

## **A Study on the Recent Demonetization in India and its Impact**

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### **Abstract**

Prime Minister Narendra Modi has announced the Demonetisation of Rs.500 and Rs.1000 notes through an unscheduled announcement on National Television on November 8, 2016. Through this move, the Government has made an attempt to tackle the three main issues affecting the Indian economy i.e. a parallel economy, counterfeit currency in circulation and terror financing. The Prime Minister has pulled out a major move and substantially enhanced his reputation as a strong leader. Similar demonetisations of banknotes have been taken in the past. In 1946, Rs.1,000, Rs.10,000 banknotes were withdrawn. In 1954, Rs.1,000, Rs.5,000, Rs.10,000 notes were reintroduced but again demonetized in January 1978. This research paper attempts to study the Demonetization, its impact on the Indian economy and analyse its benefits and consequences in detail.

### **INTRODUCTION**

At the stroke of the hour on midnight of 9<sup>th</sup> November 2016, Demonetization became the hottest topic of discussion in India. The honourable Prime Minister of India Shri Narendra Modi made an announcement and declared that the currency with denominations 500/- and 1000/- would cease to be a legal tender. The televised address of Prime Minister Narendra Modi stunned the entire country. This bold move of his meant India losing its 86% of monetary base. While few applauded this brave move and categorised it as a masterstroke, it also garnered criticism and counterviews. Demonetization is defined as a radical financial step in which a currency unit's status as a legal tender is declared invalid. This move is usually executed when old currencies have to be replaced by new ones or whenever there is a change of national currency. However, given the extent to which the project has to be executed, the move has to be well planned

in advance. The purpose of this move by the Indian Government was to tackle the black money in the economy whilst eliminating the fake currency in circulation. These fake currencies have long been used by the terror groups to fund terrorism in India. Demonetization is an established practise in monetary policy to tackle black money. This move has also been termed as a surgical attack of the Prime Minister on the black money. While this move aims to wash the stock of "black money" from the economy and get it into the licit, banked and taxable part of the economy, the current demonetization has technically been termed as a liquidity shock which has led to sudden crunch in currency availability.

### **OBJECTIVES OF STUDY:**

- To understand the various aspects of the recent demonetization in India.
- To analyse the benefits and consequences of demonetization on the Indian economy.

### **RESEARCH METHODOLOGY**

This research is conducted on the basis of the secondary data collected from various websites, Journals and Newspapers regarding Demonetization in India.

### **REVIEW OF LITERATURE**

The decision of Prime Minister Narendra Modi to demonetize Rs.500 and Rs.1000 notes met with mixed reactions. There are views and counter views. Several Bankers and businessmen have come forward and appreciated the move in the sense that it would help curb black money and it would also accelerate e-commerce. On the contrary several political leaders opposed it. An editorial by EPW states that a 2015 study by the Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency had estimated Rs.400crore worth of fake currency roughly 0.027% of the Rs.14.73 lakh crore worth of the currency demonetised is in circulation in the Indian economy. This move, at best, is a one-time step to remove fake currency in circulation. But the National Crime Records Bureau reports show that this exercise has been carried out systematically every year and there is no guarantee that the problem will not resurface in the near future.

There are studies which show estimates of just 5%–6% of the black money actually held in cash. Surely a policy that puts so much at stake to weed out such a small proportion of the black economy is not justified. Importantly, people have already devised various mechanisms to launder their unaccounted wealth held in cash. The daily wage labourers who cannot be paid wages in cash and are unable to make simple transactions like buying essentials are the worst affected. While the urban population, the formal sector and the

middle classes may still be able to wait for a “few” weeks with cashless transactions, it can hardly be imagined how the poor, who are dependent on daily earnings, can manage to wait it out till the liquidity problem is sorted out. Those who criticise this move even ask how the Reserve Bank of India could go along with their pronouncement of such an experiment which increasingly seems to be without adequate thought or preparation. A lot could have been done before such a drastic step was taken. There are views which say the idea of demonetization is good but it has to be taken into consideration that most of the black money is kept in the form of land, buildings or gold or kept abroad. What is in cash constitutes only 4% of the total amount of black money on which taxes are not being paid.

