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## Demonetization and Its Impacts in India

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### **Abstract:**

*Demonetization refers to withdrawal of a particular form of currency from circulation in an economy. Demonetization is necessary whenever there is a change of national currency and it has its pros and cons. The old units of currency must be removed and substituted with a new currency. In India, the currency was demonetized first time in 1946 and second time in 1978. On 8<sup>th</sup> November, 2016 the currency was demonetized third time by the present government. This paper elucidates the impact of demonetization on the availability of credit, spending, government finances and public.*

### **Keywords:**

Demonetization, Black Money, Cashless transactions, Counterfeiting, Real Estate and Digital Transactions.

### **Objective:**

The main objective of this paper is to study the impact of demonetization on Indian economic system and public.

### **Methodology:**

The paper is based on the secondary data. The secondary data was collected from various published sources like reports, journals, newspapers and internet etc.

### **Introduction:**

The government has implemented a major

change in the economic environment by demonetizing the high value currency notes of ₹500 and ₹1000, keeping in view the manifesto of the party to fight corruption and black money. These notes ceased to be the legal tender from the midnight of 8<sup>th</sup> November, 2016.

From a market perspective, we think that this is a very welcome move by the government and which has taken the black money hoarders with surprise. The move by the government is to tackle the menace of black money, corruption, terror funding and fake currency.

The total currency in circulation as on 31<sup>st</sup> March, 2016 is ₹16,415 billion, of which notes of ₹1,000 denomination account for 38.6% (₹6,326 billion) and ₹500 account for 47.8% (₹7,854 billion). The importance of ₹500 has been increasing over the years, from 4.1% on March, 1990 to 47.8% on March, 2016. Similarly, the share of ₹1,000 note has increased from 1.7% in 2001 to 38% in 2016. The total amount of ₹500 and ₹1,000 notes amount to ₹14,180 billion (almost 86%) as compared with India's national income of ₹1,35,761 billion in 2015-16 (i.e. 10.5% of our GDP.)

Particulars	₹500	₹1000	Total
Notes in circulation (value in INR billion)	7,854	6,326	14,180
Notes with banks together with other Govt. agencies @30%	2,356	1,898	4,254
Notes with public @70%	5,498	4,428	9,926

Due to demonetization, the total cash has to pass through the formal banking channels to get legitimacy. People have been given sufficient time (from 10<sup>th</sup> November, 2016 to 30<sup>th</sup> December, 2016) to exchange the notes held by them.<sup>1</sup> The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes.

In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. From 13<sup>th</sup> March, 2017 this squeeze will be relaxed completely.

The reasons offered for demonetization are two-fold: first, 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’.

### History of Demonetization in India:

The recent sudden move to demonetize ₹500 and ₹1,000 currency notes is not new as ₹1,000 and higher denomination notes were first demonetized in January 1946 and again in 1978. The highest denomination note ever printed by the Reserve Bank of India was the ₹10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data. To check undisclosed black money, corruption and fake

<sup>1</sup>Under certain circumstances people can exchange their currency at specified offices of RBI till 31<sup>st</sup> March, 2017.

currency the Government of India on 8<sup>th</sup> November, 2016 announced demonetization of high denomination currency notes of ₹500 and ₹1000. A new redesigned series of ₹500 and ₹2000 banknotes is in circulation since 11<sup>th</sup> November 2016. ₹1,000 note made a comeback in November 2000. ₹500 note came into circulation in October 1987. The move was then justified as an attempt to contain the volume of banknotes in circulation due to inflation. However, this is the first time that ₹2,000 currency note is being introduced.

### Implications of Demonetization:

The economic implications of demonetization are many and yield mixed results. Still these can be categorized in two parts: benefits and challenges. This move was a ‘shock doctrine’ tactic to dismantle the cash-centric black market, to cleanse the country of counterfeit notes, to digitize the economy, and to get more of the population into the formal, taxable economic grid.

On the other hand, due to this cash crunch, Indian economy ground to halt. Businesses shut down, farmers couldn’t buy seeds, taxi and rickshaw drivers didn’t have any way to receive payments, employers had no way to pay their employees, and weddings throughout the country were canceled. NITI Aayog, on 15<sup>th</sup> December, 2016 introduced two rewards schemes - ‘Lucky Grahak Yojana’ and ‘Digi Dhan Vyapar Yojana’ to promote digital transactions.

Through Lucky Grahak Yojana and Digi Dhan Vyapar Yojana, the government started giving

daily, weekly and mega-awards to encourage both consumers and merchants to make digital transactions. The estimated cost of the first phase (upto 14<sup>th</sup> April, 2017) of the scheme is ₹340 crore. Both the schemes cover small transactions between ₹50 and ₹3,000 and operate under the supervision of National Payment Corporation of India.

As per a government statement, winners will be determined by a random draw of eligible digital transaction IDs. The first draw was made on 25<sup>th</sup> November, 2016 (Christmas Day) and a mega draw will be held on 14<sup>th</sup> April, 2017 (BhimRao Ambedkar Jayanti). The eligible modes of digital payments are RuPay, AEPS, UPI and USSD. Transactions made through private credit cards and digital wallets are excluded for the time being.

