



IMPLICATIONS OF DEMONETIZATION ON INDIAN ECONOMY: AN OVERVIEW

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ABSTRACT

Prime Minister of India Narendra Modi announced the demonetization in an unscheduled live televised address at 8 pm on 8 November 2016. In the announcement, Modi declared that use of all Rs 500 and Rs 1000 banknotes of the Mahatma Gandhi Series would be invalid past midnight, and announced the issuance of new Rs 500 and Rs 2000 banknotes of the Mahatma Gandhi New Series in exchange for the old banknotes. The government claimed that the action would curtail the shadow economy, fake currency, block money, inflation, interest rate and crack down on the use of illicit and counterfeit cash to fund illegal activity and terrorism. This paper wants study the sudden nature of the announcement and the prolonged cash shortages in the weeks that followed created significant disruption throughout the economy, threatening on economic output, banking transactions, job opportunities etc. and this move of the central government called as 'surgical strike on block money' will be helpful for less cash and cashless economy in future days of India.

KEY WORDS: Demonetization, Reasons, Implications, Stock Exchanges, Banking Sector

1.1 INTRODUCTION

The demonetization effort being led by Modi, The Prime Minister of India, made an idea that Rs 500 and Rs 1,000 notes should be declared no longer legal tender, to be replaced by other notes of different designs and in one case, denominations. The aim is to wash the stock of "black money" out of the economy and get it into the licit, banked and taxable, part of the economy. There's quite obviously substantial tax revenue going uncollected. And perhaps the biggest effect is, that large portions of the population feel that the basic system is unfair. They're locked out of that easier world where matters are settled in large amounts of cash, where tax is not paid and where favours are bought. To overcome these major problems of the Indian economy and bring positive changes, central government announced demonetization. The positive microeconomic effects include inflation control, reduction in corruption and terror financing. Banks will see huge deposits and it is expected that there will be 10-15% increase in total deposits solely contributed by this demonetization, which will act as an economic stimulus. Digital economy and phone banking are booming and people are getting more innovative to work around this problem. This move will be beneficial to take India towards a less cash economy to cashless society in long term.

1.2 OBJECTIVES OF THE STUDY

1. To know the brief history of demonetization in India.
2. To know the reasons for demonetization.
3. To study the implications of the demonetization.

1.3 METHODOLOGY

This paper is completely based on the secondary data, which is available in various sources like government records, newspapers, Research articles, magazines, internet sources etc.

1.4 RESULTS AND DISCUSSIONS

History of demonetization

The Indian government had demonetized bank notes on two prior occasions, once in 1946 and then in 1978 and in both cases, the goal was to combat tax evasion by "black money" held outside the formal economic system. In 1946, the pre-independence government hoped demonetization would penalize Indian businesses that were concealing the fortunes amassed supplying the Allies in World War II. In 1978, the Janata Party coalition government demonetized banknotes of 1000, 5000 and 10,000 rupees, again in the hopes of curbing counterfeit money and black money.

In 2012, the Central Board of Direct Taxes had recommended against demonetization, saying in a report that "demonetization may not be a solution for tackling black money or economy, which is largely held in the form of benami properties, bullion and jewellery". According to data from income tax sources, black money holders kept only 6% or less of their wealth as cash, suggesting that targeting this cash would not be a successful strategy.

In June 2016, the Government of India had devised the Income Declaration Scheme that lasted till 30 September 2016, providing an opportunity to citizens holding black money and undeclared assets to avoid litigation and come clean by

declaring their assets, paying the tax on them and a penalty of 45% thereafter.

On 28 October 2016 the total banknotes in circulation in India was Rs 17.77 trillion (US\$260 billion). In terms of value, the annual report of Reserve Bank of India of 31 March 2016 stated that total bank notes in circulation valued to Rs 16.42 trillion (US\$240 billion) of which nearly 86% (around Rs 14.18 trillion (US\$210 billion) were Rs 500 and Rs 1,000 banknotes. In terms of volume, the report stated that 24% (around 22.03 billion) of the total 90,266 million (9026.6 crore) banknotes were in circulation.

The plan to demonetise the Rs 500 and Rs 1000 bank notes began six to ten months prior, and was kept highly confidential with only about ten people aware of it completely. The logistical processes and preparations for printing the new Rs 500 and Rs 2000 bank notes began in early-May. The cabinet was informed about the demonetization on 8 November 2016 in a meeting called by the Prime Minister of India Narendra Modi which was followed by Modi's public announcement about the demonetization in a televised address. After Modi's announcement, the Governor of the Reserve Bank of India, Urjit Patel, and Economic Affairs secretary, Shaktikanta Das explained in a press conference about the demonetization.

Few Reasons for Demonetization

1. **Controlling the block money:** The decision to discontinue Rs 1000 and Rs 500 banknotes as legal tender from November 9 has led to common man waiting in long queues for new currency across various banks in the country. The reason behind this move is abolish and control over the block money, which is accumulated in few hands in the country. This accumulated block money enhances the gap between rich and poor and also adverse impact on the lives of the common man and countries economic prosperity.
2. **To avoid the terror activities in India:** The major purpose behind this move is to take action against to fight terrorism funded by counterfeit notes. While the supply of notes of all denominations had increased by 40 percent between 2011 and 2016, the Rs500 and Rs 1,000 banknotes increased by 76 percent and 109 percent, respectively, owing to forgery. The forged cash was used by the various terrorists groups from India and outside Indian groups are funded to terrorist activities against India and that the demonetization had considered by the central government as a counter-terrorism weapon.
3. **Abolish fake currency:** Abolish the fake currency is also one of the important reasons among various other reasons of demonetization. The neighboring countries of India are printing fake Indian currency and penetrate it's in to the Indian economy to create imbalances in economical affairs of the country. Hence demonetization is one of the strategies against fake currency.
4. **Limiting the use of money power in the election:** Now days our election system lose its importance, because of political contestants from all parties are least bothered about value, ethics, principles and social norms. To get victory in the election parties and contestants can spend crores

of block and fake money to distribute for voters. If same thing continues, democracy lost importance and countries political stability will be in trouble.

