

A Study On Demonetisation And Its Impact On Indian Economy

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Abstract: On 8th November 2016, the Government of India announced the demonetization of all Rs.500 and Rs.1000 banknotes of the Mahatma Gandhi series. The government claimed that the action would curtail the shadow economy and crack down on the use of illicit and counterfeit cash to fund illegal activity and terrorism. This paper attempts to study the short-term and long-term impacts of demonetization with reference to the different sections of Indian economy. It also discusses whether demonetization will be instrumental in removing the black money from the Indian economy which is the prime objective behind currency swap. The move was criticised by many experts and they are of the view that though demonetization will reduce the illegal activities for quite some time, but may not put an end to the flow of black money in the economy. It is considered to have reduced the country's GDP, adversely hit the cash intensive sectors, certain sections of the society namely agriculture sector, small traders, household are facing short-term disruptions due to absence of liquid cash etc. On the other hand, corrupt practices, smuggling of arms, stock of black money will reduce, there will be substantial increase in demand of digital transactions system, collection of higher taxes will help in the development activities undertaken by the government etc. It can be said that demonetization will create cash crunch and liquidity crisis causing inconvenience to the general public in short-term, but it will prove to be beneficial to the economy in long run on aspects like government revenue, increase in deposits, low interest rates on loans, and decline in inflationary pressure etc.

Keywords: Demonetization, Black money, Short-term impact, Long-term impact, Indian economy.

I. INTRODUCTION

According to Investopedia, Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency. The current form or forms of money is pulled from circulation and retired often to be replaced with new notes or coins. Such a step, for example, was taken when the European Monetary Union nations decided to adopt Euro as a currency. Zimbabwe, Fiji, Singapore and Philippines were other countries to have opted for currency demonetization. The demonetization of 500 and 1000 was a policy enacted by the Government of India on 8th November 2016. All 500 and 1000 banknotes of the Mahatma Gandhi series ceased to be legal tender in India from 9th November 2016 (Sherline T. I, 2016). The measure according to the Government was motivated by the twin objective of curbing the menace of fake Indian currency notes and for

eliminating black money. Interestingly, even during the two previous episodes of demonetization of high value notes over INR in India, on January 12, 1946 and on January 16, 1978, the express objective of the exercise was containing black marketing or black money (Ashok K. Lahiri, 2016).

II. HISTORY OF DEMONETISATION IN INDIA

The first demonetization was when Rs.1000, Rs.5000 and Rs.10,000 notes were taken out of circulation in January 1946 a year and a half before the country won independence from the British. The Rs.10,000 notes were the largest currency denomination ever printed by the Reserve Bank of India, introduced for the first time in 1938. All three notes were introduced in 1954. In the early 1970, the Wanchoo Committee, direct tax inquiry committee set up by the Government,

suggested demonetization as a measure to unearth and counter the spread of Black Money. The move was called a ‘death blow’ to black marketers. The repercussions were similar to present demonetization with people dying of shock, exceptionally long lines at the banks and the middle classes being hit.

Then in 1977, the Janta Party coalition government came into power. A year into the government’s term, party leader Morarji Desai was more bullish about cracking down on counterfeits and black money. The High Denomination Bank Notes(Demonetization) Act, instated by the ruling party on January 16th 1978, deemed the Rs.1,000, Rs. 5,000 and Rs.10,000 notes illegal for the second time. It was termed as “an Act to provide in the public interest for the demonetization of certain high denomination bank notes and for matters connected therewith or incidental thereto”.

III. OBJECTIVES OF THE STUDY

The present study is based on Desk Research through collection of Secondary Data hence it is theoretical in nature with emphasis on Indian Economy. Following are the objectives of the study:

- ✓ To study the impact of demonetization on Black Money.
- ✓ To study the short term impact of demonetization on Indian Economy.
- ✓ To study the long term impact of demonetization on Indian Economy.

