

# Demonetisation and Indian Economy

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## **Abstract**

The demonetisation of 500-rupee note in November 2016 has had far-reaching effects on Indian Economy. It was aimed at unearthing black money, preventing circulation of fake money while promoting digital payment systems and a transition to cashless economy. However, after one year of the experiment these objectives have not been met and the economy is facing numerous hardships. The economy has slowed down with many sectors facing cash crunch and large scale closing down of small industries. The paper analyses some of these effects of demonetization on the economy and concludes that the losses far outweigh the gains from it.

## **Keywords**

Digitalization, demonetisation, India, Industry, Money, Unemployment

## **Introduction**

Money holds an important place in the working of a modern economy. It is a medium of exchange and a store of value and may be regarded as the most liquid of assets of any economic entity. The main reason behind the easy acceptability of any currency, notes and coins, as fulfilling these functions is the legal backing provided by the government of a country to that currency. In India, the Reserve bank of India is the sole note issuing authority and is responsible for the country's currency management. As of November 1, 2016, apart from coins for rupee one, two, five and ten, currency notes of denomination ten, twenty, fifty, hundred, five hundred and one thousand were in circulation in the country.

On November 8, 2016, the Prime Minister of India, in a televised address to the nation, announced that the notes of 500- and 1000-rupee denomination would cease to be legal tender henceforth to be replaced by new series of 500-rupee currency note. With a single stroke, the government invalidated nearly 86% of the currency in circulation with a tepid assurance of limited exchange of old notes through bank counters or optionally depositing the same in bank accounts.

## **Objectives and methodology**

Demonetisation was a huge shock to the Indian economy causing numerous hardships for the people and had far-reaching effects on the economic system. This paper discusses the general effects of demonetisation on the economy. While the repercussions have been adverse for the informal sector, manufacturing and real estate, the resultant impact on unemployment and incomes was expectedly harsh. The objective of the paper is to bring forth the positive and/or negative effects of demonetisation on the Indian Economy.

The data used in this paper has been gleaned from secondary sources such as government reports, RBI reports and articles from reputed newspapers and magazines.

## **Effects of demonetisation on Indian Economy**

Initially the Indian government provided two main objectives behind demonetisation – to curb black money and corruption and to prevent counterfeiting of the high-value notes with an aim to curb illegal activities like hoarding and financing terrorism. Later, new arguments in favour of demonetisation were put forth like promoting digital transactions and moving India towards a cashless economy. But financial experts have been vocal in pointing out that demonetisation in 2016 was an ill-conceived idea which did little to achieve its stated objectives while causing much harm to the general public and arresting the economic growth. The strain on cash-in-hand for the public led to sudden spurt in digital payments. But as liquidity increased with issuance of new notes of 500-rupees and 2000-rupees denomination, there was a marked reduction in electronic payments. Again, the short window provided for exchange or deposit of old notes led to an increase in opening of new bank accounts. But apart from these few instances, the different sectors of the economy suffered impacting the growth rate and output. It is expected that the Indian economy will take a

number of years to recover from the shock of demonetisation. The following paragraphs discuss the effects of demonetisation.

### Effect on the Digital Payment Systems

The Electronic Payment System was the plausibly biggest gainer after demonetisation. The digital payment system had been making progress over the years but after demonetisation a huge increase in subscriber base became evident. Faced with a cash crunch, most households preferred to carry out transactions with sellers who accepted payment digitally through UPI or Debit and Credit Cards. The business community was also quick to switch over to such platforms and the scan and pay signs sprung up everywhere from street-side stalls to neighbourhood shops to larger malls and boutiques. According to RBI, a definite increase was seen in the use of various electronic payment systems such as RTGS, NEFT, CTS, IMPS, NACH, UPI, USSD, PPI, debit and credit cards and mobile banking. The Table 1 depicts the increasing electronic transactions between November – December 2016 and October 2017. Column (i) shows total electronic transactions compiling data for all electronic payment systems, while columns ii, iii and iv show the increasing transactions of individuals in terms of UPI, card usage and mobile banking.

