

Impact of Demonetization on Indian Economy

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Abstract

The argument to place in favour of demonetisation is that the cash that would be extinguished would be “black money and fake currency” and hence, should be rightfully extinguished to set right the unreasonable incentive structure in the economy. While the facts are not available to anybody, it would be foolhardy to argue that, this is the only possibility. 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.

Keywords: demonetization, cashless transactions, credit, tax evasion

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I. INTRODUCTION

Demonetization is a process by which a series of currency will not be legal tender. The series of currency will not acceptable as valid currency. The same thing happens with the Rs. 500 and Rs. 1000 note demonetisation.

The causes of demonetization?

1. There can be many causes of demonetisation in any economy some of them are: Introduction of new currency, black marketing, currency storage, corruption and others.
2. There will be excess fake currency in the economy is main reason of demonetisation.

History of demonetization and background in India?

This is not the first time when Indian currency is demonetised in India

1. The first instance was in 1946(The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938)
2. The second in 1978(Higher denomination banknotes of Rs 1,000, Rs 5,000 and Rs 10,000 were reintroduced in 1954)
3. The third in 2016 (the. Rs 500 note came into circulation in October 1987. Rs 1,000 note made a comeback in November 2000 The move was then justified as attempt to contain the volume of banknotes in circulation due to inflation).

II. INSIGHTS – ‘DEMONETIZATION’ AND ITS IMPLICATIONS

The demonetization drive initiated by the Indian government is going to have far reaching impact on

the Indian economy. It is being considered as one of the most significant step in tackling the black and fake money issue that has gripped our country since many years. Some of the effects of the demonetization measure are:

1. The total currency in circulation as on Oct 28, 2016 was INR 17.54 lakh crores. According to the Reserve Bank of India (RBI), 86% of this component is in currency notes of INR 500 and INR 1000 denomination. Therefore, the currency that is being attempted to be demonetized is around Rs. 15 lakh crores. It is being estimated (internal estimates) that around 20% of this currency is in black. We believe that this money either will not come back into the system for exchange for new notes or will be surrendered as black money and taxes thereon will be paid.
2. The deposit of these notes with the commercial banks ends on December 30th, 2016. Thereafter, currency notes will have to be deposited with RBI till Mar 31st, 2017. We believe that after this date, the RBI will reduce notes in circulation to the extent of the money not deposited. To match its liability, it will have to reduce its asset or increase its liability. Increasing its liability would mean increase in its net non- monetary liabilities (or reserves) and declare special dividend (just an accounting entry) to the government. The government, in turn can reduce its bonds on the RBI’s balance sheet by buying its bonds back from the reserves transferred by the RBI. The government will have multiple options about what it could do with this special dividend. It

may reduce domestic outstanding debt, prepay external debt, reduce fiscal deficit as interest cost drops, and reduce its borrowing for following years. Improvement in debt/gross domestic product (GDP) ratio should also help improve the country's sovereign rating by the international agencies. RBI's balance sheet also frees up for supporting liquidity requirements of the banking system.

3. On the other hand, the banking sector is going to see a surge of liquidity as deposits get collected. Based on our assumption (internal estimates) that (20% of currency will not be tendered back), there is going to be tendering of currency from the public to the tune of Rs. 12 lakh crores (80% of Rs. 15 lakh crores). Due to the temporary restrictions on withdrawing cash, our internal estimate is that at least 50% of the cash will remain within the banking system, i.e. of Rs. 6 lakh crores. This sudden surge in deposit of 6% of current aggregate deposits will help in improvement of liquidity. This will lead to demand for fixed income securities, particularly government securities.
4. According to a world bank estimate in 2007, around 20-25 % of India's GDP is the size of the parallel black economy. The steps taken by the Indian government has led to a scare in the parallel black economy and should lead to better tax compliance going ahead. This will have a telling effect on the other heavens of black money i.e. real estate and gold. Both these sectors are going to witness reduced demand. Lower demand for gold resulting ultimately in lower import of gold is expected to improve the current account balances. The Indian rupee should remain stable and display appreciating bias against hard currencies, as the current account improves and may also move into surplus.
5. The sudden change due to reduced cash transaction will lead to reduction in economic activity. We believe that the services sector growth will be majorly affected. This will lead to lowering of inflation expectation and moderation of headline inflation too. However, the effect on inflation would depend on the moderation in economic activity in those sectors that have heavy cash transactions. RBI will find larger room to reduce repo rates with moderation in inflation.
6. There are some other positives expected over the medium to long term. A more compliant economy should increase tax collections and tax to GDP ratio should improve from both direct and indirect tax. In future, an increase in use of plastic money rather than hard currency would also lead to higher money multiplier which will

be more productive. To sum up, the fight against corruption, terror funding, counterfeit currency and the black economy should result in,

7. Increased systemic liquidity leading to higher demand for bonds
- E. Rate reductions due to lower inflation and inflationary expectations
- F. Stable to appreciating INR as current account deficit improves due to lower demand for gold
- G. Higher tax to GDP
- H. RBI freeing up balance sheet as liability declines
- I. Government would be able to bring down its outstanding debt liability and improve fiscal deficit
- J. Immediate near term impact – decline in cash transactions may lead to reduction in consumption demand leading to some decline in the GDP growth.

