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RESEARCH ARTICLE

IMPACT OF DEMONETIZATION ON THE INDIAN ECONOMY

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ABSTRACT

Demonetization announced on November 8, 2016 was aimed at dealing with corruption, black money, counterfeit currency and terror financing. Although demonetization holds enormous potential benefits in the medium to long-term, given the scale of operation, it was expected to cause temporary disruption in economic activity. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy. Further, the impact of such a move would vary depending on the extent to which the government decides to demonetize. This paper elucidates the impact of such a move on the availability of credit, spending, and level of activity and government finances. Overall economic activities will be dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits. It is clear that as of now, we are yet to come to grips with Demonetization and it would be prudent to say that unless there is more investigation into what the measure achieved or did not achieve. It would be best to say that structural reforms such as Demonetization often take time and clear thought as well as flawless execution before they begin to bear fruit. This means that we should wait until 2019 to see if demonetization succeeded or failed and considering the peoples' opinion in the coming elections over the next couple of years.

INTRODUCTION

Concept of Demonetization

Demonetization is the act of removing the current currency from the economy and replacing it with the new one. It is the step taken up by the Government generally with the motive of removal of corruption. Moreover it is the act of depriving of value of currency for official payment. It does not only include the currency but also include the precious metals. Originally Demonetization is the French word "demonetiser" dating back to 1850-55.

The reasons for the Demonetization are,

- To fight with inflation,
- To beat the corruption,
- To remove counterfeit currency and
- To discourage the cash system.

Developing country like India has to find the solution of problems like this for betterment of country. In 1982, Ghana took the decision to demonetize their 50 cedi currency, which created chaos and the decision was not well come. Afterwards Nigeria (in 1984), Myanmar (in 1987), Soviet Union (1991), North Korea and Zimbabwe had also took this type of decision in past.

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History of Demonetization in India

It is not the first time in history, that government has taken this kind of step. It has been happen twice in the past. The first currency ban was announced as on 12th January, 1946 (Saturday) by RBI headquarter. At that time currency notes of 1000 and 10,000 were totally removed from economy. Both the notes were re-introduced in year 1954. At that time people had given 10 days time period to exchange the notes. Further that was extended to 15 days more where by people has to give reasons why they had not exchanged it in previous 10 days. It had not created much effect at that time. By the end of 1947 out of Rs.143.97 crore, notes of only Rs. 134.9 crore were exchanged. Thus notes worth Rs. 9.07 were perhaps "Demonetized". The second currency ban was made on 16th January, 1978(Monday), announced by R. Janaki Raman a senior official of RBI, and at the time of Morarji Desai led Janata party. At that time currency ban was taken 1000,5000 and 10,000 out of circulation. That time the people had given only 3 days to exchange the notes. This time around 73.1 crore was demonetized. Finally the 3rd, the most recent demonetization had been announced as on 8th November, 2016 by Prime Minister Narendra Modi. This time the currency of 500 and 1000 notes are demonetized from economy. The Government has instructed the hospitals, petrol pumps, airports etc to accept the old denomination notes till 11th November, 2016.

A brief overview

On November 8, 2016, the government announced a historic measure, with profound implications for the economy. The two largest denomination notes, Rs 500 and Rs 1000, were “demonetized” with immediate effect, ceasing to be legal tender except for a few specified purposes. At one fell stroke, 86 percent of the cash in circulation was thereby rendered invalid. These notes were to be deposited in the banks by December 30, 2016, while restrictions were placed on cash withdrawals. In other words, restrictions were placed on the convertibility of domestic money and bank deposits. The aim of the action was fourfold: to curb corruption; counterfeiting the use of high denomination notes for terrorist activities; and especially the accumulation of “black money”, income that has not been declared to the tax authorities.

It followed a series of earlier efforts to curb such illicit activities, including the creation of the Special Investigative Team (SIT) in the 2014 budget;

- The Black Money and Imposition of Tax Act 2015;
- Benami Transactions Act 2016;
- The information exchange agreement with Switzerland;
- Changes in the tax treaties with Mauritius, Cyprus and Singapore; and
- The Income Disclosure Scheme.