In addition to these daily and weekly prizes, mega prizes will be announced for both, consumers and merchants for doing transactions digitally from 8<sup>th</sup> November, 2016 to 13<sup>th</sup> April, 2017. Consumers can win mega prizes of ₹1 crore, ₹50 lakh and ₹25 lakh and for merchants, the prizes are of ₹50 laks, ₹25 lakh and ₹12 lakh.

### **The macro benefits of Demonetization:**

This move by the government is likely to have short term and long term benefits for the economy.

The major benefits of recent demonetization are as follow:

#### **A) Fighting Corruption:**

Initially, demonetization was sold by Modi as a campaign to fight corruption. It was thought that the country's black market wouldn't be able to

exchange or deposit their gluts of illicitly obtained wealth and black money will be taken out of Indian economic system. As predicted by ICICI Securities Primary Dealership, the government's plan to remove ₹500 and ₹1,000 notes from circulation will disclose up to ₹4.6 lakh crore in black money. Corruption will also be automatically reduced by removing black money from the economy.

Moreover, this move would lead to cashless transactions via banking channels. With a large part of the cash moving through the banking channels, the banking sector is likely to be flush with funds and this would help them in reducing the cost of funds. Also with more money being kept in the banking channel, some of these low cost deposits may be sticky and improve the medium to long term Current Account and Savings Account (CASA) ratio of the banks.

#### **B) Sound Economy:**

The proportion of unaccounted currency would reduce from the liabilities of the government and would add to its finances. This can have very strong implication as the government would get money to spend without borrowing from the market. This would mean that while interest rates can be low, the government spending on large infrastructure (we assume that the government would invest large proportion for infra spending) projects push economic growth higher in the medium and long run. Like Finance Minister Arun Jaitley says, "Bank deposits will increase and they will have more capacity to support the economy."

#### **C) Fighting Counterfeiting:**

Another stated goal of demonetization was to curb counterfeiting. It was reported that prior to

this initiative, 250 out of every million Indian banknotes were fake - the blame mostly being placed on Pakistan, where there are rumored to be government-directed printing presses churning out Indian rupees to fuel terrorism. The new ₹500 and ₹2,000 banknotes which are currently being issued have different designs and are of different sizes than the previous notes, so all old fake notes were instantly washed off from the economy.

Undoubtedly, changing banknotes is, of course an effective means to combat counterfeiting, but how long will this last? Only time will answer this question.

#### **D) Digital Payments**

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People are adopting online payment system such as BHIM, Paytm etc. after ban for high denomination currency in India. Digital transaction systems, E-wallets and apps, online transactions using E-banking, usage of plastic money (Debit and Credit Cards), etc. has noticed substantial increases in demand. This behavioral change could be a game changer for India in the near future.

The Hindu reported that “Reserve Bank of India (RBI) has urged citizens to switch to alternative modes of payments such as pre-paid cards, credit and debit cards, mobile banking, and internet banking.”

In a press conference on 12<sup>th</sup> November, 2016 the Union Finance Minister too said that “Those in businesses should start using digital payment gateways, cards and banking system. Life will become simpler in the new financial system that is the only viable option.”

#### **E) Terror Funding:**

Union Defense Minister Manohar Parrikar called demonetization the "surgical strike" on black money, terrorism funding and drug money. Ever since demonetization of the ₹500 and ₹1000 Indian currency notes, the Indian state of Jammu and Kashmir has suddenly seen a massive downward spiral in instances of violence and stone pelting. It has almost choked the illegal Pakistani Hawala funding. Indian intelligence sources mentioned that in the past year, Pakistan pumped in approximately ₹1,000 crore for the single purpose of fomenting terror in Jammu and Kashmir and disrupt peace in the valley. The money was then spent on training, purchasing of arms and ammunition and sent to local militants in Kashmir, and thus Kashmir saw a massive upsurge in the recruitment of local in militant outfits in the past few years. With demonetization of the big currency notes, not only has such funding being blocked, the cash in hands of terrorists and their agents has been rendered worthless and Fake Indian Currency Notes (FICN) network has also been dismantled.

However, two freshly-minted ₹2,000 notes were recovered last week of February from the bodies of two terrorists, who'd been gunned down in an encounter with security forces in Jammu and Kashmir.

#### **F) Real Estate:**

Transactions in the real estate sector often have a significant cash component, as it reduces incidence of capital gains tax. Demonetization is likely to reduce the real estate prices and make it affordable.

This may be visible more in the rural belt, where many non-farming entities purchase fertile farmland, not for farming but for money parking purpose.

### **G) Elections:**

Demonetization has shocked political parties too. In many states like Punjab and Uttar Pradesh, cash donations are a huge part of "election management". In one stroke, all political parties found themselves helpless as cash hoards are often undeclared money. Parties had to completely rejig campaign strategies in the light of expected cash crunch.

