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Effects of Demonetization on Indian Economy

Dr Pushp Deep Dagar,
Assistant Professor of Commerce,
Government College for Women, Mokhra (Rohtak), India

I Introduction

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.

On November 8, 2016, the government announced a historic measure, with profound implications for the economy. The two largest denomination notes, Rs 500 and Rs1000, were demonetized with immediate effect, ceasing to be legal tender except for afew 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 December30, 2016, while restrictions were placed on cash withdrawals. In other words, restrictions were placed on the convertibility of domestic money and bank deposits. The reasons of it are to tackle black money in the economy; secondly, to lower the cash circulation in the country which is directly related to corruption in our country; thirdly, to eliminate fake currency and dodgy funds which have been used by terror groups to fund terrorism in India; and finally, the move is estimated to scoop out more than more than Rs 5 lakh crore black money from the economy.

II Objectives of the Paper

The present paper is an attempt to analyze the impact of demonetization on Indian economy. This study is also workout the experience of impact of demonetization in various countries in past years.

III Demonetization in India

In an important move, the Government of India declared that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. 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, generated by 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 soughtto be permanently and punitively increased.

This is not the first time when Indian currency is demonetized in India. Similar measures have been taken in the past. In January 1946, currency notes of 1000 and 10,000 rupees were withdrawn and new notes of 1000, 5000 and 10,000 rupees were introduced in 1954. The Janta Party coalition government had again demonetized notes of 1000, 5000 and 10,000 rupees on 16 January 1978 as a means to curb forgery and black money.

The Rs 1,000 note made a comeback in November 2000. Rs 500 note came into circulation in October 1987. The move was then justified as attempt to contain the volume of banknotes in circulation due to inflation. However, this is the first time that Rs 2,000 currency note is being introduced. Bank notes in Ashoka Pillar watermark series in Rs 10 denomination were issued between 1967 and 1992, Rs 20 in 1972 and 1975, Rs 50 in 1975 and 1981 and Rs 100 between 1967-1979.The banknotes issued during this period contained the symbols representing science and technology, progress and orientation to Indian art forms.

In the year 1980, the legend Satyameva Jayate - 'truth alone shall prevail' - was incorporated under the national emblem for the first time. In October 1987, Rs 500 banknote was introduced with the portrait of Mahatma Gandhi and Ashoka Pillar watermark. Mahatma Gandhi (MG) series banknotes – 1996 were issued in the denominations of Rs 5, (introduced in November 2001), Rs 10 (June 1996), Rs 20 (August 2001), Rs 50 (March 1997), Rs 100 (June 1996), Rs 500 (October 1997) and Rs 1,000 (November 2000). The Mahatma Gandhi Series – 2005 bank notes were issued in the denomination of Rs 10, Rs 20, Rs 50, Rs 100, Rs 500 and Rs 1,000 and contained some additional/new security features as compared to the 1996 MG series. The Rs 50 and Rs 100 banknotes were issued in August 2005, followed by Rs 500 and Rs 1,000 denominations in October 2005 and Rs 10 and Rs 20 in April 2006 and August 2006, respectively.

IV International Experience of Demonetization

Demonetization is defined as act of stripping a currency unit of its status as legal tender. It refers to cessation of current currency and replacing it with new currency. Demonetization is not a new concept; in the past also it has been utilized by various countries as well as India to curb currency some failed very badly with this move. Table 1 shows the countries which previously banned the notes and their effects on economy.

Table 1
Impact of Demonetization on Various Countries

S. No.	Country	Year	Impact on Economy Successful/unsuccessful	Reason for Failure
1.	Ghana	1982	Made economy weak unsuccessful	People support for black market and investment in physical assets.
2.	Nigeria	1984	Economy collapsed unsuccessful	Debt-ridden and inflation did not take change well.
3.	Myanmar	1987	Unsuccessful	Led to mass protest resulting in killing of many people.
4.	Russia (Soviet Union)	1991	unsuccessful	People did not take change positively due to poor harvest.
5.	Zaire	1993	unsuccessful	High inflation and a collapse in the exchange rate against the dollar
6.	North Korea	2010	Weak unsuccessful	People left with no food and shelter
7.	Zimbabwe	2015	Weak unsuccessful	Face value one hundred trillion dollars dropped to $0.5 dollar.

