

Demonetization and Its Impact

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Abstract:

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency. The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with new currency. It is necessary whenever there is a change of national currency. The old unit of currency must be removed and substituted with a new currency unit. The currency was demonetized first time in 1946 and second time in 1978. On Nov. 2016 the currency is demonetized third time by the present Modi government. This is the bold step taken by the govt. for the betterment of the economy and country.

Keywords:

Demonetization, Black Money, Counterfeit Currency, Corruption.

Introduction:

On the eve of 8th November 2016, the Government of India made an important attempt to strike the black money hoarders and counterfeit currency suppliers. The Prime Minister made a national announcement that 500 and 1000 rupee notes would cease to be legal tender money from midnight, thereby nullifying 86% of Indian currency. As much as it did enrage a minor part of the population,

it was largely considered a welcome move.

The Government of India announced that the Rs 500 and Rs 1000 denominated currency notes will cease to be legal tender. The move was targeted towards tackling black money, corruption and terrorism. After initial euphoria, questions began to emerge. What are the costs of this demonetization? Will it be effective if people can still create new black money thereafter? Will it increase the GDP? Will it increase inflation? What about tax revenues?

This report highlights the probable consequences of this decision on various economic variables and entities.

1) Effect on parallel economy

The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee Notes is expected to

- remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks,
- Temporarily stall the circulation of large volume of counterfeit currency and
- curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

2) Effect on Money Supply

With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees

notes get widely circulated in the market, money supply is expected to reduce in the short run. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money and hence money supply will decrease permanently. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.

3) Effect on Demand

The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly:

- Consumer goods
- Real Estate and Property
- Gold and luxury goods
- Automobiles (only to a certain limit)

All these mentioned sectors are expected to face certain moderation in demand from the consumer side, owing to the significant amount of cash transactions involved in these sectors.

4) Effect on Prices

Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

- Consumer goods: Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
- Real Estate and Property: Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks

transfer or cheque transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices (probably charging more on cheque payment).

5) Effect on various economic entities

With cash transaction lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- Agriculture and related sector
- Small traders
- SME
- Services Sector
- Households
- Political Parties
- Professionals like doctor, carpenter, utility service providers, etc.

6) Effect on Banks

As directed by the Government, the 500 and 1000 Rupee notes which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to

these funds for emergency purposes, there would be withdrawals at the second stage.

7) Effect on Online Transactions and alternative modes of payment

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increase in demand. This should eventually lead to strengthening of such systems and the infrastructure required.

The Short-Term Vs. The Longer-Term Implications

The Short-term Impacts:

There will be a disruption in the current liquidity situation as households are likely to get affected by the note exchange terms laid by the government. Though clarity is unfolding on this, commodity transactions and general cash market transactions are likely to feel an immediate impact. Unorganized sector proceedings, including small trade market activities, will remain volatile in the short-term. Roadside vendors, cab drivers, kiriyana stores, etc., have already stopped accepting Rs 500 and Rs 1,000 notes. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which is likely to be affected by immediate liquidity issues. Overall, negative impact on disposable income is expected along with likely disruption in the consumption patterns of the general populace. It is estimated

that there will be a negative GDP impact in the current quarter as consumption gets a shock in the immediate term. However, quantum and degree of this impact cannot be ascertained at this time.

The Longer-term Impacts:

This essentially represents a change in regime for the real and financial economy. Domestically, there could be some turmoil as the effect will be disproportionately felt by the lower and upper income classes. Internationally, the government is likely to get thumbs up for the move and more countries could potentially see this as a viable option to curb black money and stem illegal financial activity. Last, through this move by the government may not be a first, having being tried by earlier governments as a tool to fight corruption. Such an action achieves larger significance for a globally connected India as it shows boldness in tackling an issue which has remained a thorn in the growth success story of this generation.

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.

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