IV. REVIEW OF LITERATURE

On November 8th 2016, the Prime Minister by convincing that there would be a few days of hardship in our economy and announced that Rs.500 and Rs.1000 currency notes would no longer be recognized legally as a currency (S. V.Gangier.& Ranganath B., 2017). The move by the government to demonetize Rs.500 and Rs.1000 notes by replacing them with new Rs.500 and Rs.2000 notes aims to tackle the menace of black money, corruption, terror funding and fake currency (Sherline T., 2016). Black income has been causing underestimation of GDP in India as an enormous volume of income is diverted to this unaccounted sector resulting in growing continuation of parallel economy of the country. Black money has resulted in transfer of funds from India to foreign countries through clandestine channels (Dr. Sukanta S., 2010). Economic Survey 2016-17 reveals that there is various short-term and long-term impact of demonetization in our country. Short-term impacts are cash decline sharply, bank deposits increased sharply, job losses, decline in farm incomes, social disruptions, especially in cash-intensive sectors. Some long-term impacts are deposits will decline, but probably settle at a slightly higher level, loan rates could fall, formalization should reduce the flow of unaccounted income, and wealth could fall further if real estate prices continue to fall, taxes should increase as formalization expands and compliance improves. While sectors with linkages to the unorganized economy are likely to be affected, technology and financial services are expected to gain in the medium to long

term. On a positive side, there is likely to be a reset of spending patterns as this move represents indirectly a significant push towards a cashless economy (Dr. Pratap S., Virendra S.,2016). According to Wharton emeritus Professor of Management, Jitendra Singh, while it is too early to assess the impact of demonetization, the move raises long term questions, “What will have been gained from this step, and at what cost and mostly borne by whom”.

V. OBSERVATIONS

WILL DEMONETIZATION WILL PUT AN END TO BLACK MONEY

The Central Bureau of Intelligence has made a soft estimate that black money of India is around Rs 25 lakh crore or nearly US \$ 500 billion. The amount is equal to the size for the Indian government to execute two year’s budget without any tax or borrowing. The biggest mission of demonetization is described as fighting black money. India’s economy historically holds a big parallel economy where unreported income is the norm. Black money is essentially income which is generated on a regular basis via unscrupulous means or accumulated unaccounted wealth to evade taxes. The largest source of black money in the country is tax evasion. The government estimates that only about 3 percent of Indian pay income taxes. Further evasion of tax, excise, and customs are way too common.

The term ‘black money’ is used to refer to three distinct categories- black wealth, black income and black currency, the term ‘black’ connoting its ‘illegal’ or unaccounted nature. Clearly ‘black wealth’ is several times more than black income. And black income is several times more than black currency. Black income can be earned even without the use of currency, for example, with gold or diamonds. Although demonetization may prove to be useful in reducing the level of black money in the economy, it won’t stop the flow. According to Professor Arun Kumar, Jawaharlal Nehru University, “government’s move not be a sledgehammer blow to generation of black money. Instead, it would leave the economy in trouble and people harassed”. Rajesh Chakrabarti, Jindal Global University, is of the view that, “unless the root causes of corruption are removed, corruption will continue. Demonetization is sort of a dialysis, more of a short-term cleaning up than a solution of the problem”. While this move will help in cleansing the existing stock of black money, there is a need to ensure that black money does not surface in another form in due course of time. For this stringent measures and monitoring would be required. Some experts argue that demonetization may not yield desired results against black money; rather it creates inconvenience to the general public. Raghuram Rajan, the former RBI Governor says, “Since many people do not stack their black money in cash, it is not easy to flush out black money. Of course a fair amount may be in the form of gold, therefore even harder to catch”. This currency swap will not have much effect on the generation of black money through corruption. This will only attack a part of black money stock and not the flow of black money in the

economy. Broader policy action will be required to stop the generation of unaccounted wealth.