**Table:1 Electronic Payment Systems – Representative Data**  
Volume in Million, Value in Rs. billion

	Total (i)		UPI (ii)		Debit & Credit Cards at POS (iii)		Mobile Banking (iv)	
	Volume	Value	Volume	Value	Volume	Value	Volume	Value
November 2016	671.5	94004.2	0.3	0.9	205.5	352.4	72.3	1244.9
December 2016	957.5	104055.3	2.0	7.0	311.0	522.2	70.2	1365.9
October 2017	967.3	114532.2	76.8	70.3	255.7	530.5	130.9	1168.7

Source: RBI

### Effect on personal finance and small savings:

While saving for a rainy day is part of the Indian culture, till recently a large portion of this saving remained out of the formal monetary system. People generally hoarded their savings within the confines of their homes. With demonetisation, this was no longer possible resulting in most of these small savings being deposited into bank accounts or post-office savings accounts. Previously introduced 'Jan Dhan Yojna' had incentivized opening of bank accounts with zero-opening balance targeting the poorer strata of society. Now these accounts were used to deposit the money that couldn't be exchanged. In a way, this helped the poorer sections in overcoming their fear of formal banking system and helped in their integration into the modern system. With mobile phones becoming popular among all persons, the digital banking system also received a fillip as mentioned earlier.

According to RBI Mint Street Memo No. 01, for the period November 11, 2016 to February 17, 2017 the average fortnightly bank deposit growth rate was 13.9%, 3.5 percentage points in excess of the assumed normal growth.

Between November 10 to November 27, 2016 money worth Rupees 844,982 crore was exchanged or deposited in banks. Of this, Rupees 33,948 crore was exchanged while Rupees 811,033 crore was deposited. Further Rupees 216,617 crore were withdrawn by the public either through ATMs or over bank counters. RBI press release (2016) pointed out that till December 10, 2016, the banks had issued notes valued at rupees 4.61 lakh crores while notes amounting to Rupees 12.44 lakh crore had been returned. (RBI Press Release, RBI Deputy Governors brief Agencies on Currency Issues: edited manuscript, retrieved from [https://m.rbi.org.in/Scripts/BS\\_PressReleaseDisplay.aspx?prid=38886](https://m.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=38886))

### Effect on GDP growth rate

The government's decision to demonetize a large proportion of currency in circulation was expected to have far-reaching effect on National Income as it had thrown the whole economic system into disarray. Contrary to expectations, GDP growth rate of 7% for October-December 2016 quarter did not show much slowdown. Over the next few months however, it became clear that the country would not be able to grow at the expected rate due to the twin shocks of GST and demonetisation. On August 31, 2017 the CSO pointed out

that GDP Growth rate had slipped to 5.7% in the April-June 2017 quarter with manufacturing sector slowing down to 1.2%. This was a three year low in terms of growth rate. ( India Today, The Big Slide: Did both GST, Demonetisation do more harm than good to economy, September 18,2017 retrieved from <https://www.indiatoday.in/magazine/cover-story/s....>

### MSME sector

The Medium, Small and Micro Enterprises (MSME) sector was the worst hit with the decision of demonetisation. The MSME sector works on small working capital and has lower reserves. With demonetisation, the sector faced an unprecedented cash crunch affecting daily functioning forcing many industries to shut down. The imposition of a new tax regime in the form of Goods and Services Tax (GST) earlier in 2016, was already creating difficulties in terms of tax rates and monthly filling. In this scenario, demonetisation further exacerbated the problems of the MSME sector.

### Informal sector

A huge portion of the Indian economy can be classified as informal sector, consisting of self-employed persons, contractual labour and daily wage workers. This is a highly cash dependent sector. Demonetisation created a sudden shortage of funds completely paralyzing the sector leaving many unemployed. The sudden cash crunch also led to spike in costs of production for many small businessmen further increasing their problems.

### Employment and labour

Employment in the informal sector took a huge hit in the weeks and months following demonetisation. CMIE data suggests that nearly 1.5 million jobs were lost in the first four months of 2017. Also there was a spurt in labour supply in the employment generation schemes under the National Rural Employment Guarantee Act (NREGA) specially in less developed states. This points towards lack of work opportunities in the developed states leading to reverse migration of casual labour who then searched for employment in their home states.

### Conclusion

Demonetisation wiped out the household saving in form of petty cash initially as money got deposited in banks and post-office accounts. However, government claims that it would wipe out black money was falsified as RBI pointed out that nearly 98% of the demonetized currency was returned to the system. The argument regarding counterfeit currency was belied by the small number of such notes found. In contrast the hardships faced by the people were much more. The economic cost of loss in work-days as people spent hours trying to get currency converted resulted in lower productivity. The adverse effects on various sectors of the economy slowed India's growth rate and its recovery is expected to take a number of years. Overall, demonetisation created many more problems than the issues it was expected to resolve.

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