5. **Controlling the inflation:** When inflation really gets out of hand, one solution can be to completely change the currency and to start afresh. With increase in cash available for government expenditure and reduced state borrowing, inflation will fall for the short term and thus prices of basic commodities will also fall.

Implications

The immediate implications of demonetization on various sectors of the economy are as follows.

1. **Stock Exchange:** The BSE SENSEX and NIFTY 50 stock indices fell over 6 percent on the day after the announcement. In the days following the demonetization, the country faced severe cash shortages with severe detrimental effects across the economy. People seeking to exchange their bank notes had to stand in lengthy queues, and several deaths were linked due to the rush to exchange cash.
2. **Political System:** Initially, the move received support from several bankers as well as from some international commentators. It was heavily criticized by members of the opposition parties, leading to debates in both houses of parliament and triggering organized protests against the government in several places across India. The move is considered to have reduced the country's GDP and industrial production. As the cash shortages grew in the weeks following the move, the demonetization was heavily criticized by prominent economists and by world media.
3. **Banking Sector:** A State Bank of India branch remained open at night, and a long queue of people waited outside the ATM to withdraw money .In the first four days after the announcement of the step, about Rs3 trillion (US\$45 billion) in the form of old Rs 500 and Rs 1,000 banknotes had been deposited in the banking system and about Rs 500 billion (US\$7.4 billion) had been dispensed via withdrawals from bank accounts, ATMs as well as exchanges over the bank counters. Within these four days, the banking system has handled about 180 million (18 crore) transactions. The State Bank of India reported to have received more than Rs 300 billion (US\$4.5 billion) in bank deposit in first two days after demonetization. Between November 10 and November 27, banks reported exchange and deposits of demonetized banknotes worth Rs 8.45 trillion (US\$130 billion) (exchange of Rs 339.48 billion (US\$5.0 billion) and deposits of Rs 8.11 trillion (US\$120 billion)). During this period, an amount of Rs 2.16 lakh crore (US\$32 billion) had been withdrawn by people from their accounts.
4. **GDP growth rate:** Global analysts cut their forecasts of India's GDP growth rate due to demonetization. India's GDP in 2016 is estimated to be US\$2.25 trillion, hence, each 1 per cent reduction in growth rate represents a shortfall of US \$ 22.5 billion (Rs. 1.54 lakh crores) for the Indian economy. According to Societe Generale, India's quarterly GDP growth rates would drop

below 7% for an entire year at a stretch for the first time since June 2011.

5. **Drop in Industrial Output:** There was a reduction in industrial output as industries were hit by the cash crisis. The Purchasing Managers' Index (PMI) fell to 46.7 in November from 54.5 in October, recording its sharpest reduction in three years. A reading above 50 indicates growth and a reading below shows contraction. This indicates a slowdown in both, manufacturing and services industries. The PMI report also showed that the reduction in inflation in November was due to shortage in money supply.
6. **Job Opportunities:** There was a loss of jobs due to demonetisation, particularly in the unorganized and informal sector and in small enterprises.
7. **Payment of Taxes:** As the use of the demonetized notes had been allowed by the government for the payment of municipal and local body taxes, it led to people using the demonetised Rs 500 and Rs 1,000 notes to pay large amounts of outstanding and advance taxes. As a result, revenue collections of the local civic bodies jumped. The Greater Hyderabad Municipal Corporation reported collecting about Rs 1.6 billion (US\$24 million) in cash payments of outstanding and advance taxes, within 4 days. The tax collection by local bodies has surged over 260% and more than 15000 crore more after 14 days of demonetization. The total indirect tax collection rose to 14.2% only in the month of December according to Finance Minister Arun Jaitley.
8. **Donations to Temples:** In India, the cash deposited into hundis, or cash collection boxes in temples and gurudwaras are exempted from inquiry by the tax department. This exemption is sometimes misused to launder money. After the note ban, there was a spike in donations in the form of the demonetised notes in temples. Authorities of Sri Jalakanteswarar temple at Vellore discovered cash worth ¹ 4.4 million (US\$65,000) from the temple hundi in the form of defunct notes.

9. **Railway Bookings :** As soon as the demonetization was announced, it was observed by the Indian Railways authorities that a large number of people started booking tickets particularly in classes 1A and 2A for the longest distance possible, to get rid of unaccounted cash. A senior official said, "On November 13, 42.7 million passengers were nationally booked across all classes. Of these, only 1,209 were 1A and 16,999 for 2A. It is a sharp dip from the number of passengers booked on November 9, when 27,237 passengers had booked tickets in 1A and 69,950 in 2A."

CONCLUSION

Demonetization is an extremely bold step taken by the Prime Minister, especially when a large portion of the economy is run on cash transactions and the economy is largely how people feel and interpret the situation. Demonetization was a really a masterstroke. In spite of some short-term problems for common people of the country, it will help in fighting against corruption, black money, and tax evasion. Indian government's goal was to remove all **counterfeit (fake) currency** from the market which is used in **tax evasion**, corruption and even in **funding terrorist activities**. This was a very big and risky decision and as some aptly said it is a "**Masterstroke**". Some even say it is a "Surgical Attack" on black money. In simple words, old Rs 500 and Rs. 1000 notes are worthless now, they are just a piece of paper.

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