

Demonetization 2016: Impact on Indian Economy

Rupali Gupta

Assistant Professor, Govt. First Grade College, Chitradurga, Karnataka

Abstract

Demonetization is a phenomenon where the legal status of currency notes have been ripped off by the monetary authority of a nation. Panic on the faces of people, unbelievable long queues at ATMs irrespective of weekdays or weekends, heavy purchase of gold and silver till midnight, panic on the faces of black money hoarders reminds us of an the economic event that happened on November 8. 2016, at 8:00 P.M, that is demonetization of higher denomination currency of Rs. 500 and Rs. 1000. This kind of experience has not been a new one for the Indian citizens. People of India have experience this event even in 1946 and 1978. The step of demonization was taken up by the government in order to attain various objectives like- curtailment of counterfeit currency, eliminate the problem of black money, and stop the funding of terrorism and naxalites activities and so on. Demonetization has affected agriculture sector adversely, it was impacted by the input and output channels. Rural areas suffered a slow growth rate due to excessive dependence on cash transactions. The urban sector in spite of having adequate bank branches, adequate use of debit cards, ATM and online banking, people then too suffered due to limiting of per head cash withdrawals and exchanges. Though in short run it has been pinching for the people, but in long run, the benefits of the demonetization will be positive as it will be a scary demon for the black money hoarders and manufacturers of counterfeit currency.

Keywords: Black money, Demonetization, e- wallets, counterfeit currency.

Introduction

Disruption of cash flow in Indian economy enhanced the understanding about the trouble of black money as well as the importance of demonetization for Indian economy. Long queues at ATMs irrespective of weekdays or weekends, heavy purchase of gold and silver till midnight of November 8, 2016, panic on the faces of black money hoarders reminds us of an historical economic event that happened on November 8. 2016, at 8:00 P.M, when India's Prime Minister Sri Narendra Modi, announced the about the initiative of demonetization of higher denomination currency of Rs. 500 and Rs. 1000.

Demonetization is a phenomenon where the legal status of currency notes have been taken off by the monetary authorities of the nation. This kind of experience has not been a new one for the Indian citizens. People of India have experience this event even in 1946 and 1978. Indian economy is cash reliant economy, due to lack of digitalization and lack of digital literacy and as a result of demonetization, people experienced a huge set back. In this context, it becomes necessary to understand the objectives behind this initiative. The step of demonization was taken up by the government in order to attain various targets like- curtailment of counterfeit currency, eliminate the problem of black money, and stop the funding of terrorism and naxalite activities and so on. The step of demonetization was taken up with the pure intension of cleansing the economy, but whether it has really happened so is a question mark. This paper intends to analyze impact of demonetization on Indian economy and also analyze the demonetization experiences in other nations to understand the impact of demonetization.

Demonetization: The dictionary meaning of the term 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 (Kamatchi and Dr. Kalaimani, 2016). It is the act or process of taking away the legal status of currency unit

On 8 November 2016, India's Prime Minister Narendra Modi announced the Government of India's decision to cancel the legal tender character of ₹500 and ₹1,000 banknotes with effect from 9 November 2016. He also announced the issuance of new ₹500 and ₹2,000 banknotes

in exchange for the old banknotes. Ministry of Finance has been monitoring the implementation of various measures for smooth attainment of objectives of demonetization in a number of ways, like: Exchange of old currency notes for new ₹500 and ₹2,000 currency notes has been permitted until 31 December 2016, currency exchanges have been limited to specific amounts and excess amounts are required to be deposited with adequate KYC documents, cash withdrawals have been limited to ensure supply of new currency notes to maximum people and not to the few, usage of old currency notes was permitted at hospitals and pharmacies, gas stations and foreign currency exchange for tourists. These are some of the steps taken by government to implement demonization, by causing minimum hassles to the people of the country.

Research Problem

Withdrawal of 85% of currency circulation from the nation has shock struck all the elements of economy. This paper tends to analyse the reasons behind introduction of demonetization and also short term impacts of demonetization. The research problem in this paper is 'Demonetization has caused pinching short term impacts'.

