
Impact of Demonetization on Indian Economy

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Abstract

The Indian government's stated objective behind the 2016 demonetization policy are as follows; first, to make India corruption free, second, to curb black money, third, to control inflation, fourth, to stop terror financing, fifth, to make the people pay income tax and finally, to make a cashless society and create Digital India. The demonetization policy is seen as a financial reform in the country but this decision is fraught with its own merits and demerits. This paper has made an attempt in analyzing the impact of demonetization on various sectors and the economy as a whole.

Keywords: Demonetization, Black Money, Economic Growth, Liquidity.

Introduction

The Government of India, on 8th November, 2016 announced demonetization of all Rs.500 and Rs. 1,000 banknotes which stripped those currencies of their legal tender status. However, the lower denomination currencies Rs 10, Rs 20, Rs 50, Rs 100 and coins remained valid. This move was attempted by the government to tackle three problems in the economy viz., a parallel economy, counterfeit currency and terror financing. To touch upon the legality of this move, the Government of India and RBI are allowed to declare a particular tender illegal (under section 26(2) of the RBI Act, 1934) even if it affects the functioning of enterprises (reservation under the Right to Trade enshrined in the Indian Constitution). This is not the first time when Indian currency is demonetized in India. Demonetization has been implemented twice in the past on 12th January, 1946 and 16th January, 1978 to combat tax evasion and curb black money. However, this is the first time Rs 2,000 currency note is being introduced.

The first currency ban in 1946

In 1934, Rs.500 and Rs.1000 notes were introduced and after four years in 1938, Rs.10,000 notes were introduced. In 1946, the currency note of Rs.1,000 and Rs.10,000 were removed from circulation (both the notes were reintroduced in 1954 with an additional introduction of Rs.5,000 currency). The ban really did not have much impact, as the currency of such higher denomination

was not accessible to the common people. By the end of 1947, out of a total issue of Rs.143.97 crores of the high denomination notes, notes of the value of Rs. 134.9 crores were exchanged. Thus, notes worth only Rs. 9.07 crores were probably 'demonetized'. There was no fool-proof administrative method by which a particular note brought by an individual could be proved as the life-savings of the hard-working man who presented it or established as the sordid gains of a black-marketer. Another loophole was the exemption of the princely states from scrutiny or questioning when such notes were presented by them. Hence, it was more of "conversion", at varying rates of profits and losses than "demonetization".

The second ban in 1978

In the early 1970s, the Wanchoo committee, a direct tax inquiry committee set up by the *Planning Commission of India*, suggested demonetization as a measure to [unearth and counter the spread of black money](#). The then Prime Minister of India, Morarji Desai announced the currency ban in 1978 by taking Rs.1000, Rs.5000 and Rs.10,000 out of circulation, which was 1.7 per cent of total notes in circulation i.e., Rs.1.46 billion accounting for about 0.1 per cent of GDP (Hari, 2017). The sole aim of the ban was to curb black money generation in the country. However, the public nature of the recommendation sparked black money hoarders to act fast and rid themselves of high denominations before the government was able to clamp down on them.

Similarities in 1978 and 2016 ban

- The note ban by Morarji Desai and Narendra Modi aimed to drive away black money out of circulation in the economy. Hence, The High Denomination Bank Notes (Demonetization) Act, 1978 was implemented.
- Narendra Modi announced the currency ban in an address that was broadcasted across all news channels. Similarly, Desai announced the ban over the radio after which the banks were closed the following day.
- Both the affairs were kept confidential.

Differences in the currency ban

- Unlike Modi, Desai didn't have the backing of the RBI Governor. The Governor I.G.Patel believed that the ban was implemented simply to immobilize the funds of the opposition party. Patel also believed that people never store black money in the form of currency for too long.
- The 1978 currency ban affected only the privileged few, while the 2016 ban had shaken the whole country.

Demonetization in Other Countries

The measure of demonetization is not a new concept for the world. The French were the first to use the word Demonetize, in the years between 1850 -1855. There were other nations that tried demonetization in the past. Table 1 gives the details of demonetization efforts by the countries around the world.