Small farmers, sellers, merchants, daily wage labourers and traders are suffering because of lack of proper planning, intelligence and foresight such as recalibration of ATM machines. There was need to pile up enough 100 Rupee notes and other smaller denomination notes in the market before taking this step. It is being said by critics that this step was taken only to bolster the image of the Prime Minister as he has been unable to deliver on GDP growth, inflation and bringing the black money from abroad. The domestic stock market has reacted negatively to demonetisation and opened lower after digesting the intense social media heat both for and against demonetisation. However, the market gained later and reacted calmly by the close of the week. Economic Times reports show that demonetisation could bring the real estate prices down.

## IMPACT OF DEMONETIZATION ON INDIAN ECONOMY

### How quickly transactional cash changes hands in the legitimate Indian economy?

Velocity of money is the ratio between GDP and money in circulation—which RBI estimates to be around 1.3 for India. However by ‘money’, it does not mean the cash that we exchange in day-to-day transactions. Instead it is broad money where you also include bank deposits, post office savings and other bits and pieces of financial savings.

These two transactions of money in India are linked by a factor of 6. So, if velocity of money calculated using broad money is 1.3, and then it equates to six-times the amount with respect to cash in circulation. So we now have a measure of how quickly transactional cash changes hands in the legitimate Indian economy.

### Effect on GDP:

Demonetization has had an adverse effect on the GDP of the country with GDP growth estimates falling sharply as a result of the cash squeeze created in the country.

For the FY 17, the domestic economy was projected to grow at above 7.5 per cent with the International Monetary Fund (IMF) itself raising its projections by 0.2 percentage points this October to 7.6 per cent for 2016-17 and also for 2017-18. In July, World Bank projected India to grow at 7.6 per cent in 2016-17. Rating agency Fitch earlier this year had projected India's real GDP to accelerate to 7.7 per cent in 2016-17 and 7.9 per cent in 2017-18. The economy expanded at 7.6 per cent in financial year 2015-16, outpacing China for the second year in a row.

Post-demonetization, GDP growth projections for the Indian economy for FY17 has slipped to as low as 3.5 per cent. In comparison, the Chinese economy has been growing at around 6.7 per cent this year for three quarters in a row.

### Surge in digital transaction system and alternate modes of payment:

With shortage of cash in circulation, people are turning to online options, doubling downloads of payment applications (App). Kirana stores and investors alike now want to tie up with digital wallet start-ups.

- Paytm, the largest Indian mobile payment wallet with more than 100 million users and 2 million transactions a day, saw app downloads going up by three times and payments for offline transactions by five time in the first two days following the government's move.
- MobiKwik, which has around 35 million customers, saw 100% growth in customer numbers day-on-day in the past few days.
- Mobile payment app Chillr, which has 2 million downloads and is promoted by HDFC, has seen a growth of 30% in app usage and a 50% increase in downloads.
- PayU's digital wallet business, which has over 30 million consumers, saw the amount of wallet loads rise two times in the first two days.

Online transactions using E banking, usage of Plastic money (Debit and Credit Cards) etc. has also seen a substantial increase in numbers. This should eventually lead to strengthening of such systems and the necessary infrastructure required.

### The positive aspects of Demonetization:

1) Demonetization has lead people to deposit their holdings in cash in the bank. As on 18<sup>th</sup> November 2016, banks have received Rs. 5.12 trillion worth deposits. The increase in the deposits with the banks has brought the interest rates down thus making the economy vibrant, with capital inflows.

2) At present only 2.6% of the population pay taxes. With this bold move by the Modi government, evading taxes won't be an option as all accounts are linked with Aadhar and PAN card. So, money can be tracked. This was a planned move by the government.

3) Know Your Customer (KYC) was introduced wherein people were mandated to submit all their documents including PAN card and Income Declaration Scheme (IDS) urged the hoarders of undisclosed income to pay income tax with surcharge and penalty for the undisclosed amount in previous financial years thus getting immunity from any kind of enquiry.