III. ADVANTAGES OF DEMONETIZATION

1. **Attack on black money holders:**
People who possess huge amounts of black money in hard cash are at a complete loss now. Their black money in hard cash is now a pile of trash. Now if a black money holder wants to deposit money in bank account than he/she has to show ID. There Will Be 200 % penalty on income tax amount
2. **Death knell to fake currency rackets**
Most of the fake currencies used to be in the denominations of Rs. 500 and Rs. 1000. By banning Rs. 500 and Rs. 1000 notes; Modi ji has busted all these unethical rackets completely. Now there will be no use this money
3. **End of terrorist funding**
Huge sums of money especially in hard cash in the denominations of Rs. 500 and Rs. 1000 was used to fund Islamic terrorists, naxalites and other non-state actors. Now, these organizations will suffer from shortage of funds. Most of these terrorist, maoist organization used these funds for buying arms and weapons. Buying arms is an extremely difficult task now after this ban.
4. **Transparency**
Online transaction = more transparency = financial intelligence unit will. Tack all online transactions now there will be more transparency in real estate sector
5. **End of huge donations**
Huge amounts of donation that is taken in the private education and healthcare sectors would be stopped. Schools, engineering and medical colleges and hospitals (private ones) used to take huge amounts of money as donations especially in the form of hard cash in the

denominations of Rs. 500 and Rs. 1000. These money-minded people running these institutions won't be able to make any easy money now. Same applies to the real estate sector.

6. Towards a cashless economy

While it is practically impossible to have a 100% cashless economy, the proportion of hard cash in the economy will decrease and our economy will get more digitized. This will result in greater transparency. Now government has put some limitation for cash withdraw from bank accounts. People will go for online payments. They will use Paytm or other online payment companies for buying goods or making payments. More use of debit and credit card

7. Hawala transactions end

Most hawala transactions used to be carried out in the denominations of Rs. 500 and Rs. 1000. With this ban, Modiji has delivered a fatal blow to the unethical hawala traders as they can't trade anymore using denominations of Rs. 500 and Rs. 1000.

8. Improving of income tax and sales tax

9. Repayments of bank loans are increased

IV. DISADVANTAGES OF DEMONETIZATION

1. Rush at banks

Banks will be extremely over-crowded by people. People will forget everything else and throng to the places where the banned notes are being officially exchanged leading to a tremendous chaos.

2. Shortage of money to common people

There will be shortage of money for common people.

3. Stock market

Due to currency being sucked out of the market coupled with Trump's victory, the mood at the stock market was completely bearish. Sensex lost 1600 points at open. This can adversely have a negative effect on trade in general.

4. Problem for house wives

Many Indian housewives store money secretly so that they could be of help during times of financial crisis in their households. The accumulated money of our respected Indian housewives is of no use now until they exchange in the banks and post-offices.

5. Short term inflation

Due to shortage of money in the market, short-term cost push inflation will occur. The price of gold has already become sky high. Prices of vegetables and fruits have also soared burdening the common man

6. Marriage Season

Difficult for those families those have weddings.

Impact of Demonetization on Indian Economy

Impact of demonetization on various sectors of India. Both long term and short term impact of demonetization, positive and negative impact of demonetization on Indian economy.

Effects on parallel economy

1. The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee notes is expected to – remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks
2. Temporarily stall the circulation of large volume of counterfeit currency
3. It would curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

Effects on money supply

1. With the older 500 and 1000 rupees notes being scrapped, until the new 500 and 2000 rupees notes get widely circulated in the market, money supply is expected to reduce in the short run.
2. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money and hence money supply will decrease permanently.
3. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.

Effects on demand

The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly:

1. Consumer goods
2. Real Estate and Property
3. Gold and luxury goods
4. Automobiles (only to a certain limit)

All these mentioned sectors are expected to face certain moderation in demand from the consumer side, owing to the significant amount of cash transactions involved in these sectors.

Effect on Prices

Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

1. **Consumer goods:** Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
2. **Real estate and property:** Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheque transactions.

Effect on GDP

1. The GDP formation could be impacted by this measure, with reduction in the consumption demand.
2. However with the recent rise in festival demand is expected to offset this fall in overall impact.
3. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and re-enter the stream once the cash situation becomes normal.

Effect on online transactions and alternative modes of payment:

1. With cash transactions facing a reduction, alternative forms of payment will see a surge in demand.
2. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increase in demand
3. This will Bring more transparency In system And you can easily track online money

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