetisation's positive and negative effects on the Indian economy. The paper is descriptive in nature so that all the necessary and applicable data from different journals, magazines for published papers and websites were taken up. Where required, books were also referred for theoretical knowledge on the subject. The effect of demonetization in terms of Indian economy is very huge and significant. The paper concludes that the impact of demonetisation can be assumed to be favorable overall on the economy.

Keywords: Black Money, Demonetisation, GDP, Indian Economy, RBI

Introduction

Demonetisation is a situation where the country's Central Bank (Reserve Bank in India) withdraws as an official mode of payment the old currency notes of some denomination. Demonetization is the act of taking away a currency unit of its legal tender status. It is the mechanism whereby the existing notes used in the currency are cancelled for further use and new notes are used instead. In other words, demonetization means removal from circulation of a specific type of currency. The Indian Government announced on November 2016 that it would demonetize the five hundred and one thousand rupee notes, the two highest denomination notes. These ceased to be legal tender as of midnight November 8, 2016. Deposit of these notes with Commercial Banks will end on December 30, 2016. Additionally, currency notes should be deposited with RBI before 31 Mar 2017. The RBI has issued Two thousand rupee notes and new Five Hundred Rupees notes which will be put into circulation from November 10th, 2016. Notes of one hundred, fifty, twenty, seven, five, two, and one rupee coins will remain the same, and will remain unaffected by this decision. The central government's goal was to eliminate black money, fake currency, fight for tax evasion and fund terrorists. It also included people to be more digitally advanced and promoting a cashless economy.

Demonetization is the most significant measure taken in counteracting tax evasion. We must note that the demonetisation is one of a series of measures taken by the government to target black money. First, for bringing back unaccounted money invested in offshore accounts, it had given a three-month window but the response was not great. The next target was black money within India.

The phase of demonetization is one of the economic events of our time that has an impact not just on the economic but also on the social and political aspects. Every Indian citizen is sensing its effect. Demonetization has an effect on the economy through the liquidity side. Its impact will be telling because almost 86 per cent of circulating currency value has been removed without replacing any of it. According to the Annual Report for April 2015 to March 2016 of the RBI (Reserve Bank of India), the value of the currency notes at the end of March 2016 was 16.42 trillion Indian rupees. The currency notes of 500 rupees and 1,000 rupees made up 86.4 per cent of the amount. The government eliminated 86.4 per cent of the currency by value in circulation in one strike. In terms of value, these two denominations 'currency notes represented 24.4 per cent of a total of 90.27 billion pieces.

Review of Literature

The theoretical relationship between money supply and economic production goes back to money theory of quantities where a decline in money supply could be equalized to decrease production at fixed speed. It has been recorded that the share of 'cash with the public' in total money supply has substantially reduced, and deposits have risen to new levels. Bank lending to the commercial sector has seen a post-demonetisation decline. The sum of circulating currency edged higher in January 2017 although it stayed below its point of October 2016 by 45 per cent. The effect on Gross Value Added during demonetisation was felt mainly in real estate and construction, but was somehow offset by a parallel increase in agriculture, manufacturing, electricity and mining. Shanbhogue Girish, Kumar, A. Prashanth, Bhat, Swathi and Shettigar, Chethan (2016) defined currency ban as a move to stop counterfeit bank notes were allegedly used for terror financing, as well as a surgical strike to black money and corruption in the country. Demonetisation leads to cash shortages in the country which proves detrimental to a number of small business, agriculture and transportation. The shortage of cash led to chaos and most people faced problems to exchange their banknotes due to long queues outside banks and ATMs across the country. This demonetisation step was proved to be the biggest attack on black money and corruption in the history of Indian Economy and a movement toward digitalisation. It also encourages digital payments. They concluded that Demonetization is advantageous in short, medium and long-term.

'Demonetization was a despotic act' said Amartya Sen (Nobel prize winner Indian Economist) "The demonetization of currency was a despotic act as the government broke the promise of compensation that comes with a promissory note." "Demonetization goes against trust. It undermines the trust of entire economy," "Only an authoritarian government can calmly cause such misery to the people - with millions of innocent people being deprived of their money and being subjected to suffering, inconvenience and indignity in trying to get their own money back." (Sen, A., 2016). Muthulakshmi, E. Kamatchi (2017) in her paper entitled "Impacts of Demonetisation on Indian Economy-Issues & Challenges" states that when the money is withdrawn from the economy, the country will not be

benefited in short term. On the other hand, if the money paves its way into the economy it would have a positive and meaningful impact. She also states that the demonetisation move, on one hand, was a serious attack on black money, corruption, hawala transaction, counterfeit currency and terror financing. On the other hand, it had a negative impact on various sectors like commodities and real estate.

