

# Implication of Demonetization on Indian Economy

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**Abstract:** 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. Sometimes, a country completely replaces the old currency with new currency.

**IndexTerms – Demonetization, Economy, Currency.**

## I. INTRODUCTION

The history of demonetization very old, the first time it was done in January 1946, for the second time in January, 1978 and for the third time it was done in November 2016. In the year of 1946, notes of denominations 1,000 and 10,000 rupees were withdrawn from circulation. In January 1978, government demonetized banknotes of denominations 1,000, 5,000 and 10,000 rupees with the notion of curbing counterfeit currency and black money. Thorpe, 2010. The latest demonetization of denominations Rs. 500 and Rs. 1,000 banknotes was a policy decision carried out by the November 2016. The use of denominations of all Rs. 500 and Rs. 1,000 banknotes of the Mahatma Gandhi Series were invalidated. They were to be replaced by Rs. 500 and Rs. 2,000 banknotes of the Mahatma Gandhi New Series. A year ago, Prime Minister Narendra Modi announced the scrapping of high-value banknotes, which amounted to 86% of currency in circulation. The demonetization of currency notes was supposed to be an attack on black money, on counterfeit notes, and projected as part of a broader push to promote digitization and non-cash payments. A year later, progress on all these counts appears to be very modest, and should make us question whether this exercise was needed at all to fulfill its stated aims. The costs imposed by the currency- scrapping exercise were, however, quite severe, at least in the short term, disrupting ordinary life across the country for several weeks. The hardest-hit were those in rural areas, where access to banking and the internet are quite low. A 2016 Reserve Bank of India (RBI) report on branch authorization policy classified 93% of rural centers in the country as unbanked, with the population dependent on roving banking correspondents and on distant urban or semi- urban branches. Access to the internet is equally patchy, with only 3% of households in underdeveloped rural areas reporting access to internet in a 2016 consumer economy survey.

## II. IMPACT OF DEMONETIZATION ON INDIAN ECONOMY

### On GDP Growth

India's GDP which grew at 7.6% in FY 2015-16 is likely to slow down by 0.5% to 1.5% as per reports of various agencies. This is due to less availability of cash in cash-intensive sectors like manufacturing and real estate. Even the automobile industry which was growing rapidly earlier has seen a contraction in the October-December quarter of 2016. Purchasing power of consumers has been negatively affected due to cash not being readily available. We need to remember that Indian economy is largely cash driven with more than 90% transactions taking place in cash and digital transactions accounting for just the remaining 10 percent. Banks have also been focusing on the single task of deposit and withdrawals with the result that their core function of issuing loans has been adversely affected. Also current account customers, who are largely business owners, need large amounts of cash at short notice have not been able to access cash and credit owing to restrictions on withdrawals and inability of banks to focus on the task of issuing loans.

### On Tax Compliance

India's tax-to-GDP ratio is quite low at 16.6% compared to other emerging economies. It is estimated that since mom including black money, gets accounted for this will lead to better tax compliance owing to better targeting of income. Lower tax rates may result from a broader tax base with more taxpayers. The government's digital initiatives will also increase revenue through service tax. Moreover businesses that under-reported their revenue earlier, will have to make proper disclosure, especially, of revenue received through digital or cashless means.

### On Small and Medium-sized Enterprises

The small and medium-sized enterprise (SMEs) sector, as we understand, is a big chunk of the economy, contributing to eight percent of the GDP whilst employing more than 80 million people year on year. The labor wages in this sector are largely paid in cash and wages have been adversely affected by the demonetization move. Unemployment has also been reported owing to decline in demand of SME goods as the purchasing power of the consumers has contracted in the short term. Other sectors within the SME space like restaurants and transport operators have also been negatively impacted since economic activity has declined and also due to the fact that there is high tendency in this segment to accept payments through cash only.

### On Agriculture

As per as agriculture sector is concerned, wholesale vegetable markets have been witnessing declining demand and prices of tomatoes and other food items have fallen drastically making it economically unviable for the farmers to produce these crops. Which takes us to the next point. This is one sector where all transactions are in cash and, given the values involved, involve the higher denomination notes. The withdrawal of the old currency notes has put pressure on the mandis; farmers are having problems in selling their produce as both the parties have to agree on the mode of payment. In addition, since there is acute shortage of Rs 500 denomination notes

presently, change for the high denomination Rs 2000 notes is not readily available with the vegetable and fruit vendors. This is also taking the buyers away from these vendors to big retail markets thus affecting the livelihood of the unorganized sector.

### On Employment Generation

Since consumer demand has slowed and consequently industrial production has declined, employment generation has impacted by the currency demonetization drive. Since the manufacturing sector which accounts for the highest employment of skilled and semi-skilled laborers, is witnessing slowdown in production; not only less jobs are being created but lay-offs are also taking place at a higher rate. As per this report, Industry is staring at temporary job losses due to demonetization, as production gets hit, especially in labor-intensive sectors like textiles, garments, leather and jewelry. As many as 4 lakh people, mostly daily wagers, may have either lost their jobs or shunned work temporarily due to the lack of payment so far, and the number is only going to grow if the cash crunch persists.

### Impact of Demonetization on Black Money

As outlined in the first post on What is Demonetization of Currency, fighting black money rampant in the economy was one of the foremost objectives of this entire exercise and we will discuss in detail whether this objective was realized or not. If read the above post, you will know that cash component forms just 6% of the black money in the Indian economy and currency demonetization will target just this 6% black income. If various reports are anything to go by, most of this black income has been converted into white by depositing it in Jan Dhan accounts, depositing in individuals own accounts by breaking into smaller chunks, by exchanging for new currency notes through hawala dealers, by buying last-minute luxury items like jewelry and high priced mobiles, by paying advance wages to employees etc.