“It will definitely have some impact on free flow of money in elections but I don't think it will curb the whole menace. We all know that in Uttar Pradesh and Punjab elections, money plays a big role. There will be some control after the decision.”- Former Chief Election Commissioner S.Y. Quraishi.

### **H) Lower Interest Rate:**

We will see a lowering interest rates for education loans, home loans and medical loans very soon. It will make higher education and medical facilities more accessible. This change is hard to undo because if any subsequent government increases loan, it will suffer huge backlash.

### **I) Reduce Tax Avoidance:**

Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this period. During this period, dealing in sectors like jewellery and real estate will be on radar and those entering into loan transactions may also undergo tax scrutiny.

Search and Seizure activities of the IT Department will also rise to curb such malpractices. Limits have already been

prescribed for reporting to the IT Department regarding those bank accounts in which excess cash deposits are being made in this 50-days window. (₹2.5 lakh in the case of individuals and ₹12.5 lakh in case of firms)

**Challenges:** Demonetization resulted in a lot of challenges for the government and public, which are discussed as follow -

### **A) Liquidity Crunch:**

The liquidity squeeze caused by demonetization was negative across sectors with high level of cash transactions. Real estate, jewellery, retailing, restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space faced short term instability. Those companies with high level of debt faced more pressure and even faced loan defaults.

### **B) Decline in GDP:**

India may lose the “fastest growing major economy” tag to China in 2016-17 with the International Monetary Fund (IMF) lowering India's growth forecast for the current fiscal year to 6.6% from its previous forecast of 7.6% because of disruption caused by the government's move to invalidate high-value currencies.

The sudden decline in money supply and increase in bank deposits is going to adversely impact consumption demand in the economy in short term. Recession in demand resulted in loss of revenue in the form of indirect taxes such as excise duty and VAT/CST to the state and central government.

### **C) Replacement Cost of Currency:**

There will be an added replacement costs of currency. One cannot ignore the increased cost of operating ATMs need to be refilled more often and also it will be a huge burden on banks. Initially, it is very difficult to create a cashless society as more than 50% of Indian population is not well versed with card transactions. Also for these initial months, it will be very difficult to make cash transactions of a higher amount.

#### **D) Inconvenience to Public:**

After demonetization of high value currencies, we witnessed the long queues that people waiting outside the banks and ATMs across the country which created an inevitable consequence like loss of productive man hours.

Moreover, around 75+ odd people died and millions are suffering to curb utmost 5% of the total black money and 0.02% of fake currencies, as the rest of black money is in abroad and in non-monetary form.

Joblessness has been reported in various sectors of economy such as agriculture, small and medium manufacturing units, unorganized sectors such retail trade, construction etc.

#### **E) Wedding Industry and Vendors:**

Not only the to-be-weds and their families faced the effect of demonetization but also the vendors faced the heat and many suffered from huge losses due to lack of wedding orders as it was wedding session when demonization was declared.

Common men faced a lot of hardships. Marriages functions had also been worst affected by the

demonetization, to such an extent that, many families postponed the marriage functions.

#### **F) Hackers focusing India:**

With more transactions happening digitally, the Hacker around the world will have all eyes on India due to the lack of knowledge and awareness among Indian citizen about cyber security.

Further, digital wallets such as Paytm, FreeCharge, MobiKwik, etc. fall under the category of non-banking financial corporations (NBFCs). This excludes them from the ambit of RBI's governing laws.

#### **Findings and Suggestions:**

However, the recent demonetization has only hit the stock of unaccounted wealth kept exclusively in form of money. To curb regular accumulation of more unaccounted money, Government could institute a mechanism of incentivizing tax compliance and punitive and demonstrative deterrent for those caught while generating black money.

Second, by extensive financial literacy on harmful impact of unaccounted money - ranging from personal health to national loss. This should become part of school and college curriculum.

Finally, and most importantly, Government could consider transparency in political funding/election funding as is the case in the USA and some other advanced countries.

#### **Conclusion:**

Demonetization can lead to improved tax compliance, better fiscal balance, lower inflation, lower corruption, complete elimination of fake

currency and another stepping stone for sustained economic growth in the longer term. It is true that it has caused some trouble to common people, but for larger goal some extent of inconvenience is inevitable.

But when it comes to fighting black money, demonetization helped eradicate around 5% of the Black Economy which was put in cash. Also

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<sup>2</sup> **Money: The Unauthorised Biography** by Felix Martin. Bodley Head (2013), 336 pp. ISBN-10: 1847922333; ISBN-13: 978-1847922335.

<sup>3</sup> **The great Indian chemotherapy:** Demonetization causes intense pain, government needs to demonstrate more empathy - Chetan Bhagat

Indian economy might move towards digitalization. But looking at some digital economy like USA, there is no guarantee that it will put brake to corruption. Whereas Japan considered as less corrupted country even its cash economy is 20% of the GDP. So until and unless people of our country change their mindset, nothing is going to change.

<sup>3</sup> <http://www.thehindubusinessline.com/economy/demonetisation-to-increase-eco-size-enhance-revenue-base-saysjaitley/article9324312.ece>

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