Source: Compiled

It is clear from the above table that various countries adopted the policy of demonetization before India and it has affected their economy in different ways. In view of demonetization, international experience may be analyzed.

Ghana: The country in 1982 got rid of its 50 cedi note to crack down on tax evasion, address corruption and mop up excess liquidity. The move eroded confidence in the banking system as people turned to foreign currency or physical assets instead. The black market for currency flourished. As rural dwellers had to walk miles to the nearest banks to exchange their money, and after the deadline passed, there were accounts of bundles of notes abandoned as worthless.

Nigeria: In 1984, the military government led by MuhammaduBuhari instituted an anti-corruption crackdown that involved issuing new banknotes with a different color, forcing the replacement of old ones within a limited period. The move was one of a series that failed to fix a debt-burdened and inflation-ridden economy. Buhari, who is now in power again, was eventually ousted in a coup the following year**.**

Myanmar: In 1987, the country's military junta invalidated as much as 80 per cent of the value of money in circulation, according to reports at the time -- as in other such initiatives, it was directed at curbing the black market. One result was the first student demonstrations in years. Deepening economic unease helped trigger mass protests across the nation the following year that led to a government crackdown that killed thousands of people.

Russia: On its last legs, the country under Mikhail Gorbachev in January 1991 withdrew large-ruble bills from circulation in a move to take on the black economy. The reform failed to halt inflation, and instead served mainly to accelerate a slide in public confidence in the government. As political infighting combined with economic collapse, Gorbachev faced a coup attempt that August which destroyed his authority and led to the Soviet break-up the following year. Learning lessons, Russia's 1998 redenomination of the ruble, when it removed three zeroes, went altogether more smoothly.

Zaire: Dictator Mobutu SeseSeko faced increasing economic disruptions in the early 1990s, when

his administration mounted successive banknote reforms. A plan to withdraw obsolescent currency from the system in 1993 saw a surge in inflation and a collapse in the exchange rate against the dollar. After a civil war, Mobutu was ousted in 1997.

North Korea: In 2010, the regime of then-dictator Kim Jong-Il mounted a reform that knocked off two zeros from the face value of the old currency in an effort to tighten control of the economy and close black markets. Combined with a poor harvest, the measure left the country with severe food shortages, according to reports at the time. Surging rice prices stoked unrest that prompted an unusual apology from Kim, and -- reports suggested -- the execution of the ruling party's head of finance.

Zimbabwe: In January 2015, Monetary Policy Statement presented by Reserve Bank of Zimbabwe Governor John Mangudya declared that in view of 2014 Budget Statement and the Mid Term Budget Statement, the Reserve Bank shall be demonetizing the currency by June 30, 2015. One of the primary reasons for initiating demonetization in Zimbabwe was hyperinflation. People even to buy a loaf of bread had to pay the amount in a trillion! When the highest denomination note - 100 Trillion Dollar note was not issued, ATM's were running out of cash as people were withdrawing cash in billions/trillions and the cheque issued had to be double the amount as by the time cheque used to reach clearing the inflation rose.The decision to shift to the American dollar had another unintended effect: depressing economic growth, as Zimbabwean exports were hit due to a loss of competitiveness.

V Probable Consequences of the Demonetization

Understanding the benefits and costsof demonetization requires spelling out theanalytics of demonetization, which are richand complicated. Broadly, there will be anumber of effects, which are sketched outin short term and long term benefits:

A. Short Term Benefits

These benefits can be divided into three parts:

Tax on black money: Perhaps the most important way to view demonetization is as a tax administration measure, one designed to tax holdings of black money. Of course, demonetization of large denomination notes is not exactly the same as demonetization of black money. Some cash holdings were perfectly "white", the fruit of income upon which taxes had either been paid or had not been applicable in the first place.