Objectives

The objectives of the study are:

1. To analyse the experience of demonetization in India and other countries.
2. To analyse the problems motivating government to introduce demonetization.
3. To analyse the immediate impacts of demonetization over the economy.

Research Methodology

The research has been conducted based on secondary data. Both paper-based sources and electronic-source based secondary data has been utilized. The various Annual Reports of RBI has been referred for compilation of data. The study on certain variables like – cash GDP ratio, HDN as percentage of GDP, Circulation of currency, counterfeit currency has been conducted for the period of 2000-16. Statistical tools like Trend line, R^2 , Ratio and Charts have been used.

History of Demonetization in India

The history of demonetization in India can be classified into three periods namely- **Medieval Period, Pre-Independence Period and Post-Independence Period.**

1. Medieval India: Muhammad Bin Tughlaq of the Tughlaq Dynasty (Delhi Sultanate) had introduced a token currency, i.e. coins made of brass and copper, the value of which was made equal to that of gold and silver, the step taken by the Sultan can be termed as demonetization because gold and silver coins were deprived of their status as money and were replaced by brass and copper. This scheme, however, failed badly because every person started minting brass and copper coins at home and got it exchanged with Gold and Silver coins (Prakash 2016).

2. Pre-Independence India: The High Denomination Bank Notes (Demonetization) Ordinance, 1946 was passed on 12 January, 1946 by the then Governor General of India. According to the Ordinance, Rs. 500, Rs. 1,000 and Rs. 10,000 currency notes ceased to be legal tender since 12 January, 1946.

3. Post-Independence India: The High Group Bank Notes (Demonetization) Ordinance, 1978 was proclaimed by the President on 16 January, 1978. The Ordinance was afterwards revoked and was substituted by the High Denomination Bank Notes (Demonetization) Act, 1978 on 30 March, 1978. According to this new law, Rs. 1,000, Rs. 5,000 and Rs. 10,000 denomination banknotes stopped being legal tender from 17 January, 1978 (To Defy or Demonetize, 2017).

During 1978, demonetization did not have a large impact on GDP, because the value of demonetized currency notes was only 0.1% of GDP were demonetized, but in the current situation it will surely impact as the value of demonetized currency notes are 11% of GDP. In

case of 1978, currency worth 1.46 Billion INR was demonetized and 68% of it was tendered back. Initially the credit growth rate subdued and after 4 month it rose up moderately, in case of deposits there was a sharp increase like in the current scenario also (Mali, 2016).

Demonetization in other nations

Many nations of the world have experienced and experimented demonetization and an insight about it would be provided in this segment. In case of Myanmar, two instances of demonetization can be observed, one during 1985 and second during 1987, during first instance 50 and 100 Kyat notes were demonetized and a limited exchange facility was implemented and along with it 75 Kyat notes introduced, but due to this the government faced large scale public protest and it lead to economic and political instability. In the second instance 25, 35 and 75 Kyat was demonetized and a spurt in buying and hoarding of consumer essentials which resulted in inflation. Brazil also experienced demonetization in two years- 1990 and 1993, the first one was termed as 'Collar Plan', and second one as 'Real Plan', both aimed at combating hyper-inflation, by freezing all deposits above certain limit, freezing down the prices and wages and the old currency- 'cruzado novo' was replaced by 'cruzeiro'. All this led to a drastic fall in the output levels, the price rise couldn't be controlled due to excessive reinjection of liquidity, economy gradually stabilized. North Korea experimented this initiative in 2009, in order to combat black money and inflation, through demonetization of old currency and later in 2010 some restriction on free markets were eased down, the result was public protest and black marketing halted for a short time. Austria experimented this step in 1988 and 2015, to prevent counterfeiting by introducing counterfeit resistant polymer banknotes in 1988 and in 2015 a new feature 'tactile' was introduced in the currency notes, it was the first nation to circulate the complete series of polymer banknotes. Pakistan introduced demonetization in 2015, to fight corruption and black money, by introducing new features in the currency and replacing the old currency denominations of 10, 50, 100 and 1000. In Euro area the new €50 was unveiled, which was announced to be circulated since April 2017. These were some of the experiences of different nations (To Defy or Demonetize, 2017).

