

**Demonetization Drive: Biggest Economic Reform in India
One year after Demonetization**

Dr. Archana Dadhe

Ph.D,MBA,PGDIMM,PGDIM

Nagpur-440010 , India

Abstract

The historic demonetization move by the government is seen as a war on parallel economy, corruption, money laundering and to stop financing aid enjoyed by the terrorists. It has a direct impact on parallel economy and cash transactions. Along with the introduction of GST this constitutes a far reaching reset of the Indian economy.

It's a beginning in India in creating a 'less-cash society'. Once we embark on our journey to create a 'less-cash society', the goal of 'cashless society' will not remain very far. Demonetization was also supposed to curb financing of terrorism through the proceeds of Fake Indian Currency Notes (FICN).

Japan has the highest cash to GDP ratio at 19.4 per cent. India is nearly half of that at around a little over 10 per cent .As per the Transparency International's Corruption Perception Index for 2016, Japan is the twentieth least corrupt country in the world. India stands at the 79th position, despite having a much lower cash to GDP ratio. Take the case of Brazil, which has a cash to GDP ratio of 3.31 per cent. Like India, it is the 79th least corrupt country in the world. Then there is the Eurozone (country's which basically use euro as their currency).

Key Words : FICN , Eurozone , GDP, Liquidity Crunch.

Introduction

The historic demonetization move by the government is seen as a war on parallel economy, corruption, money laundering and to stop financing aid enjoyed by the terrorists. We expect this to have a direct impact on parallel economy and cash transactions. Along with the introduction of GST this constitutes a far reaching reset of the Indian economy. This decision was considered as biggest cleanliness drive against the black money in the history of Indian economy.

About 85% of all currency in circulation has just been turned into coupons that can only be exchanged in specific places. These notes can be converted into currency again only with identity proofs (which hundreds of millions don't have) and the additional hardship of standing in many queues for many hours.

The Situation

India was heavily depended on currency in handling financial transactions. Electronic or transactions by bank was limited to below 20% of daily transactions. People used to save money in currency as it was essential to handle day to day transactions. 90% of the stores in markets were not accepting electronic money. They all insisted on cash in currency. Generally India had a stable economy and people started trusting currency and they trusted the economy enough to keep the savings in currency. Remember it is not practical in fluctuating economy where people will convert money into tangible assets including Gold and it will affect the transacting capability of the people. India remained stable for long only because people maintained their money flexible for transactions.

The Issues

(1) One of the issues was fake currencies. Some source pumped huge amount of fake currencies into India. The source is within the country or outside the country is still open to discuss. But it is a fact that Indian Intelligence has utterly failed to check the flow of fake currency into Indian economy.

(2) People who earned illegal money either converted it into land and properties or precious metal like gold. Government failed to keep track of these illegal earnings as most of the illegal earnings were done by government servants or political leaders themselves. The money they did not convert into land or other properties was kept as currency of 1000s and 500s. What we understand today is that the currency that was in circulation was much more than the government estimates! It is unfortunate but it is a fact.

Why Restrictions on Currency

(1) Government wants to block further infiltration of fake currency into Indian economy. May be the Government got information from some sources that huge amount of fake currencies are being pumped into Indian markets. It may be one reason why government decided to ban the currencies.

(2) Then what is the possibility of breaking black money with ban on currency? The effect is quite negligible because all transactions through bank are not white money either.

Impact on Indian Economy

Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes, there occurred huge gap in the currency composition as after Rs 100; Rs 2000 is the only denomination.

Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination.

Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts.

1. Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.

2. Liquidity crunch (short term effect): Liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Current reports indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 mn Rs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

3. Welfare loss for the currency using population: Most active segments of the population who constitute the 'base of the pyramid' uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class.

There will be a trickle up effect of the liquidity chaos to the higher income people with time.

4. Consumption will be hit: When liquidity shortage strikes, it is consumption that is going to be adversely affected first.

Consumption ↓ → Production ↓ → Employment ↓ → Growth ↓ → Tax revenue ↓

5. Loss of Growth momentum- India risks its position of being the fastest growing largest economy: reduced consumption, income, investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.

6. Impact on bank deposits and interest rate: Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply takes place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization will produce big savings in the banking system in the medium term. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

7. Impact on black money: Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depends upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. Such a nationwide awareness and urge will encourage government to come out with even strong measures.