Tax compliance: Demonetization can also be interpreted as a regime shift on the part of the government. It is a demonstration of the state's resolve to crack down on black money, showing that tax evasion will no longer be tolerated or accepted as an inevitable part of life. Since this action has commanded support amongst the population, demonetization shows that black money will no longer be tolerated by the wider public, either. These two sanctions – financial penalty and social condemnation – could have a powerful and long-lasting effect on behavior, especially if they were combined with other incentive-compatible measures. In this case, evaders might decide in the years to come that it would be better to pay a moderate regular tax, rather than risk having to pay a sudden penal tax. Corruption and compliance could be permanently affected.

Demonetization could also aid tax administration in another way, by shifting transactions out of the cash economy and into the formal payments system. With large denominations eliminated, households and firms have begun to shift from cash to electronic payment technologies. As a result,

the tax-GDP ratio, as wellas the size of the formal economy, could be permanently higher.

Tax on Informal Savings: Beyond reducing tax evasion, demonetization could have other far reaching effects. For example, it will channel savings into the formal financial system. Without doubt, much of the cash that has been deposited in the banking system will be taken out again, as the cash withdrawal limits are eased and the note supply improves. But some of the new deposits will surely remaining the banks, where they will provide a base for banks to provide more loans, at lower interest rates.

In the longer-term, if demonetizations successful, it will reduce the equilibrium cash-GDP and cash-deposits ratio in the economy. This will increase financial savings which could have a positive impact on long run growth.

B. Long Term Benefits

By definition, it is too early to quantify the direction and magnitude of long term changes. It will take several years to see the impact of demonetization on illicit transactions, on black money, and on financial savings. But there are some signs pointing to change.

Digitalization: One intermediate objective of demonetization is to create a less-casher cash-lite economy, as this is a key to channeling more saving channeled through the formal financial system and improving tax compliance. Currently, India is far away from this objective: The Watal Committee has recently estimated that cash accounts for about 78 percent of all consumer payments. India has a very high predominance of consumer transactions carried out in cash relative to other countries. And there are many reasons for this situation. Cash has many advantages: it is convenient, accepted everywhere, and its use is costless for ordinary people, though not of course for society at large. Cash transactions are also anonymous, helping to preserve privacy, which is a virtue as long as the transactions are not illicit or designed to evade taxation.

In contrast, digital transactions face significant impediments. They require special equipment, cellphones for customers and Point-Of-Sale (POS) machines for merchants, which will only work if there is internet connectivity. They are also costly trousers, since e-payment firms need to recoup their costs by imposing charges on customers, merchants, or both. At the same time, these disadvantages are counterbalanced by two cardinal virtues. Digital transactions help bring people into the modern “wired” era.And they bring people into the formal economy, thereby increasing financial saving, reducing tax evasion, and leveling the playing field between tax-compliant and tax-evading firms.

Digitalization’s can broadly impact three sections of society: the poor, who are largely outside the digital economy; the less affluent, who are becoming part of the digital economy having acquired Jan Dhan accounts and RuPay cards; and the affluent, who are fully digitally integrated via credit cards. One simple measure that illustrates the size of these three categories is cellphone ownership. There are approximately350 million people without cellphones (the digitally excluded); 350 million with regular feature phones, and 250 million with smartphones.

Real Estate: Demonetization could have particularly profound impact on the real-estate sector. In the past, much of the black money accumulated was ultimately used to evade taxes on property sales. To the extent that black money is reduced and financial transactions increasingly take place

through electronic means, this type of tax evasion will also diminish. While too early to assess whether there will be permanent effects, the weighted average price of real estate in eight major cities, which was already on a declining trend fell further after November 8, 2016. An equilibrium reduction in real estate prices is desirable as it will lead to affordable housing for the middle class, and facilitate labour mobility across India currently impeded by high and unaffordable rents*(Economic Survey 2016-17)*.

VI Conclusions

There are both pros and cons of demonetization it is like refresh button in the Indian economy and flush all the dead deposited money into the economy, to the market through proper channels. The effort is for going cash less transactions and many e-wallet companies like Paytm etc. are having a good response and government is also encouraging the same. However, the effects of change are emergent from the system itself and cannot be determined beforehand. Hence we can only speculate future macroeconomic effects of demonetization. It is suggested that there is an acute need of educating people about various alternatives available in the market and making the online transaction.

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