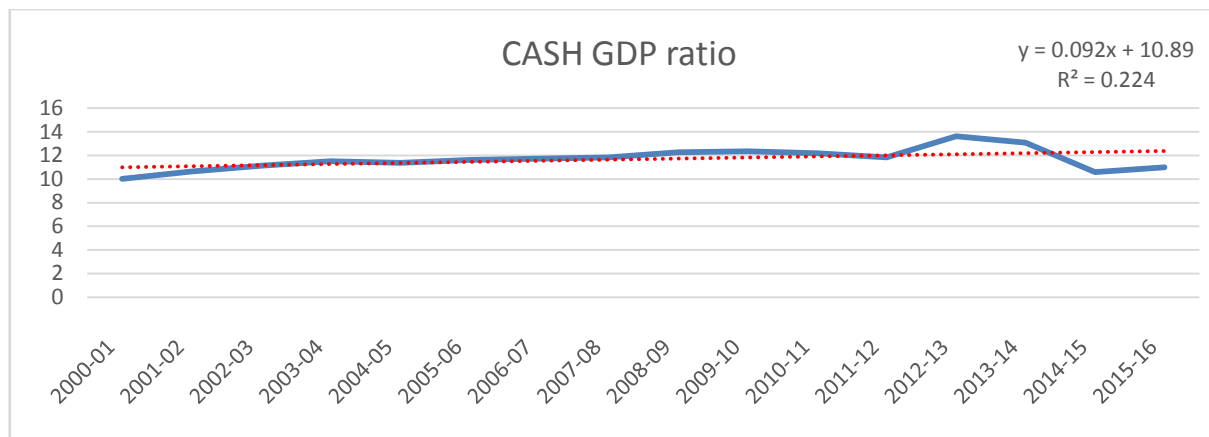
Background of India to Introduce Demonetization

Development of information technology, has led to dramatic transformation in the use of paper cheque as well as cash, yet the use of cash as a mean to settle transactions and making payments continues to be very high. Despite of huge increase in usage of plastic cards and digital transactions in recent years, the currency in circulation as a proportion of GDP is highest in India among the emerging economies. In March 2016, the cash-to-GDP ratio of India stood at 10.9%, which was highest in 16 years. This was also highest cash-GDP ratio among BRICS countries. China's currency-to-GDP Ratio stood at 14.6% in 2000 and was at 9.1% at end of 2015. Similarly, for Russia it is high at 9% while for Brazil it is 3% and South Africa it is 2.5% {lowest among BRICS}(Macroeconomic Impact of Demonetization, 2017). The Reserve Bank of India's annual report for the year 2016-17 states, the cash to GDP ratio in India was 12.2% in 2016-17. It came down to 8.8% by the end of March 2017 as demonetization hit the total high value currency in circulation. As the development of the country increases then the cash GDP ratio should fall but, in case of India, this was not happening.

Cash GDP Ratio Analysis

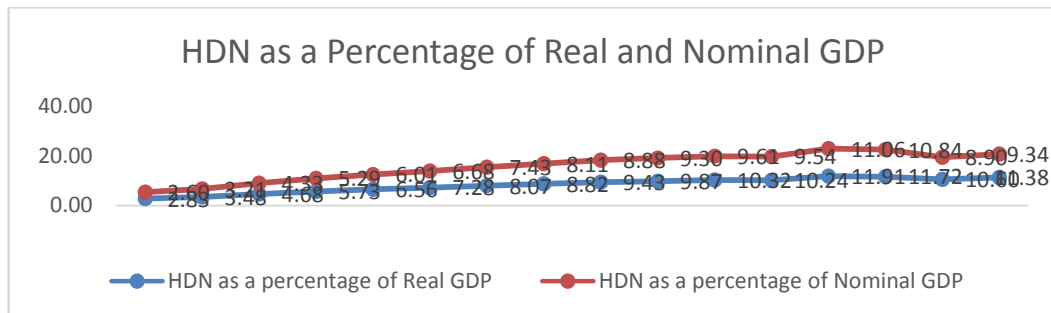
| Year | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 |
|----------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| CASH GDP ratio | 10.02 | 10.65 | 11.1 | 11.509 | 11.4 | 11.6 | 12 | 11.85 | 12.3 | 12.34 | 12.2 | 11.85 | 13.9 | 13.1 | 10.6 | 10.9 |

