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DEMONETIZATION AND INDIAN ECONOMY

By Hiral Sheth

Abstract

Demonetization can be said as a "Surgical Strike" on Black Money, Terrorism, Fake Currency, Unorganized trading, Real Estate, Share market etc. It has been a radical, unprecedented step of the Government of India taken on 8^{th} November 2016; the liquidity squeeze has been easing since end of December 2016. There has been both the short term impact on the economy as well as long run repercussions to be witnessed in future. Demonetization has been an effort to include digitally excluded category into digital phase where the mode payment would become easier and the government would have records of transaction which in turn would help to fight against tax evasions, corruptions, terrorism etc. This move had led to masses becoming tech- savvy and has also helped to eradicate parallel economy. .

Keywords

Demonetization, Digital Economy

Introduction

TAKA MATI, MATI TAKA (Money is dust and dust is money)

-Ramkrishna Paramshansa

On 8th November Indian Prime Minister Mr. Narender Modi announced in a broadcast to the nation that Rs 500 and Rs 1000 currency notes would no longer be recognized as legal currency. People were given time up to 31st March, 2017 to exchange the notes held by them. These notes were replaced by new denomination i.e. Rs 2000 with a new look. The Prime minister narrated that the move complements the country's Swachh Bharat Abhiyan. "For years, this country has felt the corruption, black money and terrorism are like the festering sores, holding us back in the race towards development. To break the grip of corruption and black money, we have decided that these currency notes presently in use will no longer be legal tender from midnight,"

The reasons offered for demonetisation are two-fold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the "black economy". 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.

Objectives of the Research Paper

a. To study the impact of demonetization on Indian economy.
b. To understand relation of demonetization in leading India into a new digital economy.
c. To understand the expected and actual outcome of demonetization.

Rationale of the Study

India's demonetization is the unprecedented act in international economic history as it was combined with secrecy and suddenness amidst normal economic & political conditions. All other incidents of demonetization so far has occurred due to hyperinflation, wars, political upheavals or other extreme circumstances. The recent move by the government is bound to have broader implications on the economy. According to RBI the most important reason behind demonetization was to curb increasing amount of fake currencies in the market and counterfeiting rising amount of black money in the economy generated by income that had not been declared to tax authorities and use of high denomination notes for terrorist activities. The demonetization measure would for sure change the face of the Indian economy in the upcoming years.

Research Methodology

The paper is based on secondary data. The data has been collected from books, magazine, newspapers etc.

Earlier Instances of Demonetization and the Present Situation

Before discussing the current state of affairs let us take a peek in the history. 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 1000 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 1000, INR 5000 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. Hence, there is a big difference between demonetization, now and then.

In terms of value, the annual report of Reserve Bank of India of 31st March 2016 stated that total bank notes in circulation valued to Rs.16.4 Lakh crore (US$240 billion) of which nearly 86% (i.e. Rs. 14.2 lakh crore (US$210 billion)) were 500 and 1000 rupee notes. At one stroke 86% of the cash in the circulation was thereby rendered invalid which definitely is a big concern for the Government.

Rs 500 and Rs 1,000 banknotes in circulation						
	Volume (crore pieces)			Value (Rs lakh crore)		
Denomination (Rs)	Mar-14	Mar-15	Mar-16	Mar-14	Mar-15	Mar-16
500	1141	1313	1571	5.7	6.6	7.9
(% share)	14.7	15.7	17.4	44.4	45.9	47.8
1,000	508	561	633	5.1	5.6	6.3
(% share)	6.6	6.7	7.0	39.6	39.3	38.5
500 and 1000 together	**1649**	**1874**	**2203**	**10.8**	**12.2**	**14.2**
(% share)	21.3	22.4	24.4	84.1	85.2	86.4
Total of all notes	**7733**	**8358**	**9027**	**12.8**	**14.3**	**16.4**
Source: RBI						

Impact on the Indian Economy

- **Liquidity crunch (short term effect):** 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. 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 presses can print only 2000 million units of Rs 500 notes by the end of this year. Nearly 16000 mn of Rs 500 notes were in circulation by the end of March 2016. Some portions of this were filled by the new Rs 2000 notes. However, towards the end of March approximately 10000 mn units was printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

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

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thus reduce income to the poor working class. There will be a trickle up effect of the liquidity chaos to the higher income people with time.