8. Impact on counterfeit currency: the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the unmeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

9. B2B ecommerce: It increases the potential online market size multi-fold, especially when it will be followed up by GST. Short term, there will be an impact on COD (Cash on delivery) orders, but with new currency coming in that should be tackled soon. We must understand that COD is only a mode of payment. Most of our COD orders are tax paid by our B2B buyers. So in the long run, even that should not be impacted.

10. Challenge for e Commerce: While e-commerce companies that see a huge chunk of payments happening through Cash on Delivery mode will face some challenges in the initial few days, in the long run this move will only bring about positive changes.

11. Impact On Healthcare Sector: Delay In Treatment For Many Patients:70-80 per cent door step services in healthcare such as diagnostics or home care are paid at the time of visit in cash. These services are going to get affected by a lot of cancellation in the absence of cash.

Old high denomination ban will impact the private healthcare sector for next 3 to 6 months, and the impact would be higher for home healthcare service providers and door step service providers. If we look at consumers such as patients with chronic illness and old patients, they always keep cash with them for all sorts of medical needs and usually old patients living alone always ensure they have sufficient cash for emergencies.

Looking at the new limits for withdrawal it will take time for these people who rarely go to a bank to recollect sufficient cash. Even once the bank gets opened everyone would like to use cash for daily needs until there is an emergency. I am afraid that medical services being part of urgency and critical category are not kept out from the ban. This also could result in the delay in treatment for many patients.

A Year after Demonetization

1) The total value of the Rs 500 and Rs 1,000 notes that were invalidated stood at Rs 15.44 lakh crore. The government expected that around Rs 4-5 lakh crore of the invalidated notes won't make it back into the banking system.

The hope was that those who have black money in the form of cash will not deposit it in the banks because they would end up creating an audit trail. This would end up destroying black money.

2) In May 2012, the ministry of finance had published a White Paper on black money. As per data offered in this White Paper, it can be calculated that on an average around 4.9 percent of the black money is held in the form of cash. A bulk of the black money is held in the form of real estate and gold.

3) In the past, demonetization has been thought of as a way of getting black money out of circulation. "Black money hoarders find ways to divide their hoard into many smaller pieces. It is not that easy to flush out the black money."

Those with black money found various ingenious ways to divide their black money into smaller amounts and exchange it.

4) No country in a reasonably good economic position has demonetized currency in the past, at the same level that India did. This is primarily because the economics of demonetization is very complex. In short demonetization as a tool to weed out black money.

5) Demonetization was also supposed to "to curb financing of terrorism through the proceeds of Fake Indian Currency Notes (FICN)." Take a look at Table 1, which basically lists out the number of fake currency notes that were detected in the banking system.

Table 1: Denomination-wise Counterfeit Notes Detected in the Banking System

Denomination (₹)	(No. of pieces)		
	2014-15	2015-16	2016-17
1	2	3	4
2 and 5	0	2	80
10	268	134	523
20	106	96	324
50	7,160	6,453	9,222
100	181,799	221,447	177,195
500 (MG series)	273,923	261,695	317,567
500 (New design)	0	0	199
1,000	131,190	143,099	256,324
2,000	0	0	638
Total	594,446	632, 926	762,072

ANNUAL REPORT OF THE RESERVE BANK OF INDIA.

(April to March)

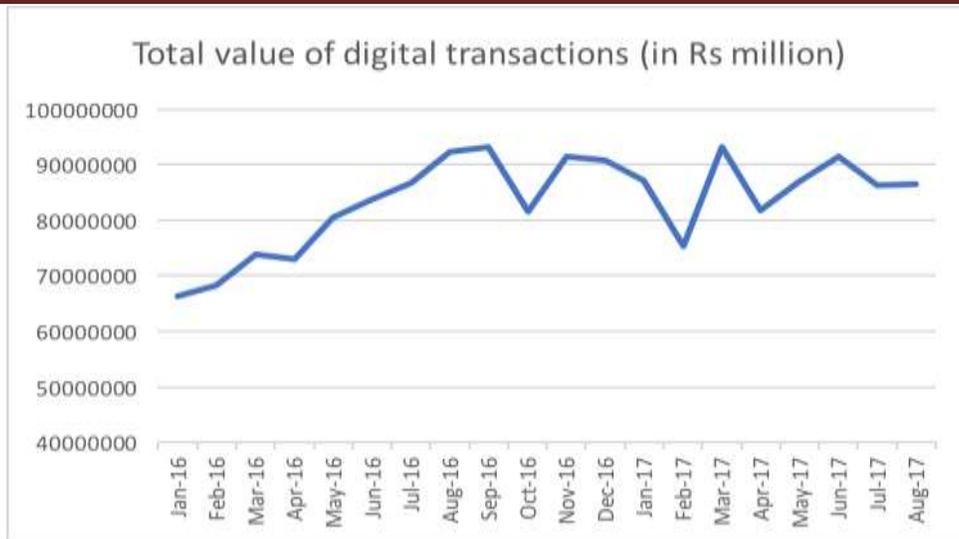
(Source: Annual report of the Reserve Bank of India)

