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Impact of Demonetization on Indian Economy

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ABSTRACT

Demonetization is the most memorable experience of the present generation and it one of the economic event of our time. Demonetization is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data. During that time less than 5% of Indian population had access to such notes and it did not leave much impact on the population of country. It was done to avoid corrupt deals and to restrict illegal use of high denomination currency.

The current demonetization is supposed to work as a cleaning agent and may help in the production of several good things in the economy. On the one hand, it has created unavoidable income and welfare losses to the deprived sections of the society and daily wage earners and to those also who are not aware of the technology. Overall economic activities come to a hold in the short run. On the other hand, the hidden benefits of demonetization will be felt soon, more transparency, reduced usage of black currency, corrupt practices and undocumented transactions can be taken as long term benefits. The latest demonetization has a great and unexpected impact as the demonetized currency represents 86% of the total currency in circulation.

***Keywords*--** demonetization, published, currency, Businesses

I. OBJECTIVES

The main objective of this paper is to study the impact of demonetization on 8th Nov. 2016 by the present government on Indian economy and system.

II. METHODOLOGY

The paper is based on the secondary data. The secondary data was collected from various published sources like reports, magazines, journals, newspapers and the like etc.

III. INTRODUCTION

Process of removing a currency from general usage, or circulation is known as demonetization. On the evening of 8th November 2016, Prime Minister Narendra Modi made an unprecedented speech on national television, all currency notes of denominations Rs. 500 and Rs. 1000 were to lose legal sanction from midnight. While currency notes of Rs. 500 are now to be re-issued, Rs. 1000 currency notes will be completely done away with. Additionally, technologically advanced currency notes of denomination Rs. 500 and Rs. 2000 will be introduced in limited numbers from November 10. However, all notes in lower denomination will remain unaffected.

Hoping to see a 'Modified country, he gave two primary reasons for this decision; to "break the grip of illicit cash and black money on the economy" and to "check enemies from across the border using fake currency notes". As the note printing presses went into an overdrive, the course of action was called as a radical step by some, while others had conflicting views. The public called it a masterstroke, while the political opposition stood against the act calling it an 'imprudent' move that penalizes common man and is akin to burning down the forest to catch a few black sheep.

As the clock ticked down to midnight on November 8th, a huge portion of Indian society instantaneously found them stripped of the ability to interact economically. Up to that point, upwards of 95% of all transactions in India were conducted in cash and 90% of vendors didn't have the means to accept anything but. On top of this, 85% of workers were paid exclusively in cash and almost half of the population didn't even have bank accounts. Due to this cash crunch, India ground to a halt. Businesses shut down, farmers couldn't buy seeds, taxi and rickshaw drivers didn't have any way to receive payments, employers had no way to pay their employees, hospitals were refusing patients who only had old banknotes, fishermen watched their catch wither up and rot, some families had difficulty buying food, and weddings throughout the country were canceled.

IV. HISTORY OF DEMONETIZATION IN INDIA

This is not the first time India has implemented demonetization. The Government announced its first demonetization way back in 1946. Reserve Bank of India (RBI) had introduced INR 10,000 notes in 1938, and the rich hoarded money, at the expense of hyperinflation. Being on the verge of independence, the Government banned denominations of INR 500, INR 1,000 and INR 10,000 in 1946 to curb black money. But the bold move of demonetization in the past turned out to be a currency conversion drive, as the high currency notes were accessible only to the rich mass.

Demonetization shook the country again in January 1978, with the banning of INR 1,000, INR 5,000 and INR 10,000 notes. People who possessed these notes were given merely a week's time to exchange any high denomination bank notes. However, it went away as an ineffective move without impacting the economy much, as higher value notes were not a part of the common man's wallet, then. The circulation of these high-value notes was barely 2% of the total currency, as compared to today's 86% which definitely is a big concern for the Government.

V. DEMONETIZATION IN OTHER COUNTRIES

While demonetization has worked for some countries, it has been a big reason for the complete breakdown of the economy of other countries. It depends on the execution plans that decide whether demonetization will jolt the economy or drown the country drastically.

Several countries have embraced this policy in the past, as a measure to tackle the problems of black money and counterfeiting. Some met the purpose, whereas some failed miserably. The major demonetization phenomenon of the modern currency was the introduction of Euro when all EU nations demonetized their currency and started using Euro.

Some success stories of implementing demonetization are as follows.

- In 1969, President of USA, Richard Nixon announced all notes above USD 100 null and void. Even today USD 100 notes are the maximum available for circulation.
- In 1996, Australia became the first country to circulate a full series of polymer bank notes, after replacing all paper-based notes, which was systemically declared non-tender for legal purposes.

However, we have some examples where demonetization proved to be a disaster. In 1982, Ghana ditched their 50 cedis note to tackle tax evasion and pour out excess liquidity. This made the people of the country invest heavily in physical assets, which visibly turned the economy weak. In 1984, Nigeria, the debt-ridden and inflation-hit country wasn't able to steer the change properly, and the economy collapsed. In 1987, Myanmar's military quashed around 80% value of money to restrain black money. The decision led to an economic disruption which in turn led to mass protests that affected lives of many people.

In 1991, Soviet Union's Mikhail Gorbachev addressed the nation to withdraw large-Ruble notes from circulation in order to curb the black money. The move choked the economy, which resulted in a coup attempt that brought down his authority and led to the breakup of Soviet Union. A demonetized North Korea left people homeless and starving in the year 2010. Kim-Jong ll introduced a reform that knocked off two zeros from the face value of the old currency in order to curb black money.

VI. IMPACT OF DEMONETIZATION ON INDIAN ECONOMY

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. 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.

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 centres at the border, people are being given IOUs in lieu of the balance they were entitled to, which would be valid for six months.

The short-term effect on the economy would depend on the speed with which and the extent to which the cash is replaced by the authorities. To give an example from two sectors which are supposed to have large employment effect on the economy, we can talk about agriculture, automobiles and construction.

This is the sowing season for the Rabi crop in some parts of the country and the harvesting season for the Kharif crop. Most of the purchases and sales in this segment of the economy are carried out through cash. With the elimination of cash from the economy, sale of kharif crop would be difficult unless the crop is sold on the promise of payment in future. Given the limited bargaining power of the farmer, the price they can realize for the crop can be adversely affected. On the other hand, in the sowing activity, people would not get access to the inputs required since most of the inputs are now purchased from the market unless they seek access to credit from the supplier. In other words, with demonetization, there would be a significant strengthening of the informal sector credit market in the rural economy. Further, if there are agents who do not get access to credit from the informal sector agents, their sowing activity and hence their incomes in the next season would be adversely affected. Thus, in spite of a good monsoon in large parts of the country, the farmer might not get the benefits.

The second sector which could be adversely affected would be the construction sector. The sector, it is often argued, works with a significant amount of cash. Payments to workers as well as a variety of purchases might be carried out in cash. So, on the supply side, this sector can be adversely affected. On the other hand, on the demand side, the demand for houses and buildings would appear as a demand for non-essentials and might be pushed on to the back burner until the economic situation normalizes. Thus, to the extent there are agents in the economy whose demand was backed by savings from unaccounted incomes held in the form of cash which got extinguished on demonetization, there would be a compression of demand.

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 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.

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.

VII. CONCLUSION

The demonetization undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be "black money" and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetization on the economy and its agents.

It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

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