- **Consumption will be hit:** When liquidity shortage strikes, it is consumption that is going to be adversely affected first. Reduced income will adversely affect the purchasing power of people.
  Consumption ↓→ Production ↓→ Employment ↓→ Growth ↓→ Tax revenue ↓
- **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.
- **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. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

Digitalization and Demonetization

Cash has many advantages: it is convenient, accepted everywhere, and its use is costless for ordinary people. Cash transactions are also anonymous, helping preserve privacy, which is a virtue as long as transactions are not illicit or designed to evade taxation. In contrast, digital transactions face impediments. They require special equipment, cell phones for customers and Point -of - Sale (POS) machines for merchants, which will only work if there is internet connectivity. But the fact, Digital transaction help bring people into the modern "wired" era. It will bring people into the formal economy, thereby increasing financial savings, reducing tax evasion and establishing a level playing field between tax complying and tax evading firms.

There are approximately 350 million people without cell phones (the digitally excluded); 350 million with regular "feature" phones, and 250 million with smart phones. In wake of demonetization, the government has taken a number of steps to facilitate and incentivize the move to a digital economy. They include:

- Launch of BHIM (Bharat Interface for Money) app for Smart phone users based on United Payments Interface (UPI) which has created inter-operability of digital transactions.
- Launch of BHIM USSD a product that allows feature phone users to take advantage of UPI.
- Launch of Aadhaar Merchant pay aimed at 350 millions who do not have cell phones. This enables anyone with just Aadhaar number and bank account to make a merchant payment using his biometric identification. Aadhaar Merchant pay will soon be integrated with BHIM and the necessary POS devices will be rolled out soon.

As people have started to use such e-payment systems, they have discovered that is more convenient to conduct financial activities electronically.

Rhetoric vs. Realty of Demonetization

Ever since Prime Minister Narendra Modi announced the demonetization, many have criticized the move that was taken without adequate ground work saying it has impacted the economic growth. Meanwhile, the government has been of the view that it has had positive effect on the economy. From assets and liabilities of the RBI, here we draw up the debit and credit of demonetization:

- **Rhetoric**: Demonetization will result in at least Rs 3 lakh crore not getting returned (may be burnt down by tax evaders because they won't be able to account for it.

  Reality: 99.3 percent of all the old notes have been returned: Rs 15.44 lakh crore demonetized vs Rs 15.28 lakh crore returned.

- **Rhetoric:** Fake notes are flooding the system; demonetisation of all 500, 1000 rupee notes will end all these fakes and new 2000 rupee notes with new security features will replace them.
  Reality: Yes, numbers of counterfeit notes caught have risen by 20 percent but total number of counterfeits caught account for 0.0007 percent of total notes in circulation. And by the way, 638 new notes in circulation of the new 2000 notes were also found to be fake.

- **Rhetoric**: The demonetization exercise was always intended to get cash into the banking system. Now watch the rise in new tax registrations and taxes collected.
  Reality: Yes, number of new tax filers increased by 25 percent; but there have been years in the past when new tax registrations have raised even by 27 percent; total income tax collections rose 20 percent in FY17; they rose over 16 percent in FY15. Demonetisation obviously has not been all that game changing at least so far.

- **Rhetoric:** Demonetization was all about increasing digitisation.
  Reality: Nandan Nilekani's Aadhaar, NPCI's UPI and Vijay Shekhar Sharma's PayTm are sounder ways to increase digitisation without such a big fat human cost; in any case RBI itself reported in April a fall in the pace of digitisation as cash returned to the system.

- **Rhetoric:** Long-term gains in the form of long-term tax growth and long-term digitization of economy.
  Reality: Short term costs were more than long term gains. GVA in Q3 FY17 was 6.7 percent vs 7.3 percent year ago; GVA in Q4 FY17 was 5.6 percent vs 8.7 percent year ago.RBI spent Rs 7,900 crore in note printing in FY17, vs only Rs 3,400 crore in FY16. RBI spent Rs 17,400 crore mopping-up idle cash in FY17 against earning over Rs 500 crore year ago.

Conclusion

If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand, if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries shows that the move was one of the series that failed to fix a debt-burdened and inflation-ridden economy. Economic growth has got a setback as compared with the previous year but, we cannot say it will be same in the near future as well. This intervention is a one-time draining of this current stock of black money but unless the root causes of corruption are removed, corruption will continue. It is sort of like a dialysis, more of a short term cleaning up than a solution of the problem. It needs to be repeated periodically.

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Bio

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