The number of fake Rs 500 (old) and Rs 1,000 notes that were detected during the financial year stood at around 5.74 lakh. The total number of demonetized notes stood at around 2,400 crore.

In fact, if you look at Table 1 carefully, fake notes of the new Rs 500 and Rs 2,000 hit the market, soon after demonetization.

6) Next objective was to move towards a cashless society through digital transactions. The great task that the country wants to accomplish today is the realization of our dream of a 'Cashless Society'. It is true that a hundred percent cashless society is not possible. But why should India not make a beginning in creating a 'less-cash society'? Once we embark on our journey to create a 'less-cash society', the goal of 'cashless society' will not remain very far."Indeed, a very noble motive.

Data for total digital transactions is available up to August 2017 and has been adjusted for real time gross settlement, which can only be used for transactions of Rs 2 lakh or more. Take a look at Figure 1.



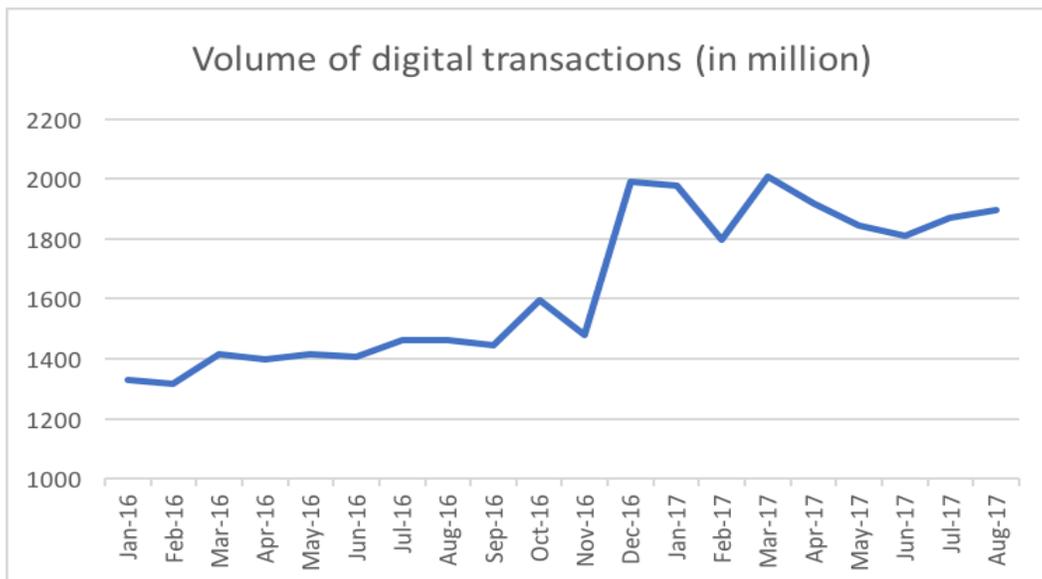
RESERVE BANK OF INDIA

(Source: Reserve Bank of India)

As Figure 1 tells us, digital transactions by value kept increasing between January and August 2016. After that they have gone up and down. This also reflects the overall slowdown of the economy post demonetization.

Volume of digital transactions take a look at Figure 2.

Figure 2:



RESERVE BANK OF INDIA

(Source: Reserve Bank of India)

While, there was a huge one time jump when it comes to the volume of digital transactions post demonetization, things have remained flattish since then. The initial jump wasn't surprising given that there was barely any cash going around in the financial system. But that growth hasn't sustained.

