

IMPACT OF DEMONETIZATION ON INDIAN ECONOMY: MICRO AND MACRO PERSPECTIVE

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ABSTRACT

In the words of a common Indian the meaning of demonetization is the process of abolishing the old currency notes of 500 and 1000 from circulation by central bank i.e. reserve bank of India. As a matter of fact this was the actual mode of payment in open market. It can also be said that the currency is being stripped from being a unit of payment and cancelling its status as legal tender. It was the midnight of 8th November, 2016 when the act of demonetization took place in India, at this juncture the government announced that the 500 and 1000 currency notes will no longer be in circulation and will not be considered as legal mode of payment. On the other hand new currency notes of 2000 and 500 denominations will be introduced in the market and other denominations like 1,5,10, 20, 50 and 100 will remain in circulation. Government took this decision for the certain reason of eradicating corruption, curb the menace of black money and duplicate notes from circulation.

KEYWORDS: *Demonetization, Indian Economy, Tax Evasion, Industrial Sectors.*

Introduction

The dictionary meaning of demonetize is "To deprive (a metal) of its capacity as a monetary standard" or "To withdraw from use as currency" So, demonetization is the act of stripping a currency unit of its status as legal tender. It is the act or process of removing the legal status of currency unit. A currency on which Governor of RBI on behalf of Central Government guarantees by making statement "I promises to pay the bearer, the sum of money" which empowers it a legal status. From the date of demonetization, all old currencies which are demonetized will cease to be a legal tender. The meaning of demonetization is that *the 500 and 1000 currency notes will no longer be in circulation and will not be considered as legal mode of payment. On the other hand new currency notes of 2000 and 500 denominations will be introduced in the market and other denominations like 1,5,10, 20, 50 and 100 will remain in circulation.* On 28 October 2016, the value of currency in circulation was around 18 lakh crores and out of this total value of money in circulation around 14 lakh crores were constituted by 500 and 1000 currency notes as a matter of fact this was around 80% of the total money in circulation. One of the main objectives of demonetization was to eradicate the black money from circulation and strengthen the economic system of the country. Some of the other reasons can be listed as follows:

- To eliminate counterfeit currency
- To shrink the size of the parallel economy and black money in India
- To reduce corruption and

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- To curtail terror financing

As far as the menace of black money is concerned it is having the power of a shadow economy which can generate high inflation in the market and affects the middle class of the society to a high extent. Even it creates an unanswered question for the poor section of the society. Now if the same money will actually be in circulation then it can be used by the government for the respective welfare of the society and other activities of development. So, in order to curb the menace of black money, various measures have been taken by the Government which includes,

- Constitution of a Special Investigation Team (SIT) under the Chairmanship of a former Supreme Court Judge B.P. Jeevan Reddy and implementing some of its recommendations;
- enactment of a new law viz., 'The Black Money and Imposition of Tax Act, 2015' to deal with black money stashed abroad;
- Introduction of 'Benami Transactions Amendment Bill 2015' enabling confiscation of Benami property;
- Enhancing the sharing and exchange of information with foreign countries and proactive involvement in international efforts to combat tax evasion/black money;
- Introducing Income Declaration Scheme, 2016;
- Use of information technology for mining of information;
- Prescribing requirement of PAN numbers on high value transactions;
- Taking action against hoarders through enforcement agencies; and
- Constitution of Multi Agency Group with members (investigation) of CBDT for speedy investigations against Indian persons having undisclosed foreign assets.

Objectives

- To study the impact of demonetization on various sectors of the Indian Economy;
- To identify the probable consequences of the demonetization.

Research Methodology

As his present study is based on secondary data, hence no stone is left unturned to assemble the information. The data has been collected from internet. Graph and percentile method has been used to analyze the data.

Experiences from other Countries

- **Russia:**
 - As we all know that ruble is the official currency in Russia and in the year 1991 the then government of Russia headed by Mikhail Gorbachev withdraw the high denomination rubles from circulation. This step was taken by the government to curb the menace of black money from the country. But this was the wrong decision which was taken in a hurry without a proper planning and backup and it backfired within no time. As a result of the same in place of decreasing the inflation raised and the government lost the confidence of public. The economy of the country trashed to a level where the Soviet union was carried to breakup in the following year. The recurring government took a lesson from this and systematically reduced the high denomination notes from circulation without much affecting the system and minimum oppose from public.
- **Zaire:**
- As far as Zaire is concerned, like North Korea, there prevails the dictatorship. Here also demonetization took place in the name of economic reform in the year 1990. Dictator Mobutu SeseSeko took the step without proper planning and administrative setup which resulted in the increase of inflation and decrease in the value of currency as against US dollar. The after effect of demonetization were so adverse that civil war broke out in the country and in the year 1997 Mobutu has to abandon his leadership.