Source: Data compiled and calculated from RBI Handbook of Statistics



Source: Data compiled and calculated from RBI Handbook of Statistics

As the country develops, the digitalization of transactions increases, which indicates a qualitative improvement and enhancement of transparency, but India is a cash reliant economy, this can be easily understood by analyzing High Denomination Notes (HDN) as a percentage of real and nominal GDP. The following figure 2 represents the HDN as a percentage of GDP from 2000-2016 and the chart represents an upward trend in the variable. In 2000-01, HDN as a percentage of real GDP was 2.60 and as percentage of nominal GDP was 2.83, which has increased to 9.34 & 11.38 respectively in 2015-16. This data becomes relevant because there is a positive correlation between higher cash circulation and illegitimate activities. The question of HDN arises as they are readily used for growth of corruption and terror funding as they are much easier to port when compared to small denomination currency. Therefore, reduction of currency circulation can control corruption and also other illegal activities.



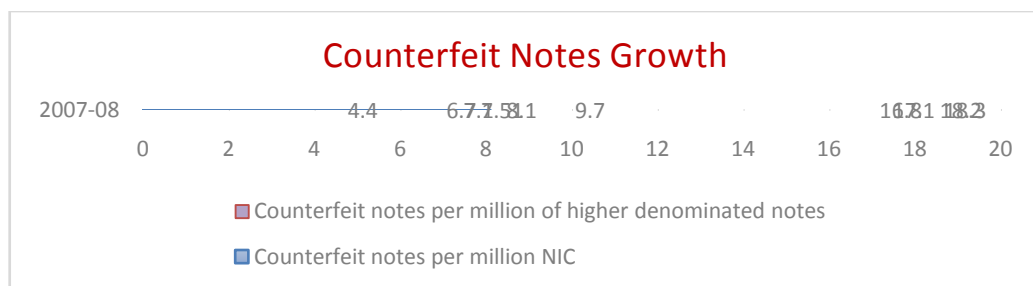
Source: Compiled and Calculated from RBI Reports.

Another major problem encountered by India is threat of Counterfeiting, which can shackle down to foundations of economy. The unwell wishers of the economy have been using this tool to fund terror activities, create political instability, break down the morals of political leaders, creating price instability, and increase in amount of frauds, reduction in the value of real money. The following table reveals notes in circulation and counterfeit notes from 2007-08 to 2011-12. The counterfeit notes per million Notes in circulation in 2007-08 was 4.4 and in the same year the counterfeit notes per million higher denomination was 9.7 and it has increased to 7.51 and 18.2 in 2011-12, this clearly reveals more counterfeit notes are more in high denomination notes.

Counterfeit currency in circulation in India

| year | Notes in circulation (NIC) (million pieces) | Notes in circulation (% of Money Supply) | Notes in circulation of higher denomination (Rs.100 and above) | | Counterfeit notes detected (No. of pieces) | Counterfeit notes per million NIC | Counterfeit notes per million of higher denominated notes |
|---------|---|--|--|------|--|-----------------------------------|---|
| 2007-08 | 44225 | 11 | 30131 | 2 | 195811 | 4.4 | 9.7 |
| 2008-09 | 48963 | 10.7 | 21788 | 8.2 | 398111 | 8.1 | 18.3 |
| 2009-10 | 56549 | 15.5 | 23509 | 7.9 | 401476 | 7.1 | 17.1 |
| 2010-11 | 64577 | 14.2 | 25957 | 10.4 | 435607 | 6.7 | 16.8 |
| 2011-12 | 69382 | 7.4 | 27844 | 7.2 | 521155 | 7.51 | 18.2 |

Source: RBI Annual Reports



The facts presented in table are presented in the bar diagram given above. It clearly reveals from 2007 to 2011, the counterfeit notes per million of higher denomination notes has increased from 9.7 to 18.2. All these facts readily state the reasons behind the introduction of demonetization.