TABLE: 1**DEMONETIZATION EFFORTS IN OTHER COUNTRIES**

S. No.	Country	Year of Demonetization	Reason for Demonetization
1	Nigeria	1984	To curb black money
2	Ghana	1982	To tackle tax evasion.
3	Zimbabwe	2015	To solve the problem of hyperinflation and to stabilize the economy
4	North Korea	2010	To banish the black market
5	Soviet Union	1991	To end black money
6	Australia	1996	To stop counterfeiting
7	Myanmar	1987	To curb black money

Source: Compiled by the authors

Reasons for 2016 Demonetization in India

Deodhar (2016) in his article “Black Money and Demonetisation” highlighted that the demonetization of Rs.500 and Rs.1000 by the government was targeted towards tackling black money, corruption and terrorism. With a view to curb financing of terrorism through the proceeds of Fake Indian Currency Notes (FICN) and use of such funds for subversive activities such as espionage, smuggling of arms, drugs and other contrabands into India, it was decided to cancel the legal tender character of the High Denomination bank notes.

Fake Indian Currency Notes (FICN) in circulation in high denominations was comparatively larger as compared to those in other denominations. Use of high denomination notes for storage of unaccounted wealth has been evident from cash recoveries made by law enforcement agencies from time to time. These notes are known to facilitate generation of black money. In this connection, it may be noted that while the total number of bank notes in circulation rose by 40 per cent between 2011 and 2016, the increase in number of notes of Rs.500 denomination was 76 per cent and for Rs.1,000 denomination was 109 per cent during this period.

As per the data provided by Swiss Bank in 2011, India is topping the list with almost \$1500 billion of its black money deposited with them, followed by Russia \$470 billion. The amount of black money is increasing year by year significantly (Ramdurg and Basavaraj, 2016).

The reason for 2016 demonetization in India was,

- To eliminate counterfeit currency
- To shrink the size of the parallel economy and black money in India
- To reduce corruption and
- To curtail terror financing

A parallel shadow economy corrodes and eats into the vitals of the country’s economy. It generates inflation which adversely affects the poor and the middle classes more than others. It deprives Government of its legitimate revenues which could have been otherwise used for welfare and development activities. So, in order to curb the menace of black money, various measures have been taken by the Government which includes, (i) Constitution of a Special Investigation Team (SIT) under the Chairmanship of a former Supreme Court Judge B.P. Jeevan Reddy and implementing some of its recommendations; (ii) enactment of a new law viz., ‘The Black Money

and Imposition of Tax Act, 2015' to deal with black money stashed abroad; (iii) Introduction of 'Benami Transactions Amendment Bill 2015' enabling confiscation of Benami property (iv) Enhancing the sharing and exchange of information with foreign countries and proactive involvement in international efforts to combat tax evasion/black money; (v) Introducing Income Declaration Scheme, 2016; (vi) Use of information technology for mining of information; (vii) Prescribing requirement of PAN numbers on high value transactions, (viii) Taking action against hoarders through enforcement agencies; and (ix) Constitution of Multi Agency Group with members (investigation) of CBDT for speedy investigations against Indian persons having undisclosed foreign assets.

Impact of 2016 Demonetization on the Economy

Indian high value currency has been stripped of its status as a legal tender for the third time in 2016. The impact of this demonetization on the economy was high primarily because, the demonetized currency represented 86.5 per cent of the total currency in circulation. In a historic move, the Modi government decided to cancel the legal tender of Rs.500 and Rs.1000 notes in a bid to curb and eliminate [black money](#) and counterfeiting, which is also likely to impact the macro economic variables in the country.

Liquidity

Notes in circulation as of November 4, 2016 was Rs. 17,742 billion i.e., 13 per cent of GDP and the value of Rs. 500 and Rs. 1,000 notes in circulation was Rs. 15,347 billion which was about 86.5 per cent of notes in circulation i.e., 11 per cent of GDP (Hari, 2017). The demonetization move along with the imposition of withdrawal limits resulted in severe contraction in money supply and reduced the usage of these notes and thus negatively impacted the liquidity in the immediate term. In the long run, the shift over to digital payments and issuing of new currency notes will bring about cash circulation to mean levels.

TABLE: 2

BANK NOTES IN CIRCULATION AS ON MARCH 2016

Denomination (in Rs.)	Volume (million pieces)	Volume of Bank Notes in Circulation (in per cent)	Value (in billions)	Value of Bank Notes in Circulation (in per cent)
2 and 5	11,626	12.9	45	0.3
10	32,015	35.5	320	1.9
20	4,924	5.4	98	0.6
50	3,890	4.3	194	1.2
100	15,778	17.5	1578	9.6
500	15,707	17.4	7854	47.8
1000	6,326	7	6326	38.6
Total	90,266	100	16,415	100

