

Demonetisation: A Cross Analysis of its Impact in India

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1. Introduction

Demonetisation is undoubtedly most remarkable and a memorable economic event of our time. Its impact was felt by every Indian citizen. Demonetisation affects the economy through the liquidity side. Its effect has been a telling one because nearly 86% of currency value in circulation was withdrawn without replacing a bulk of it. As a result of an announcement made by the prime minister Mr. Narendra Modi, on 8th of November 2016 Rs 500 and Rs 1000 notes were withdrawn from circulation. There occurred a huge gap in the currency composition as after Rs 100, Rs 2000 was the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 reduced the utility of Rs 2000. Effectively, this made Rs 2000 less useful as a transaction currency, though it was a good store value denomination. Individuals had to stand in long queues to exchange currencies, businessmen panicked, trade dwindled and politicians-critics left no stone unturned to criticize this move.

2. Objectives of this Paper

1. To study the experience of impact of demonetization in various sectors of the Indian Economy, in the post demonetisation era;
2. To analyze the current, the immediate positive and negative impacts of demonetization in Indian economy;
3. To find out the probable consequences of the demonetization.

3. Research Methodology:

The paper is based on secondary data. The data have been collected from various books, periodicals, Economic Survey, RBI bulletin, IMF and World Bank Review of Indian Economy and internet sources.

Impact of Demonetisation—A Cross Analysis: The Economic survey 2016-17, rightly called demonization as a regime shift. Demonetisation technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise produced following short/long term consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetisation effects clearly depends upon the duration of the liquidity shock. Following are the main impacts of demonetisation, if we make a retrospective analysis:

Adverse Impacts: There are many economists, politicians, bureaucrats and critics who have openly criticized the demonetization move of the government. They opined that the government had made no prior planning for implementing a financial instrument with such far reaching consequences.

Following adverse impacts of demonetisation brought hardships for the Indian economy and its people:

1. **Liquidity crunch (Short term effect):** Demonetisation acted as a 'Liquidity Shock' that disturbed the economic activities and the life of people. Liquidity shock means people are not able to get sufficient volume of popular denomination, especially Rs 500. This currency unit was the favorable denomination in daily life of Indians. It constituted nearly 49% of the previous currency supply in terms of value. Higher the time required to re-supply Rs 500 notes, higher would be the duration of the liquidity crunch. Various reports indicated that all security printing presses could print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 million Rs 500 notes were in circulation at the end of March 2016. Some portions of this were filled by the new Rs 2000 notes. Towards the end of March 2017 approximately 10000 ml units were printed and replaced. All this indicates that the currency crunch in our economy lasted for the next four months after the demonetization drive was launched.
2. **Welfare loss for the currency using population:** Most active segments of the population who constitute the 'base of the pyramid'—the people in the **Informal sector** or the **Unorganized sector**, use currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections lost income in the absence of liquid cash. Cash stringency compelled firms to reduce labour cost and thus reduced income of the poor working class. There was a trickle up effect of the liquidity chaos to the higher income group of people also for some time.
3. **Reduction in Consumption:** When people faced liquidity shortage their consumption was adversely affected at first. Later the reduced consumption brought down the overall production and employment in many sectors. As a result, the growth rate of the economy came down and so came down the tax-revenue collection of the government.
4. **Loss of Growth in economy-** India risked its position of being the fastest growing largest economy in the world by the demonetisation move. The liquidity crunch impact resulted in reduced consumption, income, investment etc. which finally reduced India's GDP growth in the next three quarters of 2017. Latest IMF report has projected a lower growth rate of 6.7% for Indian economy in the year 2017 less than that of China with 6.8%. Thus, India slid down to second position. However, the IMF has also projected that

India will have a growth rate of 7.4% in the year 2018 ahead of 7.1% in 2016.

5. **Impact on bank deposits and interest rate:** Deposit in the short term may rise, but in the long term, it will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply takes place. This means that new savings with banks is only transitory or short-term deposits. It would be encashed by the savers at the appropriate time. It is not necessary that demonetization will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.
6. **Impact on black money:** Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence, the amount of black money countered by demonetisation depends upon the amount of black money held in the form of cash only and it was less than expected or hyped by the government. Latest RBI report in September 2017 says that 96% of the demonetized currency has been exchanged. Hence, critics say that demonetization has almost failed in its effort to check black money. But more than anything else, demonetization had a big propaganda effect. People are now much convinced about the need to fight black income. Such a nationwide awareness and urge will encourage the government to come out with even strong measures.

Demonetisation as a cleaning exercise produced several good things in the economy. At the same time, it created unavoidable income and welfare losses to the poor sections of the society who get income based on their daily work and they do not have a digital transaction culture. Overall economic activities were dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed out as the long-term benefits.