Impact of Demonization on the Economy

As per Reserve Bank of India (RBI) figures, the higher denomination notes of Rs 500 and Rs 1000 constitute 86.4 per cent of the total currency in circulation in the economy, by value. Therefore, with the stroke of a pen, the government nullified 86 per cent of the currency in the economy. This huge monetary shock to the economy has both short-term and long-term effects. In the analysis of impact, the boundary has been restricted to immediate or short term impacts and not the long term impacts, because this is not appropriate to be judgmental with the initiative in such a short span of time. Secondly, Keynes quotes it rightly, ‘All are dead in long run’ as lots of uncertainty may disturb the prediction. Withdrawal of money supply from the economy has sharply reduced transactions and exchanges, primarily for those sectors which were cash-reliant, and due to this economic activities has come to a standstill in many sectors.

1. Sectoral Impact

A. Primary sector: It is the backbone of Indian economy, almost 70% of rural households depend on it and it provides jobs to almost 56% of labour force according to 2011 census. The economic survey 2016 reveals that 17% of total GDP is generated through this sector and 10%

of export earnings are derived from this sector. The worst impact of this demonetization policy has been on the informal sector and agriculture. With money suddenly vanishing from the system, buyers are not being able to purchase from the retail stores, and retailers are not being able to buy from the wholesalers, who in turn are not being able to buy from the farmers. As a result, the entire supply chain of products like vegetables, fish and other perishable items have been badly hit. Farmers are not able to purchase seeds for the next harvest and the total production of various fruits and vegetables saw a downfall. The farmers who were already suffering from many other problems like – debt trap, shortage of water and electricity supply, small land holdings and many more, demonetization has added to the worries of the farmers. But, the policy framers assure that these impacts are short terms hiccups, but in long run these will be wiped up as the government will have adequate amount of revenue, which will be utilized for completion of ongoing irrigation projects, provision of agricultural subsidy, availability of loans at cheaper rate of interest which will help in asset creation for farmers, establishment of large number of warehouses can be observed, and due to digitalization of cash payment the farmers will gain strength in their bargaining power. In case of non-farm activities, there was a downfall in the demand of goods and supply of the products related to dairy farming, poultry, apiculture, etc. was in excess of the demand. Demonetization has not been beneficial to the agriculture sector as well as the allied activities sector in present, now a question arises will it actually benefit in long run.

B. Secondary sector: Due to liquidity crunch, the manufacturing sector has been experiencing a slowdown, the old orders were not taken away and the new orders weren't placed. The MSME were the worst hit and almost 35% of workers in these enterprises lost their job due to this act of government. But the statistics released by CSO reveals a different story, inspite of the problem of liquidity crunch, the manufacturing services performed well as the currency was used to purchase the raw materials, inputs and other requirements rather than doing away with the cash. The data released by the Central Statistics Office (CSO) on March 2017, showed industrial output rose by 2.7% in January 2017 from a decline of 1.6% during the same month a year earlier and above the revised 0.1% contraction in December 2016. The manufacturing sector, accounting for a little over 75% of the total Index of Industrial Production (IIP), grew 2.3% in January, up from a contraction of (-) 2.94% in January 2016 and (-) 1.97% in December 2016 but slower than November's 5.47% pace. The manufacturing sector rose by 2.3% in January 2017 as compared to a contraction of 2.9% in January 2016, while the electricity sector rose 3.9% year-on-year during the month compared to 6.6% expansion in the same month last year (Worstall, 2017). Hence the impact of demonetization on the secondary sector cannot be exactly analyzed at present.