4) The Government made its final move with Demonetization, wherein the hoarders of undisclosed money were left with worthless wad of 500 and 1000 banknotes.

5) It will help the government to fight Black money, corruption, terrorism and counterfeit currency with one single decision. As a result of which Arms smuggling, espionage and terrorist related activities will be choked due to lack of funding.

6) There has been a substantial decrease in the terrorist activities in Jammu and Kashmir like paying people to pelt stones, as the funding for these activities have stopped due to non-availability of money.

7) This decision will help institutionalize the real estate sector bringing more transparency in the Indian real estate industry. This step would give the Indian real estate sector more credibility making it more attractive to the foreign as well as domestic investors.

8) People who belong to the middle and upper middle class of the economy were not impacted as much as the people belonging to the lower strata of the economy as most of them already have access to internet banking and other digital systems for transactions. This move has hence pushed people of all the strata to come forward and accept the digital infrastructure which will eventually help India in becoming a cashless economy in times to come.

9) The move to ban the Rs500 and Rs 1000 notes to curb black money and counterfeit currency wouldn't have been successful if it wasn't put forward in an unscheduled announcement as people would have found ways to secure or transform their black money to white.

#### **Negative effects of Demonetization:**

1) People in the economy are facing liquidity shock, meaning people are not able to get sufficient volume of currency due to lack of proper planning prior to the implementation of demonetization. As on 28th October 2016 the total banknotes in circulation in India was Rs. 17.77 lakh crore of which Rs. 14.18 lakh crore was in the form of Rs.500 and Rs. 1000 banknotes (i.e. 86% of the total currency in circulation in the form of Rs.500 and Rs.1000 banknotes) was stripped off its legal tender status as a part of the surgical strike without proper arrangements to replace the same.



2) The announcement of demonetization on the night of 8<sup>th</sup> November 2016 by the Prime Minister, Narendra Modi, along with the message that the ATMs will be shut for the next two days and banks will be shut on 9<sup>th</sup> Nov 2016 sent a wave of shock across the nation with people trying to withdraw money in denominations of 100s leaving the ATMs dry.

3) Those in possession of unaccounted wealth were seen rushing to jewellers to buy gold. The people were willing to pay huge premiums and the jewellers were ready to accept old currency notes. The transactions took place on pre-dated bills; even VAT was paid. As a result of this rush, there was a sudden spurt in demand for gold and the prices soared high. According to market estimates, as much as \$1 billion worth of gold, or around 30 tonnes, has been imported since November 9.

4) The worst affected people were the daily wagers. Those paid in Rs.500 or Rs. 1000 had to go without food as the legal tender was no longer accepted and they didn't have debit or credit cards to pay for what they ate.

5) The long queues in front of ATMs maybe a temporary hassle. But there is no clarification on the inconvenience caused to the general public at large and what measures are taken to tackle the unbanked villages. The haphazard management and execution led people to buy and sell the old notes in a parallel black market.

6) The ATM machines weren't calibrated for the new notes that came in circulation.

The existing cassettes in the ATM machines were configured to hold the larger size currency and the first lot of 5 million new Rs 500 notes got dispatched weeks after demonetization.

7) A huge share of the black money is stashed away in foreign banks and foreign investments. This move practically has no impact on that money.

8) Only a fraction of black money exists in the form of cash. People who involve in black business turn black money into white money by spending them in real estate business or by buying gold or other assets. Most of the black money would have been already invested.

9) The government has not taken any significant measure to curb the re-emergence of counterfeit notes which may come back in circulation in near future.

### **CONCLUSION**

This bold move by the government is one of the most historical steps that India has come across and the changes that the economy would face would definitely cause certain inconveniences which should be supported by all. It will definitely have collateral damages in terms of inconveniences, lack of liquidity and adjustments. The entire financial machinery is being recalibrated and one should look at the bigger picture which is deemed to fetch results in the long term. It is too early to conclude what the macroeconomic effect of demonetization is going to be. Time will be the biggest decider.

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