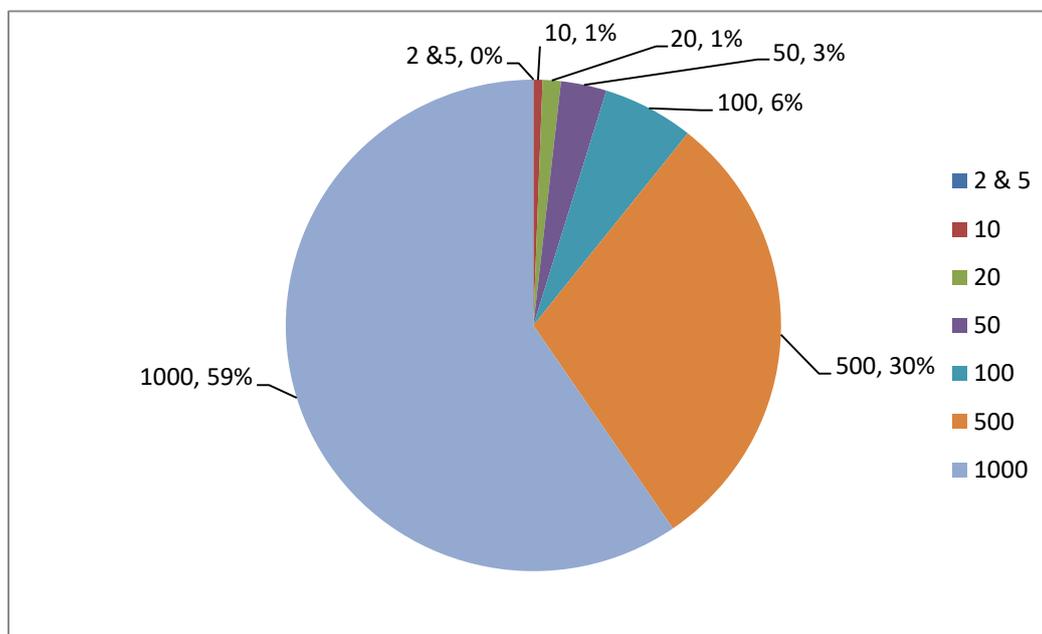
Source: Reserve Bank of India

Table 2 shows that at the end of March 2016, the value of banknotes in circulation was Rs.16,415 billion. In value terms, Rs.500 and Rs.1,000 banknotes together accounted for 86.5 per cent of the

total value of banknotes in circulation; by volume, Rs.10 and Rs.100 banknotes constituted 53 per cent of the total banknotes in circulation.

CHART: 1

VALUE OF BANK NOTES IN CIRCULATION (IN PER CENT) AS OF MARCH 2016



Source: Reserve Bank of India

GDP

IMF projected that India's growth will slow down to 6.6 per cent in 2016-17 fiscal due to the strains that have emerged in the economy as a result of "temporary disruptions" caused by demonetization. As per IMF, demonetization would have only short term impact on the economy and it would bounce back to its expected growth of more than 8 per cent in the next few years. Post demonetization, cash shortages and payment disruptions caused by the currency exchange initiative have undermined consumption and business activity, posing a new challenge to sustaining the growth momentum.

Inflation

Declaring the existing stock of Rs.500 and Rs.1,000 notes as illegal tender addressed multiple issues with one stroke. Most importantly, it has straight away wiped out most of the illegal cash accumulated over a number of years from the system. This will have a direct impact on inflation as there will not have too much money chasing too few goods and excess money supply will no longer fuel price rise and counterfeit currency circulating in the country has ceased to be of any value. Hence, there will be downward pressure on prices due to lower demand especially in rural areas where share of cash transaction is high (Hari, 2017). 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 (Rao et.al, 2016).

Credit Creation

The demonetization move would bring back a lot of money outside the system back into the financial system which can be used by banks for financing the commercial activities. This would not only improve the profitability of banks, but would also pave way for reduction of interest rates and partly address the problem of NPAs. Thus, demonetization has brought a large part of money into the formal banking system which has increased the ability of the banks to lend.

Taxation

According to the Finance Minister Arun Jaitley, both indirect taxes and direct taxes levied by the Union government registered good growth in the month of December 2016 suggesting that the impact of demonetization on economic activity was limited. There has been a 26.2 percent increase in central indirect tax collection till November 30, 2016. Excise duty was up by 43.5 percent, service tax by 25.7 percent and custom duties up by 5.6 percent. Till 19th December, 2016 direct tax collection increased to the extent of 14.4 per cent.