C. Tertiary sector: This sector has been a major contributor of India's GDP; it generates almost 54-56% of GDP in India. Liquidity crunch has hard hit this sector also. But the impact on the sector can be analyzed more effectively by analyzing some of the sub sectors of this sector like- banking, automobile sales, real estate, construction, print media, education, health etc.

a) Banking sector: The rate of deposit increased, which created adequate base for credit creation. The financial savings are expected to increase as a result of the shift from unproductive physical asset based savings to interest-bearing financial assets. This in turn, is expected to enhance the liquidity position of banks, which can be leveraged for lending purposes. The sector in near future will also experience a paradigm shift towards creation of cashless economy and higher degree of digitalization. But it is important to note here, though the banks had enough of loans to be circulated, but the demand for the loans may contract due to the pessimistic atmosphere of investments.

b) Automobile: In this sector a short term revival of demand for two wheeler vehicles was observed. Secondly, due to reduction of rate of interest on vehicle loans and reduction of EMI, the demand for vehicles increased for short run. But this was observed only in urban areas and not much in rural areas as there the major transactions were done with cash and not loans. But presently the demand of SUVs and luxury cars is less due to demonization and

combined impact of GST. The resale value of the vehicles also observed a downturn due to liquidity crunch.

c) NBFC and Finance: In case of gold finance, positive impact was observed in medium term. But on the other hand, micro finance was adversely hit in short term, but in medium term and long term the impact would be positive. Due to slowdown in real estate sector, the housing finance fell down rapidly.

d) Real estate: This is a sector that aids more than hundred sectors, and demonetization gave a major stroke to this sector. According to Economic Survey 2017, this sector experienced a loss of 22,000crores during November and December 2016. On an average each state experienced a loss of 1000crores of revenue that was generated from this sector. In this area the big projects came to a standstill due to cash crunch, especially the raw materials associated with this sector experienced a set-back, nearly 60-65% of downfall was observed in the purchase of the inputs related to this sector.

The small builders and contractors related to small cities and towns suffered largely as they were predominantly depending on cash transactions. Resale properties suffered more the primary sale of properties. But the policy framers anticipate that in long run it would be beneficial due to combined effect of demonization, introduction of RERA and GST. The properties will become affordable to common man.

2. Uprooting the parallel economy: Demonization is a currency side step, it itself cannot uproot the problems related to black money; it can contribute in the eradication of the problem. Around Rs. 14.68 lakh crores of Rs. 15.44 lakh crores demonetized currency was obtained by RBI. It was also widely reported that Jan Dhan accounts witnessed a surge in deposits during the 50-day window from November 8 - December 30, though the amount of this increase was relatively small, around Rs 42,000crores (Blaggan, 2017).

3. Tax Collection: The indirect tax collections of the government will fall due to fall in aggregate demand. The collection of direct taxes may be higher for a short term, but in long run government may have to experience a fiscal deficit due to demonetization. Having closed the voluntary disclosure window for undisclosed money, it has been reported that government will keep a close watch on deposits over Rs 2 lakh in cash. This would mean increased tax net, higher tax collection and a better tax to GDP ratio. As the money gets accounted and more taxes are collected, government might be tempted to reduce tax rates going forward (Singh and Singh, 2016).

4. E-wallets: With cash transactions impacted by a decrease in liquidity, alternative payment methods, such as e-wallets, online transactions using e-banking, debit and credit card usage have increased significantly. This will increase usage of such payment systems, and enable a shift towards an efficient cashless infrastructure.