A Brief History of Demonetization in India

India had already been through the demonetization situation twice before November 8, 2016. The first was in January 1946 when Rs1,000, Rs5,000, and Rs10,000 notes were taken out of circulation, a year and a half before the country achieved independence from the British. The Rs10,000 notes was the largest currency denomination ever issued by India's Reserve Bank which was first launched in 1938. In 1954 all three notes were restored. The Wanchoo Committee, a direct tax inquiry committee formed by the government in the early 70s, suggested demonetization as a step to undermine and combat the spread of black money. However, black money hoarders were fuelled by the public existence of the proposal to move quickly and rid themselves of high denominations before the government could clamp them down, Mint reported. Then, in 1977, the coalition government of the Janata Party came to power. A year into the term of government, party leader Morarji Desai was more optimistic about cracking down on black money and counterfeits. The High Denomination Bank Notes (Demonetisation) Act, initiated on Jan. 16, 1978 by the ruling party, for the second time declared the Rs 1,000, Rs 5,000 and Rs 10,000 notes unconstitutional.

Reasons behind Demonetization:

One of the reasons that led the government to demonetize notes of Rs. 500 and Rs. 1000 was that their circulation was not in line with economic growth. According to the Ministry of Finance, the circulation of all notes grew by 40% during the periods 2011-2016 but the circulation of Rs. 500 and Rs. 1000 notes increased by 76% and 109% respectively. Comparatively speaking, the economy only expanded by 30 per cent, well below the circulation of money.

It was also done to act against the rising amount of corruption in India, and also to combat tax evasion attacks. It's done because there are many individuals in the world who keep the cash with them to stop paying taxes. The numerous factors, such as curbing the economy of black money, which will have a profound effect on the country's parallel economy, lowering the country's cash circulation, which is directly related to corruption, removing the fake currency used by terrorist groups to fund terrorism in India, increase GDP and hit Maoists.

Constitutional Validity of Demonetization in India

A PIL was heard in the court of the Chief Justice challenging the Government's decision on demonetization. The concerns posed against the exercise are that it violates the right to equality (Article 14), the right to freedom of expression, commerce, etc. (Article 19), the right to life security (Article 19) and the right to property (Article 300-A) of the Constitution. The court had not issued a

stay on the notification from the government. The Court also finds it should not intervene with the government's economic policies. Act Section 26(2) allows the govt. to declare 'any series' of notes as illegal. There has been a narrow definition that the term 'any' can not be translated as 'all' and thus can not be removed from the whole denomination. The General Clauses Act and multiple decisions of the Court, however, have affirmed that 'any' can also mean 'all' unless expressly excluded by the Act. Section 26(2) of the RBI Act also grants Union ancillary powers to allow it to smoothly carry out the demonetization. It was also held that restricting the use of property in itself does not contravene the right to property itself.

Impact of Demonetization on Indian Economy

India's government demonetized the currency as an tool to counter corruption and black money, which are Indian economy's main problems. This demonetisation has proven to be a turning point for the economy by cleaning up the black money which, in turn, has given the treasury more borrowing, strengthened inflation outlook and increased India's GDP. Investment opportunities were also revived and provided infrastructure and manufacturing sector a boost. The following are the positive as well as the negative economic effects:

Positive Impact of Demonetization:

- **Impact on Black Money:** Prime Minister Narendra Modi managed to scrape black money on a single stroke. Rs 3 lakh crore is calculated as black money out of the total currency which is Rs 17 lakh crore. Black-money operators operate a parallel economy that weakens the economy's foundations. Modi's decision to demonize resulted in the collection of massive deposits with the bank, all uncounted money was either deposited with the heavy penalty into the banks or completely destroyed.
- **Impact on Various Taxes:** The 2016 Income Disclosure Scheme was fairly successful. It gathered Rs 65,250 crore, seven times more than one of those schemes had mopped up in 1997. The government also passed legislation to curb benami transactions and revised India's Double Taxation Avoidance Agreements with Mauritius and Cyprus. We can't see the demonetisation going in solitary confinement – this is part of the broader plan to expose black money. The number of returns filed as at August 5, 2017 has reported a rise of 24.7 percent compared to a rate of growth of 9.9 percent in the previous year. The total number of returns (electronic plus paper) filed during the entire 2016-17 fiscal year was 5.43 crore, which is 17.3 per cent higher than the returns filed during the 2015-16 fiscal year. For 2016-17, the tax base was raised to 1,26 crore new taxpayers (return filers plus non-filers making tax payments) (until June 30, 2017). In the 19 per cent rise in direct tax receipts, the impact of demonetisation is also clearly evident. Advance tax collection under gross income tax showed an increase of approximately 41.79 percent over the same period in 2016-2017; personal income tax collection showed an increase of 34.25 percent. According to the income tax department, the number of e>Returns filed by individual taxpayers until August 5 rose from 2,22 crore filed during the same time last year to 2,79 crore, an increase of approximately 57 lakh returns or 25.3 per cent. Tax enforcement will increase further.