7) An increase in the income tax base, has been highlighted as another benefit of demonetization. For the period, April to September 2017, "Net Direct Tax collections represent 39.4% of the total Budget Estimates of Direct Taxes". For the same period last year, "38.65% of the Budget Estimates of direct taxes for FY 2016-17 has been achieved." Yes, there has been a marginal improvement in direct tax collection.

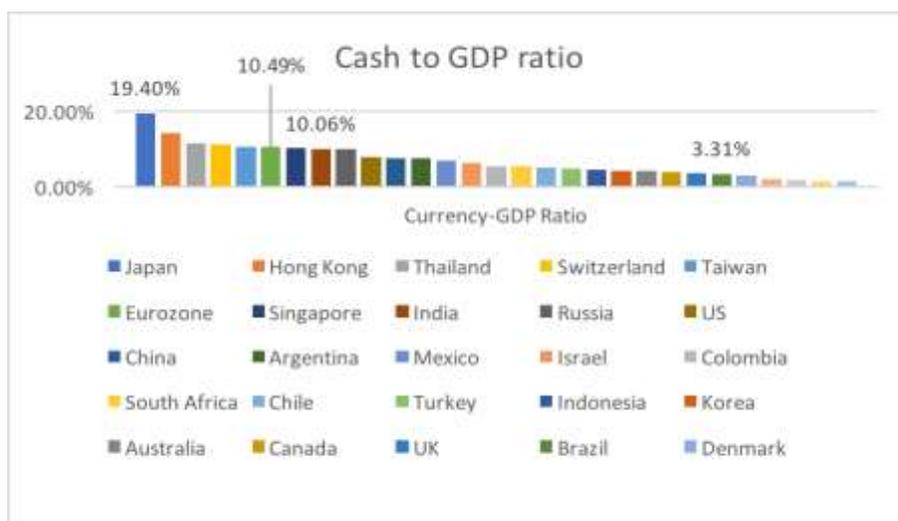
8) The GDP numbers tend to measure the formal part of the economy, and not the informal one. The value created by the informal sector will be captured in the form of income, wealth or consumption effects.

9) One of the claimed successes of demonetization has been that the cash to gross domestic product (GDP) ratio has come down. (after demonetization, the cash to GDP ratio has come down to 9 per cent."

For the period of three months ending March 2017 and June 2017, the non-government part of the GDP (which forms around 90 per cent of the GDP) has grown by a little over 4 per cent. When growth in economic activity slows down, the growth in currency in circulation is bound to be impacted as well.

10) Another point that is being made is that a lower cash to GDP ratio means that the country has become more honest. Take a look Figure 3. It basically plots the cash to GDP ratio of different countries.

Figure 3:



[HTTPS://SCHOLAR.HARVARD.EDU/ROGOFF/CURSE_OF_CASH_DATA](https://scholar.harvard.edu/rogooff/curse_of_cash_data)

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Japan has the highest cash to GDP ratio at 19.4 per cent. India is nearly half of that at around a little over 10 per cent. As per the Transparency International's Corruption Perception Index for 2016, Japan is the twentieth least corrupt country in the world. India stands at the 79th position, despite having a much lower cash to GDP ratio. Take the case of Brazil, which has a cash to GDP ratio of 3.31 per cent. Like India, it is the 79th least corrupt country in the world. Then there is the Eurozone (country's which basically use euro as their currency). Their cash to GDP ratio is higher than that of India.

Conclusion-

Central government's decision to demonetize the high value currency is one of the major step towards the eradication of black money in India. The demonetization drive has affected some extent to the general public, but for larger interest of the country. It's a beginning in India in creating a 'less-cash society'. Digital transactions by value kept increasing between January and August 2016. After that they have gone up and down. This also reflects the overall slowdown of the economy post demonetization. Once we embark on our journey to create a 'less-cash society', the goal of 'cashless society' will not remain very far. Demonetization was also supposed to curb financing of terrorism through the proceeds of Fake Indian Currency Notes (FICN). An increase in the income tax base, has been highlighted as another benefit of demonetization. Japan has the highest cash to GDP ratio at 19.4 per cent. India is nearly half of that at around a little over 10 per cent.