Conclusion

The demonetization 2016, undertaken by the government of India was a shock to the economy. The short-term impact of the demonetization depends on how much of the currency is replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be "black money". While the facts are not available to anybody, it would be meaningless to argue that this is the only possibility. Impacts of demonetization which were positive as well as negative. Withdrawal of cash, the economic activities were hard hit undoubtedly and it will surely have an impact for at least two years. Due to demonetization, for sure the people have realized the importance of banking habits in rural areas, growth of digital transactions were obvious, generators of black money were socially condemned. The question of GDP slow down cannot be answered, as demonetization is not the only cause for this act. The introduction of GST regime has also impacted the slowdown. Hence demonetization cannot be considered as the only cause for GDP slowdown. In the process of demonetization, the some banking officials became opportunist by exchanging old currency notes for new currency notes at 60% or 70%, if this wouldn't happen, then the accountability of amount of counterfeit notes would be

easier. But in long run the benefits of the demonetization will be positive as it will be a scary demon for the black money hoarders and manufacturers of counterfeit currency.

References

Journals:

1. Kamatchi, Muthulakshmi.E., Dr. Kalaimani, G. (2016). Impact of Demonetization on Indian Economy, *IOSR Journal of Humanities and Social Science*. Retrieved from, www.iosrjournals.org/iosr-jhss/papers/Conf.DAGCBEDE/...2/9.%2034-38.pdf
2. Dr. Tiwari, Devendra Kumar and Ms. Khan, Shahwar. (2017), A study on Demonetization and its Impact on Corruption and Black Money, *Saudi Journal of Humanities and Social Sciences*. Retrieved from, <http://scholarsmepub.com/wp-content/uploads/2017/07/SJHSS-26466-470.pdf>
3. Dr. Singh, Partap and Singh, Virender. (2016) Impact on Demonetization on Indian Economy, *International Journal of Science, Technology and Management*. Retrieved from, www.ijstm.com
4. Mali, Vedashree, (2016), Demonetization: A step towards modified India. *International Journal of Commerce and Management Research*.2 (12), 35-36.
5. Singh, Partap. (2010). Impact of Financial crisis on Indian Economy. *Southern Economist*. 2(49), 98-102.
6. Prakash, Akanksha. (2016). "Constitutional legality of demonetization", *International Journal of Legal Insight*, Retrieved www.ijli.in/assets/docs/AkankshaPrakash.pdf

Reports and Working Papers:

1. Handbook of Statistics on Indian Economy 2017, Retrieved from, <https://rbi.org.in/SCRIPTS/AnnualPublications.aspx?head=Handbook%20of%20Statistics%20on%20Indian%20Economy>
2. Handbook of Statistics on Indian Economy 2016, Retrieved from, <https://rbi.org.in/SCRIPTS/AnnualPublications.aspx?head=Handbook+of+Statistics+on+Indian+Economy>
3. To Defy or Demonetize. *Economic Survey*, Retrieved from indiabudget.nic.in/es2016-17/echap03.pdf
4. Macroeconomic Impact of Demonetisation- A Preliminary Assessment, RBI -Reserve Bank of India, March 2017. Retrieved from, <https://rbi.org.in/.../OccasionalPublications.aspx?...Macroeconomic%20Impact%20of..>
5. Bose, Sanjay and Das, Abhiman. (Estimation of Counterfeit Currency Notes in India – Alternative Methodologies. RBI Working Paper Series No. 03. Retrieved from, <https://www.rbi.org.in/scripts/PublicationsView.aspx?id=14947>
6. Demonetization: Impact on Economy. NIPFP Working Paper series No. 182. Retrieved from, www.nipfp.org.in/media/medialibrary/2016/11/WP_2016_182.pd

Newspapers:

1. Worstall, Tim (2017). India's Industrial Output Up, Appears Demonetization Effect Is Over. Retrieved from, <https://www.forbes.com/sites/timworstall/2017/03/11/indias-industrial-output-up-appears-demonetisation-effect-is-over/#3eedb3c81c5f>
2. Blaggan, Ishita. (2017). TheDeMo Effect – One Year and Counting. Retrieved from, <https://www.businessinsider.in/The-DeMo-Effect-One-Year-and-Counting/articleshow/61573391.cms>
3. Dhar, Khan. (2017). RBI annual report: How Government, RBI made a loss during demonetization. Retrieved from, <http://www.businesstoday.in/current/economy-politics/rbi-annual-report-loss-demonetisation-printing-notes-note-ban-data/story/259391.html>