- **Impact on Banking System:** Truly, it did not confiscate black money hordes. However, the banks have reported lakhs of suspicious transactions where people have deposited large amounts of cash with banks which are not explained by their financial history. Demonetisation has also strengthened transmission in the banking system, contributing to greater savings finance.
- **Impact on Real estate:** Immovable property is said to be an industry that prospers on black money. There's a massive amount of illicit money involved in that business. An estimate tells us that at least 40 per cent of real estate transactions in Delhi-NCR are in black. Modi's push towards demonetisation reduced the influx of uncounted money into the real estate market. It will help to curb the use of black money in the real estate market, which in turn contributes to lower land and property prices.
- **Impact on Hawala transactions:** Demonetisation has been a big thrash for hawala racketeers. Despite their actual movement money is transferred in Hawala. Hawala has been the road for money laundering and terror funding. Hawala rackets run on money in black. The sudden disappearance from the economy of black money has become a surgical blow to hawala operations. It has also documented the destruction of currency notes by hawala operators.
- **Impact on Falsified currency:** Demonetisation was a strong blow to Indian falsified currency. Currency was wasted with syndicate operator operating both within and outside the region. Counterfeit currency is one of the key reasons why the actual value of Indian currency is devalued. The Indian Statistical Institute estimated that fake currency notes of Rs 400 crore were in circulation in the economy at any given point in time, and about Rs 70 crore fake currency notes are forced into the country each year. But the actual number could be a lot higher.
- **Impact on Terror funding:** Terror financing's principal source is through counterfeit currency and hawala. That's how it does work. The fake currency is circulated via the hawala operators 'network. Those hawala operators have a link with gamblers and weapons and narcotics smugglers. Indirectly, these are winding up financing terrorism. Furthermore, through donations routing these money through hawala transactions, the terrorists get huge money. With control in the distribution of counterfeit currency and hawala operators, all outlets of terror funding are now blocked.
- **Impact on Maoism:** Maoist sympathizers have proclaimed the demonetization drive of Modi to be "undeclared financial emergency." There are grounds for that. Currency prohibition has proven a significant assault on the Maoist movement. Black money is Maoists 'primary source of income. Maoists used to collect the crores of rupees by extortion annually. Such uncounted money is being used to purchase weapons and explosives. All those black currencies are reduced to pieces of paper with Modi's demonetisation push. No big incident of violence from states like Andhra Pradesh, Odisha, Telangana, and then Chhattisgarh, has ever occurred since the note ban.
- **Impact on Anti-Social Activities:** Demonetisation is a strong blow to the anti-social practices. Smuggling may be curbed because of the demonetization funding of antisocial activities. Such anti-social practices are crippling the economy. The antisocial leftists are having trouble healing from this. And the anti-social activities can be further curbed.

Negative Impact of Demonetization:

- **Decrease in GDP:** Withdrawal of the highest currency notes reduces the economic growth rate. Demonetisation decreases patterns of trade, income, expenditure etc. It will bring about a slowdown in the growth rate of India as the liquidity crisis itself can last three-four months.
- **Increases Liquidity Crisis:** Demonetisation has given rise to liquidity issue as people have found it hard to get enough cash to meet their basic needs. The marginal part of society relies primarily on cash to perform their everyday transactions. For the total circulating currency, 500 rupee notes accounted for almost 49 per cent in value terms. More time it takes to resupply Rs 500 notes, the longer the liquidity crisis period would be.
- **Black money not recovered as expected:** One of the key reasons behind demonetisation was to curb black money, but in reality only a small portion of black money is kept in cash form. The bulk of black money is held in land, gold, houses, etc. Therefore the amount of uncounted money deposited with the banks is only equal to the amount deposited in cash. Countrywide recognition for combating black money is generated among the people.
- **Small Scale Industries Suffered:** The small industrial units, which primarily work in the cash economy, have suffered and some jobs have been lost, impacting economic development.
- **Adverse impact on informal sector:** Informal sector players as they deal mainly in cash only face tough time because of this demonetization scheme. Sudden removal of cash from market put their business on a dormant phase. It is important to note that their income is not black because they do not fall under the income tax bracket due to the reduced salary that has now become even smaller.
- **Consumptions hampered:** Cash shortage adversely affected people's buying behavior in India. Sales of consumer durables which are likely to be hampered in the short term are cash transactions, particularly sales through unorganized channels. The majority of retailers' transactions are via currency, which has reduced their trade volume.
- **Loss of well-being:** Many of the population who make up the lower middle and lower classes use currency to meet their everyday transactions. Such society groups as daily wage labourers, small traders, and other poor parts of society use cash more frequently. With the lack of cash these parts of society have lost their income. Cash crunch has driven businesses to slash labor costs and thus raise lower middle class incomes.
- **Excessive burden on bank employees:** It is a simple fact that bank workers are overburdened to deal with the crisis and even after working too hard they are unable to meet people's needs.

Social Impact of Demonetisation:

The demonetization has had a mixed social effect. On the one side, the educated, prosperous, and wealthy class turned their old notes into the new currency sitting in their rooms by giving the banking agents a fee. The poor and the downtrodden on the other hand had to wait in long lines to exchange their old currency. This highlights Indian economy's shocking inequality.

This demonetization exercise also underlined the significance of citizens from the so-called lower strata. A significant number of middle-class households depended on their staff to use the maximum of their bank accounts to turn their illegitimate black money into white, such as domestic servants,

maids, drivers etc. This highlights the fact that when a individual or any segment of society gets rich or educated, the so-called lower strata forms an integral part of our everyday life without which survival can get harder. This segment of society should therefore be viewed with utmost respect and should not be deprived of its due share either in terms of money or social norms.

Suggestions and Recommendations:

Even from the point of view of promoting digital money, the government doesn't need to bring out of circulation 86 per cent of all currency. However as reported in many studies, very little black money has been captured. On 30 August 2017, the Reserve Bank of India released its demonetisation report. It said in the study that 99 per cent of the banned notes came back into the banking system that trashes all Narendra Modi's claims that the move would wipe out black money and falsify currency. With 99% of the currency back in the economy, demonetization failure implies two things: either the black money kept in cash was very small or the government failed to enforce demonetization effectively and all the black money kept in Rs. 500 and Rs. 1000 poured back into the banking system.

However, this is likely to generate other benefits for the economy in the long term. India made the first transition from a cash economy to a digital economy. Larger amount of savings and cash will find a way into the mainstream economy and will be used for the development of physical and financial properties. Using UPI, wallets and cards-driven digital currency and payment systems will create enormous transparency and pave the way for Fintech companies in India to grow faster, particularly in transactions and online lending space. However, it must be agreed that the caricatured version of black money which drives Indian real estate no longer applies.

The move was aimed at rising the high gap between the social status of the rich and the poor, and at targeting the parallel economy. Unfortunately, the high impact was not there. The explanation for this is obvious, people are clever. When something is done against their illegal conduct, they will find another way to circumvent it. People managed Duping bank staffs during demonetization, transferring money to the account of some unknown individual, wasting currencies. So, "It's easier to waste the uncounted money than get caught red-handed and let the government grab it." People remain the same, so there's no change in India's social image.

Conclusions

Demonetisation was a bold and radical step taken by India's government to curb black money, and one that would have a significant effect on the country's parallel economy. Arresting the unaccounted money was an effort. The decision concerning the demonetisation of the old currency was considered a surgical strike against the undeclared money in Indian Economy history, it could be a step towards the cashless economy. The step was an attempt to deal with the danger of illegal capital, corruption, terror financing and falsified currency. Black money and fake currencies are contributing to more extremism, violence and corruption. A total of Rs. 16.42 lakh crore worth of currency was in circulation as of the 2015-2016 statistics shown by Reserve Bank of India's rulebook as of the end of April 2016. For this, Rs. 14,18 lakh crore was in Rs. 500 and Rs 1,000 denomination notes

represented about 2300 crore notes, which accounted for about 26 percent of the total circulating notes. The impact of demonetization was very huge and significantly major in terms of Indian economy; although there was some negative impact as well as the positive impact.

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