VI. SHORT-TERM IMPACTS OF DEMONETIZATION ON INDIAN ECONOMY

POSITIVE IMPACTS

- ✓ For quite some time at least, people who are involved in counterfeit currency and terrorism will not be able to continue it further. The smuggling of arms and dealing with the terrorist will not sustain further as all the money will be on record now.
- ✓ It will drastically affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalized by authorities.
- ✓ It will certainly flush out a good chunk of black money hoarded in currency notes of such denominations (Rs.500 and Rs.1000).
- ✓ Decline in inflationary pressure as demand along with household inflation expectations are likely to go down. This would make RBI more comfortable on managing inflation in future increasing the possibility of rate cuts.

NEGATIVE IMPACTS

- ✓ Commodity and general cash market transactions felt an immediate impact. There is a disruption in current liquidity situation, as households are likely to get affected by the note exchange and currency withdrawals terms laid by the government.
- ✓ Economy has already borne short-term costs such as the time people wasted in long ques, liquidity crisis in the informal economy, the worker layoffs and many tragic deaths.
- ✓ Certain sections of the society namely agriculture sector, small traders, households, daily wage earners etc faced short-term disruptions due to absence of liquid cash.
- ✓ GDP formation will be affected with the reduction in consumption demand and negative impact on disposable income.
- ✓ Land parcels are usually paid in cash. With restrictions on cash transactions, land prices would fall. As smaller/unorganized players get affected, demand for real estate may decline.
- ✓ There would be negative impact on NBFC's that make disbursements in cash and do most of their collections in cash. These include gold financing companies, micro finance institutions etc.
- ✓ There will be added replacement costs of currency. Increased cost of operating ATM's need to be refilled more often and also it will be a huge burden on banks. Moreover disruption of old currency units and printing of new currency will involve costs, which has to be borne by government and if costs are higher than the benefits then there is no use of demonetization.

VII. LONG-TERM IMPACTS OF DEMONETIZATION ON INDIAN ECONOMY

POSITIVE IMPACTS

- ✓ Government revenue will boost up as more earnings will be declared.
- ✓ Collection of higher taxes will help in nation building like development of roads, infrastructure, transportation and many others.
- ✓ People who have opened Jan Dhan accounts under the Prime Minister Jan Dhan Yojna, can now deposit their cash under this scheme and this money can be used for implementation of national developmental projects which will demand more labor and other skilled manpower which will give rise to employment opportunities.
- ✓ Cash in system will boost educational loans and business loans thus bringing more opportunities.
- ✓ Substantial increase in the demand of digital transactions, E-Wallets, usage of plastic money, online transactions using E-banking etc.

NEGATIVE IMPACTS

- ✓ Demonetization itself will not fight black income. The most important policy should be tax administration where the tax authorities can monitor expenditure and matching it with income of the respective individuals.
- ✓ Professor Arun Kumar, Jawaharlal Nehru University, is of the view that demonetization is no silver bullet against fake currency. Fresh printing and import of counterfeit currency will not stop with demonetization.
- ✓ Though Digitization may be a positive effect of demonetization, India to become cash less economy will take time. Bloomberg data shows the share of cash in the volume of consumer transactions is 98% and much of the cash transactions are in rural India. PwC Report showed that India's unbanked population still stood at 233 million, suggesting that much remains to be done before people can be on boarded on to the digital bandwagon.

VIII. CONCLUSION

It may be right to say that demonetization will prove to be beneficial for Indian economy in long run. The impact of currency swap on country's tax structure would be felt in years to come. Government revenue will increase in the form of increased tax collection, bank deposits will increase leading to lower interest rates on loans, and government can channelize this increased revenue towards implementation of projects of National importance. Further the funding to illegal or unlawful activities which arise due to unaccounted cash flow will reduce. Government can now easily track unreported income resulting in reducing of corrupt practices and money laundering. But it is also to be noted that the ultimate objective of demonetization to flush out black money from the economy may not be achieved, until the actual people behind black money are targeted. Moreover, people have invested their black money in assets like real estate and gold; therefore it

becomes difficult on government's part to track black money. The success of demonetization depends upon the formalization by the government which will hopefully change the mindset of people to refrain from illegal activities and black money.

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