- **Myanmar:** In Myanmar demonetization was done to curb the effect of black market and outset the shadow economy of black money. This was the year 1987 when the authorities withdrew around 80% of the currency from circulation. This decision was not accepted by the people of the country and a civil war broke out, where thousands of civilians were killed without any good reason.
- **North Korea:** Again in case of north Korea demonetization took place in the year 2010, here also the step was taken to fight back the black market and regain control over the economy. This was the regime of Kim Jong II, who is popular to run the country as a dictator. As a matter of fact the decision of demonetization didn't worked out for the country as the largest food shortage in the history of the country occurred and other dimensions were also adversely affected. Finally Kim jong II has to apologize publically.
- **Ghana:** The economy of Ghana was considered as one of the mildest economies of the world, where the government has minimum surge over the economic dimensions. As a result of the same it became easy for the citizen to evade taxes and take undue advantage of the same. In order to meet the requirement of development at economic level, in the year 1982 demonetization took place. Again this step of the authorities didn't worked out and the situation became even worse when and people started to take the support of foreign currency and other physical assets and instead of decreasing the effect black market increased in the country which was the result of the lack of proper infrastructure in the country.

Impact of 2016 Demonetization on the Economy

Improvement in Government's fiscal position going forward

The implication for the fiscal deficit is a clear positive, as the government could gain windfall assuming large number of unaccounted currency does not make its way back into the banking system. Also incrementally we might see tax reporting discipline and hence the increase in tax collection through better reporting and audit.

Higher benefits for the Government if lesser currency notes comes back into the system

The high denomination currency which has to be demonetized accounts for **85.2%** of total notes which is nearly Rs. 15trn worth currency in the economy. Conservatively, we assume that 80% of this old currency (Rs. 12 trn) will be deposited back in banks in order to get the new currencies in exchange. RBI will have to replace this Rs.12 trn old currency with new currencies, which will be part of RBI's liability. The balance amount (unaccounted part of the demonetized currency) to the tune of Rs. 3 trn will not be deposited back in the banks will reduce RBI's liability to that extent as these notes may cease to exist.

Increase in Tax Reporting leading to better revenue hence better fiscal

Going forward an increase in tax collection through better reporting and audit is likely. Once cash holdings are deposited into the banks to exchange new currencies, understating true income for tax purposes will be very difficult. This may potentially lead to better compliance, thereby increasing the tax base and revenues of the government.

System Liquidity to increase going forward

Banking system liquidity will get a major boost with deposits increasing and currency in circulation growth reducing going forward, as unaccounted cash money is flushed out of the system and future cash transactions also reduce. Despite an expected improvement in banking sector liquidity, the credit growth is not expected to improve meaningfully going forward. In fact credit growth could slow down in the short term as loans to the retail sector, NBFCs and services slow down further due to the adverse impact of demonetization in these segments.

Inflation Expected to Fall Further

The move is likely to have a strong disinflationary impulse. The real estate sector, where a sizable proportion of transactions were conducted in cash (and often with black money), will be the worst affected followed by an expected slowdown in consumption demand. In our CPI forecast, we have assumed in housing inflation as well as slowdown in consumption demand, which has the potential to reduce CPI inflation average to 4.3% - 4.6%, from our current forecast of **4.8%**.