Positive Effects of Demonetisation: In what could be termed as the mother of all reforms, Prime Minister Modi's demonetisation move will have far reaching implications. This is not to dispute that the transformative step has brought some hardship for the citizens, but they are temporary and would blow over soon. For the larger benefit of the nation, we the citizens can bear such hiccups with a smile. After all, this is how we as citizens can contribute in policy making and nation building. While bank employees worked overtime to make Modi's ambitious demonetisation drive a success, let's discuss its many-fold impacts.

1. **Demonetisation has strengthened tax administrative measures against black money:** Demonetisation's prime objective was fighting black money. It has fortified the tax administrator's tools, interventions and interactions with the taxpayers by producing greater compliance. Here, the initiative has tackled black money both direct and indirect ways.

The direct effect was the amount of black money unearthed from savings made by the people during the demonetization period. There are three black money windows. **First** is CBDT's **Operation Clean Money (OCM)** initiative. As per the preliminary report of the ITD (Income Tax Department), an undisclosed income over Rs 9,334 crore between November 9, 2016 and February 28, 2017 reported. Similarly, approximately 1300 high risk cases were reported under the second phase of the OCM (Status Report May 2017). The exact amount can be estimated after the completion of the long process required. The **second** window is the **Pradhan Mantri Garib Kalyan Yojana** where nearly Rs 5000 crore were deposited according to the initial estimates. **Third** is the extension of **Income Disclosure Scheme (IDS)** to March 31, 2017.

The indirect working of the demonetisation has been much stronger as it has strengthened the tax enforcement mechanism. Demonetisation helped to add more people into the tax net. A minimum of 1.56 lakh people are expected to be added to the income tax net under the Operation Clean Money. The tax department has got information about such people when they saved money in the bank accounts during the demonetisation period. The ITD has also made advanced tax administration practices including the Aadhar-PAN linkage initiative that ultimately led to recording of black money under multiple PAN cards by a single person. According to Parliamentary information, more than 11.44 lakh permanent account numbers (PANs) were deleted or deactivated as they are cases of multiple PANs.

2. **Demonetisation has made a social shake-up of Indian society for detaching practices related with black money:** The biggest contribution of demonetisation is its campaign value as a nationwide awareness programme against black money. Although several other initiatives in the past like the Income Disclosure Scheme were launched, the readiness of the people to undergo sacrifices expecting the end of black money has made the programme a 'mass movement against black money'. This will help India to create a compliant and transparent society. Future government steps for transparency, based on Aadhar identification will also be smooth given the awareness of the people about the need to create a compliant society.
3. **Demonetisation has boosted digital payments:** One of the welcome turns around in the demonetisation program was the inseparable link between demonetisation and digitalization of transactions. Inarguably, demonetisation encouraged people to embrace digital methods. Though its pace is slow as

there are several hindrances which certainly are getting reduced, demonetisation has inaugurated the march towards cashless society with a bang. Popularization of digital payment methods, instruments and institutions prove that demonetisation has facilitated digital transactions. PoS machines, and use of card-based payments are very popular now compared to the pre-demonetisation period. Among the more sophisticated groups, online payments have become common.

4. **Demonetisation has propelled accessory programmes to fight black money:** Another remarkable feature of demonetisation is that it has created several other accessory measures that are needed to fight black money. Alone, demonetisation is weak; but together with these newly launched initiatives, it can create a compliant society. The main such steps are: Benami Prohibition Amendment Act, banning of cash transactions above Rs 3 lakh, Aadhaar –PAN linkage, Mandatory PAN requirement for bank savings above Rs 50000, non-cash settlement of property transactions etc. These measures have reduced the circumference of the parallel economy.
5. **Demonetisation has reduced the informal economy:** With the increased use of digital payments, economic transactions become recorded. Along with the highly digital documented GST, India's informal sector is getting absorbed into the formal economy.
6. **Enhanced Tax Compliance:** Demonetisation has addressed one of the chief demerit of India's direct tax system 'poor compliance'. Once savings, payments, income flows and other transactions are digitalized and recorded, it will give way to a better compliant society. Cashless and digital transaction society is the infrastructural foundation of a compliant society.
7. **Reduction of Counterfeit currency:** Demonetisation has dealt a death blow to the counterfeit/fake Indian currency syndicate operating both inside and outside the country. Counterfeit currency seriously devalues the real worth of Indian currency. A study conducted by Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency (NIA) suggests that fake Indian currency notes (FICN) amounting to Rs 400 crore are in circulation in the country at any given point of time and around Rs 70 crore fake notes are pumped into Indian economy every year. The estimation is based on recovery and seizure made by various agencies. But the actual figure could be much larger. A one India report, quoting an Intelligence Bureau dossier, says fake Indian currency worth Rs 12 lakh crore has pumped into Indian financial system over the years. Needless to say, that most of the fake currencies circulated in India are of Rs 500 and Rs 1000 denominations. It is also pertinent to mention that the fake currency floating inside the Indian financial system is not counted within the Rs 17 lakh crore of total currency in circulation in the country. This is an open secret that one of our neighboring country has been printing fake Indian currency at its government printing press. The neighboring nation

funnels the counterfeit currency through the frontier at Jammu & Kashmir and via India's porous border with Bangladesh and Nepal. With Prime Minister Modi's decision to pull out the old Rs 500 and Rs 1,000 notes and replace them with new Rs 500 and Rs 2,000 series has completely stalled the circulation of counterfeit Indian currency. Experts say the new currency notes have come with advanced international security features which are almost impossible to replicate.