Demonetization was aimed at signaling a regime change, emphasizing the government’s determination to penalize illicit activities and the associated wealth. In effect, the tax on all illicit activities, as well as legal activities that were not disclosed to the tax authorities, was sought to be permanently and punitively increased. India’s demonetization is unprecedented in international economic history, in that it combined secrecy and suddenness amidst normal economic and political conditions. All other sudden demonetizations have occurred in the context of hyperinflation, wars, political upheavals, or other extreme circumstances. But the Indian economy had been growing at the fastest clip in the world on the back of stable macroeconomics and an impressive set of reforms. India’s action is not unprecedented in its own economic history: there were two previous instances of demonetization, in 1946 and 1978, the latter not having any significant effect on cash. But the recent action had large, albeit temporary, currency consequences. The annual percentage changes in currency since 1953. For 2016-17, this change is expected to be only 1.2 percent year-on-year, more than 2 percentage points lower than four previous troughs, which averaged about 3.3 percent. In the wake of the Global Financial Crisis (GFC), advanced economies have used monetary policy to stimulate growth, stretching its use to domains heretofore considered heretical such as negative interest rate policies and “helicopter drops” of money. In fact, India has given a whole new expression to unconventional monetary policy, with the difference that whereas advanced economies have focused on expanding the money supply, India’s demonetization has reduced it. This policy could be considered a “reverse helicopter drop”, or perhaps more accurately a “helicopter Hoover”. The public debate on demonetization has raised three sets of questions.

- First, broader aspects of management, as reflected in the design and implementation of the initiative.
- Second, its economic impact in the short and medium run.
- Third, its implications for the broader vision underlying the future conduct of economic policy.

Objective

The objective of the study is to study the impact of demonetization on various sectors of the Indian economy.

A move towards a cashless economic framework

Cash transactions were another tool for unscrupulous parties to refrain from paying the necessary taxes and duties. The call for demonetization will make the Indian economy to embrace the plastic money to a higher extent. This will bring more transactions in the market under the supervision of the government. According to an estimate by State Bank of India, out of Rs 12 lakh crores in the cash economy, Rs 3 lakh crores may never come back into the system. So, this will be the monetary surplus in the Reserve Bank of India. Out of the Rs 12 lakh crores that comes in, the government should get substantial tax revenue of about Rs 2 lakh crores. This should have far-reaching consequences on the Indian growth story. But if Rs 5 lakh cores come into the banking system, because of the fractional reserves basis, this Rs 5 lakh crores can become Rs 20 lakh crores. Let us assume Rs 100 is deposited in a bank. About one quarter of the amount will be invested in government bonds and reserves. The remaining 75 per cent will be available for lending. This 75 per cent gets into the banking system. Our study estimate is, that at a minimum, the banking system multiplies the money in the system by three or four times. Money creation by banks wills increases prosperity. The black or the cash economy therefore is inefficient in using money this way.

Impact of demonetization

Understanding the benefits and costs of demonetization requires spelling out the analytics of demonetization, which are rich and complicated. Analytically, demonetization should be seen as comprising the following:

- A money supply contraction but only of one type of “money” cash;
- A tax on unaccounted private wealth maintained in the form of cash black money; and
- A tax on savings outside the formal financial system.

SHORT-TERM AND MEDIUM-TERM IMPACTS

Very short-term impact

The demonetization, by removing 86 per cent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy.

Impact of demonetization

Sector	Impact	
Money/interest rates	Effect through end-December	Likely longer-term effect
	Cash declined sharply	Cash will recover but settle at a lower level
	Bank deposits increased sharply	Deposits will decline, but probably settle at a slightly higher level
	RBI's balance sheet largely unchanged: return of currency reduced the central bank's cash liabilities but increased its deposit liabilities to commercial banks	RBI's balance sheet will shrink, after the deadline for redeeming outstanding notes
	Interest rates on deposits, loans, and government securities declined; implicit rate on cash increased	Loan rates could fall further, if much of the deposit increase proves durable
Financial System Savings	Increased	Increase, to the extent that the cash deposit ratio falls permanently
Corruption (underlying illicit activities)		Could decline, if incentives for compliance improve
Unaccounted income/black money (underlying activity may or may not be illicit)	Stock of black money fell, as some holders came into the tax net	Formalization should reduce the flow of unaccounted income
Private Wealth	Private sector wealth declined, since some high denomination notes were not returned and real estate prices fell	Wealth could fall further, if real estate prices continue to decline
Public Sector Wealth	No effect.	Government/RBI's wealth will increase when unreturned cash is extinguished, reducing liabilities
Formalization/ digitalization	Digital transactions amongst new users (RuPay/ AEPS) increased sharply; existing users' transactions increased in line with historical trend	Some return to cash as supply normalizes, but the now-launched digital revolution will continue
Real estate	Prices declined, as wealth fell while cash shortages impeded transactions	Prices could fall further as investing undeclared income in real estate becomes more difficult; but tax component could rise, especially if GST imposed on real estate
Broader economy	Job losses, decline in farm incomes, social disruption, especially in cash-intensive sectors	Should gradually stabilize as the economy is demonetized
GDP	Growth slowed, as demonetization reduced demand (cash, private wealth), supply (reduced liquidity and working capital, and disrupted supply chains), and increased uncertainty	Could be beneficial in the long run if formalization increases and corruption falls
	Cash-intensive sectors (agriculture, real estate, jewelers) were affected more Recorded GDP will understate impact on informal sector because informal manufacturing is estimated using formal sector indicators (Index of Industrial Production). But over time as the economy becomes more formalized the underestimation will decline. Recorded GDP will also be overstated because banking sector value added is based (inter alia) on deposits which have surged temporarily	Informal output could decline but recorded GDP would increase as the economy becomes more formalized
Tax collection	Income taxes rose because of increased disclosure Payments to local bodies and incomes increased because demonetized notes remained legal tender for tax payments/clearances of arrears	Indirect and corporate taxes could decline, to the extent growth slows Over long run, taxes should increase as formalization expands and compliance improves
Uncertainty/ Credibility	Uncertainty increased, as firms and households were unsure of the economic impact and implications for future policy Investment decisions and durable goods purchases postponed	Credibility will be strengthened if demonetization is accompanied by Complementary measures. Early and full demonetization essential. Tax arbitrariness and harassment could attenuate credibility