Impact of 2016 Demonetization on Various Sectors in India

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 (Rao et.al., 2016). Demonetization will scratch the surface of many industries, which have been conduits of black money. The impact of demonetization on various sectors of Indian economy is as follows:

Real Estate

It is still too early to accurately gauge the depth of the shakeup caused by demonetization, but its impact on the real estate sector is apparent. Since the announcement of demonetization, the ripples have been spreading through the already disturbed sector, which has been experiencing excruciatingly slow growth in recent times. The real estate sector will definitely be affected by the demonetization exercise, as it has traditionally seen a very high involvement of black money and cash transactions. But, over the long term, the Indian real estate sector will emerge stronger, healthier and capable of sustained growth.

Agro and related sectors

The sector typically sees high cash transactions and therefore near-term impact could be seen till liquidity is infused in the rural areas. As farmers face a temporary shortage of cash in hand, it could lead to a delay in payment which in turn would hurt the related companies in the short term.

Manufacturing Sector

Demonetization of high-value currency notes in November hit the manufacturing sector as indicated by a private sector survey. The Nikkei India Manufacturing Purchasing Managers' Index (PMI) fell to 49.6 in December, the first time it hit below the 50-mark in 2016, from 52.3 in November. A reading below 50 implies contraction while one above 50 indicates expansion. Companies saw new work and output dip for the first time in 2016. In turn, quantities of purchases were scaled back and employment lowered.

Services Sector

Hit hard by demonetization, the services sector slipped into contraction in November 2016, worst slump in nearly three years, as new orders dried up and customers cut spending due to cash shortages. The Nikkei India Services Purchasing Managers' Index (PMI), which tracks services sector companies on a monthly basis, stood at 46.7 in November, down from 54.5 in October. Due to cash crunch in the economy, businesses declined in hotels, restaurants and renting activities. The gloomy PMI figures for the Indian service sector shows that companies were heavily impacted by the ban on Rs.500 and Rs. 1,000 notes. The drop in services activity suggests larger dependence on cash transactions.

Automobiles

Clampdown on cash transactions and temporary cash crunch hurt purchases of two wheelers, where the percentage of cash transactions has been high. In case of passenger vehicles, the seasonal slowdown seen during November and December months could get more pronounced as consumers delay purchases due to temporary liquidity crunch and expectations of rate cuts. However, as most passenger vehicles are financed through loans, the blip would be temporary. Thus, slackness in the economy on account of demonetization could have a negative impact on the commercial vehicle volumes.

Consumer Durables

Approximately 70-75 per cent of transactions in this sector are cash transactions and hence the immediate demand for products in this sector will fall. However, adjustments in the form of new currency usage and digital payment systems will place this sector in a neutral position.

Financial Sector

The biggest beneficiary from the demonetization policy will be the banking sector because of the increase in the CASA (Current Account and Savings Account) deposits which will result in substantial liquidity with the banks which in turn increases the Net Interest Income and the Net earnings of the banks. However, this will not be abnormally high since the RBI has increased the CRR in the short term to mop up some of this liquidity.

Conclusion

The demonetization move has created chaos in every strata of the society whether upper, middle or lower. This is because, India is cash based economy and demonetization temporarily decreased the liquidity position. Decreased liquidity leads to less demand which in turn results in low productivity causing a slowdown in consumer market. Without adequate and proper planning, the demonetization-driven cash crunch has rendered Indian economy paralyzed at least for short duration. It has affected the informal sector where cashless transactions are minimal. Informal sector includes 106 activities like agriculture, workers in construction, local transport, community services and small workshops like shoe makes and garment makers, rural populations and the urban poor and middle class (Sinha and Rai, 2016). The government claims that demonetization would curtail the shadow economy. However, according to the data from income tax probes, black money holders kept only 6 per cent or less of their wealth as cash, suggesting that targeting this

cash would not be a successful strategy. In 2012, the Central Board of Direct Taxes recommended against demonetization saying that “demonetization may not be a solution for tackling black money which is largely held in the form of benami properties, bullion and jewellery”. Few economists and policy makers are of the opinion that this demonetization move by the government will hamper the economic growth for three to four quarters of the financial year; but would be beneficial for the economy in the long run. Unless the prime objective of demonetization viz., curbing black money and counterfeit notes is achieved, the long run benefits would remain a distant dream. The success of demonetization depends upon the efficiency of the government and administrative machinery in mitigating corruption. Since there is no precedent to such massive demonetization move in India, we can only speculate future macroeconomic effects of demonetization.

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