Growth to be positively impacted over medium to long term with near term hiccups

The move is likely to be negative for growth in the near-term, as informal sector activity, which is supported primarily through cash transactions, slows down in a knee-jerk response. By expenditure, personal consumption accounts for nearly 60% of total GDP. Sectors such as agriculture, construction, trade, hotels, transport, real estate and other services amount to around 56% of total GVA. Our assumption is close to 30% of the economy (50% of the above sectors) will be affected due to limited availability of legal tender. *However this impact should be felt only in the short run as money from informal channels getting converted into formal banking channels because of the current measure would lead to faster expansion of our GDP (due to higher multiplier than parallel economy), thereby leading to higher GDP growth going forward.*

Liquidity

Notes in circulation as of November 4, 2016 was Rs. 17,742 billion i.e., 13 per cent of GDP and the value of Rs. 500 and Rs. 1,000 currency notes in circulation was around 15,000 billion and this values around 87% of all the denominations of the currency notes in circulation and constitutes around 11% of the country's of GDP (Hari, 2017). The demonetization move along with the imposition of withdrawal limits resulted in severe contraction in the supply of currency notes which again negatively impacted the liquidity in the immediate term. Apparently the authorities believed that focus on digital payments and issue of new currency of different denominations will bring about cash circulation to mean levels.

GDP

IMF projected that India's growth will slow down to 6.6% in the financial year of 201617, and demonetization will play major role in this slow down of the economy. On the other hand IMF also projected that this effect will be short term only and will not last longer than a year, but this much time will be sufficient to bring down the growth rate of the country. Then again the rate of growth will rise to the level of 8% in the coming years. Obviously there will be a shortage of cash for some time and the consumption level also decreased. This decision has the effect on the respective business activities in the country as the same slowed down, this was again a challenge for the authorities to adjust the same according to the need of the economy.

Inflation

Demonetization addressed multiple issues with one stroke. Most importantly, it has straight away wiped out most of the illegal cash accumulated over a number of years from the system. This will have a direct impact on inflation as there will not have too much money chasing too few goods and excess money supply will no longer fuel price rise and counterfeit currency circulating in the country has ceased to be of any value. Hence, there will be downward pressure on prices due to lower demand especially in rural areas where share of cash transaction is high (Hari, 2017). If in any of the countries, comes under the head of developing economy, the basic medium of exchange i.e. the currency are changed or devalued then certainly it will affect the prices of the commodities in the country. This will not be as per the expectation of the people and economic unrest may occur. (Raoet.al., 2016).

Credit Creation

The demonetization move would bring back a lot of money outside the system back into the financial system which can be used by banks for financing the commercial activities. This would not only improve the profitability of banks, but would also pave way for reduction of interest rates and partly address the problem of NPAs. Thus, demonetization has brought a large part of money into the formal banking system which has increased the ability of the banks to lend.

Taxation

According to the Finance Minister Arun Jaitley, both indirect taxes and direct taxes levied by the Union government registered good growth in the month of December 2016 suggesting that the impact of demonetization on economic activity was limited. There has been a 26.2 percent increase in central indirect tax collection till November 30, 2016. Excise duty was up by 43.5 percent, service tax by 25.7 percent and custom duties up by 5.6 percent. Till 19th December, 2016 direct tax collection increased to the extent of 14.4 per cent.

Impact of Demonetization on Various Sectors of the Indian Economy

Job Market

The experts of the job market use to believe the drive of demonetization will certainly affect the job market, but the extent of this effect will be not be devastating. There will be no dearth of jobs at the

senior level of management, but then again the over hiring scenario will be slowed down. On the other hand the companies might not be looking forward towards downsizing apparently the incentives and the respective increments will certainly get affected. The major effect of demonetization will be on the job market of retail industry, FMCG sector, companies engaged in infrastructural development, auto ancillary market and building material. This issue can be met out by focusing on the current trend of the economy and then job sector portfolio, in India, we can bifurcate the job market in two segments i.e. formal sector and informal sector, and as a matter of fact maximum of the people are engaged in the informal sector. This means that all the people engaged in the informal sector are having an opportunity to shift from one sector to another till the ratio of hiring regains, which certainly will.

Consumer Expenditure

For any of the developing economy the expenditure made by the consumers, for buying the commodities of their use, is one of the main contributors in GDP. The act of demonetization has reduced the same, and this can be seen in the last two quarters. The reasons for the same can be stated as the following:

- At the time of demonetization the lower denominations currency notes were not much in circulation, and apparently the sudden withdrawal of high denomination currency notes dropped the sale of FMCG by 25% in the month of November. This also stands true for the popular retail stores, the items affected were like grocery items and daily use items.
- As an effect of demonetization, many of the big production houses have cut down their production quantities which adversely affected the supply chain network in the country in all respects.