This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash.

- In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing. For instance, transport services, *kirana*, fruits and vegetables and all other perishables, would face compression in demand which is backed by purchasing power. This in turn can have two effects: while it is expected that supply exceeds demand, there would be a fall in prices, however, if supply too gets curtailed for want of a medium of exchange, prices might, in fact, rise. Thus, while generally people seem to expect prices to fall, it is quite possible that prices would instead rise.
- Alternatively, to keep the flows going, people might take recourse to credit - both the retailers and other agents in the economy might make supplies on credit in the hope that when the liquidity status is corrected, the payments can be realized. In these cases, the price of commodities might rise instead of falling. In other words, the impact of an incremental reduction in money supply where the demand and the supply chain remain

unaffected would be different from a case where there is a drastic reduction in money supply and outputs might adjust rather than the adjustment being in prices. In other words, the expectation that inflation would decline might be belied.

- A further impact would be a compression of the demand for non-essentials by all the agents in the economy in the face of uncertainty in the availability of cash. The demand from segments which have access to digital medium of exchange would remain unaffected, but that from the rest of the economy would get compressed. This would transmit the effect to the rest of the sectors in the economy as well.
- Another sector where one expects to see effects in the very short run is the real estate space. With contraction in demand from one set of agents – say agents who have earned unaccounted incomes and placed them within the real estate space – either prices within this segment would fall or transactions would cease to happen. While of itself, this would be considered a positive development and evidence of a correction in the unaccounted incomes, it could lead to a compression in investments in the construction sector which can have adverse income and employment consequences for the economy.
- There are likely to be two spin-offs from this change – one, there would be some increase in tax collections in the short term, and second; various IOUs could emerge as currency substitutes. To the extent people attempt to get rid of unaccounted cash balances through purchase of goods and services and/or payment of property taxes, one should witness a spurt in tax collections in indirect taxes as well as property tax in the month after demonetization which would disappear thereafter. There is evidence already that property tax collections in some cities are higher than last year. Similarly, in the case of currency substitutes, at MCD tax collection centers at the border, people are being given IOUs in lieu of the balance they were entitled to, which would be valid for six months.

Short-term effect with incomplete replacement:

- If, on the other hand, the authorities choose to replace only a fraction of the total cash that was surrendered by the people to the banking sector, then one would witness some other changes/effects in the economy. For transactions to be restored to the pre-change level, a number of agents who are using cash as a medium of exchange have to move to using digital versions of money as the medium of exchange. While this change is gradually happening in the economy, if it is forced by making cash inaccessible, the compression in demand as well as in income generation in the economy would continue for a longer period until people get familiar with the functioning and use of these media.