This is supported by the fact that almost the entire amount of Rs 14.18 lac crores in Rs 500 and Rs 1000 currency denominations lying with the public has returned to the banks at the time of writing this post. This implies that the dividend which the govt. has been hoping for by way of 2-3 lac crores not returning to the banking system (since it is black money and/or counterfeit currency) has turned out to be a mirage. Beside, as per various announcements by the govt. from time to time that deposits by housewives and those exempt from tax will not be scrutinized has provided a way out for black money hoarders to convert their money into white.

However there have also been some positive impacts like one time removal of counterfeit or fake currency from the economic system. Some people argue that since black money has reduced, prices of black money intensive sectors like real estate and gold jewelry will go down. This remains to be seen. But, demonetization cannot and will not prevent future generation of black money since black money problem is more of a cultural mindset in India than a legal problem.

It will also be easier for the corrupt and black money hoarders to deal in Rs 2000 currency notes as compared to Rs 500 and Rs 1000 notes since higher currency value can now be carried with greater ease. A total of Rs 3185 crores in black money of which Rs 86 crores in new notes has been seized by the Income Tax authorities since the launch of the demonetization drive on 8th November. This implies that on the one hand black money is getting unearthed and on the other leakage of new currency notes is taking place; most probably through the banking system itself.

### Impact of Demonetization on Terror Funding and Fake Currency

This was another stated objective of the currency demonetization drive of the government. While initial reports suggest that terror related activities in J&K witnessed a noticeable halt in the days following the demonetization drive, including, stone pelting by misguided youths; the recent Nagrota attack shows that terrorism is continuing in the valley. Although the availability of cash has surely declined among the terror groups presently. The govt. also claimed that the new currency notes contain very high security features and are almost impossible to replicate. But this claim does not seem to be true since many stories of counterfeit currency have come to light since the note ban was announced on November 8th. However, in the short term, circulation of fake currency has definitely slowed down considerably since the infrastructure set up to print fake currency notes in neighboring countries like Pakistan has been rendered useless by the demonetization drive.

### Impact of Demonetization on Cashless Transactions

As it has been mentioned in the previous section that cashless transactions account for only 10% of all transactions on daily basis. The government in order to divert some of the blame for the poor implementation of this demonetization exercise announced mid-way that making India a cashless or less cash economy was one of the important objectives of this demonetization drive. Towards this end, the Finance ministry, RBI and NITI Aayog announced a host of incentives to boost cashless transactions. This was also done to ease some of the problems that have resulted due to acute shortage of cash in the economy.

### III. SOME OF THESE INCENTIVES INCLUDE

- No Service Tax on cashless transactions below Rs 2000
- Providing cash backs ranging from 0.25-0.75 percent on various transactions like paying for fuel, govt utility bills, Stamp papers, property registrations etc.
- Encouraging use of Point-of-Sale (POS) machines and mobile wallets like PAYTM by businesses and individuals
- Reducing self-assessment tax from 8% to 6% on businesses with annual turnover of less than Rs 2 crores
- Announcing monthly jackpots for people using cashless transactions in government services And other incentives

As a result, use of mobile wallets and cashless transactions, as a whole, has increased by about 300% since the launch of demonetization exercise. However, we need to remember that this 300% increase is against a very low base of digital transactions and most of this increase has been noticed in the urban areas where people have ready access to PoS machines, internet banking, and mobile wallets. Cashless transactions are still rarely used in rural areas and in the informal sector like roadside vendors, small shops, buying seeds, wage payments etc.

#### IV. IMPACT OF DEMONETIZATION ON INFLATION

The Reserve Bank of India (RBI) considers the Wholesale price index (WPI) and the Consumer Price Index (CPI) to measure inflation. Demonetization is expected to reduce inflation as consumers have cut down on spending and aggregate demand has considerably fallen. According to government press releases, the official WPI for 'All Commodities' (Base: 2004-05-100) for the month of December 2016 declined by 0.2 percent to 182.8 (provisional) from 183.1 (provisional) for the previous month. The index started rising during the month of January and rose by 1.0 percent to 184.6 (provisional) from 182.8 (provisional) for the previous month. This may be correlated with the availability of cash with people, which led to increased spending. Many Political Parties use large amounts of undeclared cash to campaign for elections and meet other requirements. Due to Demonetization, such acts might get restricted to an extent and parties will have to formulate new strategies.

#### V. CONCLUSION

Impact like reducing the cash flow to terror organizations, dismantling of Demonetization of old currency notes surely has had some positive counterfeit currency infrastructure, better income tax and indirect taxation, boost to digital economy. However, it has come at a huge social and economic cost. Sandeep Dongre writes that demonetization costs are estimated at Rs 1.28 lakh crore to the economy for the 50-day time period till the end of depositing period of old currency. This includes a cost of Rs 17,000 crore towards the government and the RBI for implementing the demonetization process in India. This monetary reform, no doubt will have short-term effect rather than in the long run.

However, demonetization alone will not counter black money in the economy rather it has to be strengthen bringing the offshore tax evaders to book whose names figure in the Panama papers, raid on benami properties, making donations to political parties open to public scrutiny and making it mandatory for all donations above Rs 2000 to political parties and religious places to be through digital means only. This entire exercise seemed more like a carpet bombing than a surgical strike where the vast majority of honest and law abiding citizens had to undergo terrible hardships in order to catch the few black sheep who have hoarded black money and who also managed to convert their black income into white.

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