In order to sort out the above problem, the government of India might take some corrective actions to fuel the market again, like providing privileges to online shoppers in the form of cash discounts, cash back. Even the rural customers can also be targeted by the way of their respective Jan Dhan Accounts. Even the reductions in the taxes for a particular can also be a good idea.

Real Estate

Real estate is one of the sectors that are most affected by demonetization, as a matter of fact the market of real estate dipped by almost 40%. This drop was experienced in both the enquiries of sales and actual sales. Even in the metropolitan cities like Bengluru and Delhi this dip was even steeper where the market dropped by almost 60%. The situation became even worse when the buyers started waiting for the sudden slash in the prices. The answer is hidden in the question itself; if the industry agrees to reduce the prices to a certain extent then the industry may gradually overcome the problem. On the other hand if the government can work on tax reductions which can help the industry to recover in terms of sales.

E-Commerce

This is also one of the major sectors that were affected by the act of demonetization, with all the above mentioned reasons the value input of the online shoppers dipped by almost 50%, this drop was experienced just after the announcement of demonetization. As a matter of fact this was the time when the ecommerce companies' use earn the maximum sales i.e. last quarter of the year. This particular dip is expected to retain at least by March 2017. Even the impact can be experienced in the sale of high end products like LED televisions, music systems, smart phones, etc. There was a positive side of the situation as well where high rise was experienced in case of online or digital payments, all the people having the facility of online or digital payments started trying it, this again can put the ecommerce industry on the brighter side as there was a hike experienced in the online order in the same period. More of the online payment modes can be created which can be in the form of online wallets or new type of cards and payment by cards for cash on delivery mode. Time bound cash deduction can also be a good idea.

Tourism

As mentioned above the period of demonetization is the peak period for the tourism industry as well. Other than the listed metro cities, the inbound and outbound tourism has decreased around 40%, and this was visible in the form of scarcity of cash in the hotel industry and even in case of civil aviation sector. There are some of the tourist places where the entry and use of other facilities is digitally enabled, but this doesn't stands true for most of the cases, and the scarcity of cash made the situation even worse for the tourism industry. Considering the tourism as one of the major contributors the government may provide a certain amount of cash at certain points to cater the tourist for inbound tourism and even the infrastructure for the development digital payments must be developed as early as possible.

Aviation

Aviation is one of the most prestigious and fastest growing industries in the Indian Scenario, the impact of demonetization was around 28% dip in the customer bookings. But then again the industry recovered at a fast pace, but haven't reached the previous benchmark till the last quarter of the year. The cash payments were mostly hit in the period, like in case of travel agencies who use to take cash payments. This issue of dip in booking can be stopped by providing offers to the passengers, provide proper infrastructure for the sake of online payments.

Telecom

The sale of mobile phones dipped by almost 28% in the period of demonetization, i.e. the month of November, this drop of sales was in comparison with the last quarters. Again this drive has accumulated inventories at the end of retailers, but then again the online shoppers who use to make digital payments by credit and debit cards were less affected. The reports of IDC claims that the drop in sales of featured phones will be around 25% and that of smart phones will be around 18%.

Agriculture

As a matter of fact agriculture is one of the favorite sectors of the policy makers and maximum of the benefits are being provided to this sector in terms of money and policy as well. In the lieu of the same, farmers get benefitted even in the period of demonetization where the government allowed them to deposit any amount of money under the government transactions. Even at the village level the old currency notes were accepted for a particular period of time, i.e. till the last dates of surrendering them, this decision has made the sector keep going even in the later period. Then again to regain the earlier pace it will take at least another two quarters. The activation of Jan Dhan accounts and initiation of digital payments can improve the situation even more faster.

Conclusion

The demonetization move has created chaos in every strata of the society whether upper, middle or lower. This is because, India is cash based economy and demonetization temporarily decreased the liquidity position. Decreased liquidity leads to less demand which in turn results in low productivity causing a slowdown in consumer market. Without adequate and proper planning, the demonetization-driven cash crunch has rendered Indian economy paralyzed at least for short duration. Demonetization is one of the major decisions taken in the economic history of the country, where the currency notes of highest denominations were withdrawn from circulation, this drive is expected to impact the economy to a certain level, and up to a certain time, but as the time passes by people will understand the necessity of the same. The experts of the economy believe that the black money may not be fully eradicated but then again it will improve the condition of the economy to a certain extent.

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