Medium-term effects

- In the medium term, the effects would be related to the extent to which the currency is not replaced within the economy. If the entire currency is replaced, there would not be any major effects on the economy. However, it is to be expected that the entire currency would not be replaced – to the extent currency is extinguished and to the extent some of the currency remains as bank deposits, there would be some impact on the economy. The first effect would be a compression of the economy to the extent the extinguished currency was working as a medium of exchange. The currency that is placed in the banks but not withdrawn, it is argued, would generate an expansion in deposits in the economy. In the discussions on demonetization, there is a consistent reference to the resultant increase in credit creation in the economy. Like Finance Minister Arun Jaitley says, "Bank deposits will increase and they will have more capacity to support the economy."4 The total cumulative credit that can potentially be generated is defined in terms of the reserve ratio. Total credit potential = incremental deposit generated*(1/reserve ratio)
- In India, the cash reserve ratio is 4 per cent while there is a statutory liquidity ratio of 22 per cent5. In determining the credit creation, it is important to take into account only the CRR and the additional credit creation can be 25 times the amount of money deposited in the banks as a result of the proposed demonetisation. 6 This amount however, will be generated only if there exists an equivalent demand for credit in the economy.

Impact of demonetization on Indian econmy

Not all sectors of the economy are going to be equally hit by the demonetization. Some industries are particularly prone to illicit transactions. These sectors include real estate and bullion. Both these areas saw heavy short selling in the stock market in the day immediately after the crackdown on black money. The price of gold is expected to rise higher as people will hoard their future black money in gold. However, the prices of real estate are expected to come down by 15% to 20%. For the overheated property market, this may actually be a boon.

The Deflationary Effect

In the beginning, the money supply of India will be severely curtailed. Approximately $85 billion in black money circulates in India. Not even one-fourth of the money may be legalized into the new currency. This may levy a substantial deflationary pressure on the economy. The prices of everything from real estate to food stuff will decrease making people richer in terms of purchasing power.

The Inflationary Effect

In the medium to long term, the demonetization is likely to have an inflationary effect on the economy. This is because banks can increase the money supply with the help of something called as a money multiplier. Thus every rupee invested in a bank will lead to loans worth four or five rupees circulating in the market. As soon as the banks can start lending money to the people, the inflation will resume. This inflation is likely to bring the asset prices back to ground zero albeit with a little correction. Black money's favorite hoarding asset classes like real estate will not be overpriced.

The End Result

In the end, the inflationary and deflationary effects are likely to set off each other and cause a balance. However, critics argue that Modi has only targeted the stockpile of black money currently present. What about the generation of new black money. The government has not taken any measures to curb the new supply. Hence the problem of black money has not really been solved.

Summary

Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes, there occurred huge gap in the currency composition as after Rs 100; Rs 2000 is the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination. Demonetization 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 may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts. Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.

I. **Liquidity crunch (short term effect):** liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Current reports indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 million Rs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 million units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

II. **Welfare loss for the currency using population:** Most active segments of the population who constitute the 'base of the pyramid' 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 will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class. There will be a trickle up effect of the liquidity chaos to the higher income people with time.

III. **Consumption will be hit:** When liquidity shortage strikes, it is consumption that is going to be adversely affected first.

Consumption ↓→ Production ↓→ Employment ↓→ Growth ↓→ Tax revenue ↓

IV. **Loss of Growth momentum**- India risks its position of being the fastest growing largest economy: reduced consumption, income, investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.

V. **Impact on bank deposits and interest rate:** Deposit in the short term may rise, but in the long term, its effect 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 deposit. It may be en-cashed 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.

VI. **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 demonetization depends upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. Such a nationwide awareness and urge will encourage government to come out with even strong measures.

VII. **Impact on counterfeit currency:** the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

VIII. Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

Conclusion

As a measure that was intended to check corruption and launch a war on Black Money, the intentions of Demonetization were certainly good considering the fact that rampant corruption exists at all levels of Indian society as well as the fact that the Scourge of Black Money is so deep and widespread that unless, shock therapy, was administered. There was no way in which the malaise of Black Money could be eradicated. In addition, as the metaphor used by many to refer to Demonetization as surgery performed on the Indian Economy, the fact that it was undertaken when the patient was healthy means that some good has certainly come out of the policy. Indeed, the fact that the country now has a wider tax base on account of the fear of the black money holders of the law, the measure certainly helped in this respect. Moreover, the fact that world over, countries are moving towards a cashless paradigm means that if India has to join the league of developed nations, it certainly has to administer some strong medicine that is disruptive in nature. Moreover, the move towards Digitization of payments and commercial transactions or the dream of Digital India is a good move since the majority of Indians are under 30 which mean that to guarantee a future for them; it is necessary to make a behavioral change in them. Indeed, the whole exercise was spun as an attempt to induce a behavioral change among Indians to move towards a corruption free, and digital country which is certainly needed if India has to progress.

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