8. **Terror financing:** Terror financing is sourced through counterfeit currency and hawala transactions. This is how terror financing works. Fake currency circulation is routed through a multi-layered network of hawala operators which are closely linked to satta (gambling) and smuggling of drugs, opium and arms. Indirectly, they all end up financing terrorism. In addition, the terrorists collect huge donations and then route the money through hawala transactions. With the circulation of counterfeit Indian currency completely stalled and hawala transactions stopped, all windows for terror financing have been closed.
9. **Blow to Naxalism :** Naxalist sympathizers (Maoist) call Modi's demonetisation move an "undeclared financial emergency". There are reasons for it. Demonetisation has hit the Naxalism and their movement hard. Black money is the oxygen for Naxalites. According to an estimate, Naxalists manage to raise Rs 300 to Rs 400 crore annually through donations, levy and extortions. The illicit money is used to purchase arms and ammunition, food and medicine and daily essentials, apart from distributing it among the ranks and the cadre. Police sources in both Chhattisgarh and Odisha have reported that the Naxalists have stashed old high denomination notes to the tune of over Rs 10,000 crore at their dumps in the dense jungles of Odisha-Chhattisgarh border. No wonder, with Modi's demonetisation drive, all those illegal moneys are reduced to paper scrap. Naxalites are in a state of coma and Naxal activities see a crippling blow. Ever since the demonetization announcement was made, no major violence was reported from the Naxal infested states like Chhattisgarh, Odisha, Andhra Pradesh and Telangana.
10. **Kashmir unrest:** The four-month-long unrest in Kashmir valley is on a backburner, thanks to demonetisation. According to DGP J&K in October 2017, there has been a 90% reduction in stone pelting on security forces ever since the demonetisation announcement was made. An intelligence estimate suggests that one of our neighboring country sends Rs 1,000 crore annually to the separatists for fuelling unrest in Kashmir. The money is transferred through hawala route. With hawala transactions completely choked up, the separatists are now clueless. It won't be wrong to say that Modi has completely shattered the stone pelters in Kashmir with his stone called demonetization and has reduced Kashmiri unrest.
11. **North-East Insurgency:** Demonetisation has severely affected the multiple militant groups operating in the North-Eastern States. According to intelligence

estimates the north-eastern insurgent groups together have a corpus of Rs 400 crore annually. The insurgents source their funding in two ways. They raise funds through levy and extortions like the Maoists do. But unlike Maoists, the leaders of North-East militant outfits do not live in the jungle. Their English-speaking high-ranking leaders run operations from their dens in Myanmar, Bangladesh and Nepal. From there they also transfer huge illegal money via hawala route to their cadre for running the militancy. With the extortion money stopped completely in the absence of cash inflow and hawala operations coming to a complete halt, all activities of North-East militants have shuttered down.

The Sectoral Impacts: 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 sectoral basis, the commodities and agricultural sector, including the market for consumer durables and nondurables is expected to feel the heat. In the short to medium-term, large denomination purchases will likely be made via electronic purchases rather than through brick-and-mortar outlets. This will impact the retail sector adversely. The luxury goods market is also likely to get affected as this move represents an erosion of real wealth to a large extent. Areas of sub-sectoral impact will be felt in luxury cars, SUVs, gems, jewellery, gold and high-end branded products.

The real estate sector is likely to see a significant negative impact in the medium- to long-term, particularly in the repurchase market. There are expectations of a revaluation of current real estate transactions across the board representing possible losses to players in the sector. The luxury goods market is also likely to get affected as this move represents an erosion of real wealth to a large number of people.

On the positive side, there is likely to be a reset of spending patterns as this move represents indirectly a significant push towards a cashless economy. Businesses in the fin-tech sector, including payment banks, mobile wallets, electronic transfer providers, etc., are expected to see gains.

4. Conclusion

If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand, if the money finds its way in the economy it could have a meaningful impact. However, experiences from different countries shows that the demonetisation move was one of the series that failed to fix a debt burdened and inflation-ridden economy. Altogether, demonetisation has produced some pleasant and surprising good effects on the economy; whatever may be the quality of economic logic behind it. Given the short-term and medium-term negative feedback effects are gone, the government can continue with the group of supportive measures to eradicate the evil of black money.

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