



Demonetization Strategy: Impact On The Indian Population

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Abstract

The discussion post in favor of demonetization is that the cash that would be quenching “black money” should be lawfully put out to set right the perverse incentive arrangement in the economy. This article has attempted to assess the impact as well as consequences that occur during demonetization and how the tool of Demonetization can be used to exterminate parallel economy. Demonetization is one of the big steps initiated by the Government in addressing several issues like black money, fake currency, corruption, terrorism, etc. The history of demonetization in India and around the world is addressed. Lessons from historical demonetization direct us to redefine a country’s financial system by overpowering the previous causes of failure. Demonetization obviously brings a lot of embarrassment to the ordinary population but it is for only the short term. However, the long-term benefits of demonetization override the short-term challenges.

keywords: demonetization, Indian economy, black money, parallel economy, tax evasion, fake currency, corruption

Overview

Money is the lifeblood of every financial system. With the growth of society and mankind, the needs of human beings increased. To fulfill humans, an unlimited wants barter system

came forward. But over some time, the creation of money became a strong pillar to build an economy. Money exchange appears to be more suitable than barter because it removes the “double concurrence of wants” and is capable of supporting a relatively complex economy. Money exchange facilitates simply doing business, making easy taxation and national integration such as production, trade, distribution, services, etc. form an economy.

The Indian Economy which was well thought-out as the “fastest-growing major economy” in the world and the “only bright spot” with promising Markets gives the thought to have slowed down before the latest “surprise treatment” of “demonetization. While this is certainly causing concern with projected growth figures revised downwards from 7.6 % to 7.1% for the year ending March 2017, what is cause for greater worry and even alarm is the view among some economists including the former Prime Minister Dr. Manmohan Singh (reputed economist too) that the current and ongoing attempt to flush out black money would cut off a good 2% of the Gross Domestic Product.

Demonetization is to take steps of stripping a currency unit of its position as legal tender. Demonetization for us means that RBI has withdrawn the old Rs 500 and Rs 1000 notes as a certified mode of payment. On 28 October 2016, the total circulated currency in India was Rs. 17.77 lakh crore (US\$260 billion). As per the annual report of RBI of 31 March 2016 stated the total bank currency in flow was valued at Rs.16.42 lakh crore (US\$240 billion) of which almost 86% (i.e. Rs. 14.18 lakh crore (US\$210 billion)) was 500- and 1000-rupee notes. In terms of volume, the information stated that 24% (i.e. 2,203 crores) of the total 9,026.6 crores of bank currency were in circulation.

In a significant move, the Government of India declared to take away 500- and 1000-rupee notes from 8th November 2016 at midnight. The RBI issued 2000-rupee notes and new notes of Five hundred rupees which were placed in circulation from 10th November 2016. The rest of the other Notes were stay behind as legal tender. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money, and forged notes. This move is expected to rinse out the formal economic system and remove black money.

Demonetization in India:

Similar measures have been taken in the past.

- The Reserve Bank of India, introduced Rs 10,000 notes (largest currency denomination) ever printed for the first time in 1938. In the year 1945, all three notes were introduced again. In January 1946, currency notes of 1000 and 10,000 rupees were withdrawn and new notes of 1000, 5000, and 10,000 rupees were introduced in 1954.

- In 1977 Wanchoo committee (set up in the 1970s), a direct tax inquiry commission suggested demonetization as a measure to unearth and counter the spread of black money. The Janata Party had again demonetized notes of 1000, 5000, and 10,000 rupees on 16 January 1978 as a means to control forgery and black money. Historically, previous Indian governments had demonetized bank notes.

- 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 RBI of 31 March 2016 stated that total

banknotes in circulation were valued at 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. They were taken out of circulation in 2016.

Demonetization is the most important and necessary when a national currency changes. There are both pros and cons of demonetization in the Indian economy. The reasons for demonetization are to control forged notes that could be contributing to terrorism, and to undermine or eliminate the “black economy”.

There would be agents in the economy who are holding cash that they cannot explain and hence they cannot put in the banking system. This part of this legal tender will be extinguished since it would not be replaced in any manner.

The government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to a cashless medium of exchange.

The experiential level of these two components will be unraveled only over the next six months. These two would have different effects on the economy in the short term and the medium term, as will be explored below.

Essential for the Study:

1. The fake Indian currency notes in the higher denomination have increased.
2. Unaccounted money, is often used in any form of corruption and illegal activities.
3. The Financial Action Task Force that looks at the criminal use of the international financial system, notes that high-value bills are used in money laundering schemes, racketeering, etc.,
4. In the United States, the highest denomination banknote is \$100, and in the United Kingdom, the utmost denomination banknotes are £50.
5. The uppermost denomination note is essentially 50-100 times the smallest denomination note of one dollar or one pound.
6. In India, up until now the uppermost denomination note was Rs 1,000 and this was 1,000 times the smallest denomination notes of Re 1 (Note: Re 1 notes are issued by the ministry of finance).

Objectives of Paper

- To analyze the current immediate (Short and medium term) impact of demonetization on the Indian economy;
- To work out the probable consequences of the demonetization.

Research Methodology

The paper is based on derived data. The data has been composed of the internet, research papers, books, newspapers, etc.

Procedure Adopted For Exchange of Old Notes

The Reserve Bank of India laid down a detailed procedure for the exchange of the demonetized banknotes New Series of Rs.500 and Rs.2000 banknotes and continued with old Rs.100 banknotes. Following are the key points:

- Citizens were allowed to tender their old bank currency notes till 30 December 2016 at RBI or any bank branch and credit the value into their respective bank accounts.
- Cash withdrawals from bank accounts were limited to Rs.10, 000 per day and Rs.20, 000 per week from 9 November 2016 to 24 November 2016.
- For instant cash needs, the old banknotes of value up to Rs.4000 per individual could be exchanged for the new Rs.500 and Rs.2000 banknotes as well as Rs.100 banknotes over the counter of bank branches from 10 November 2016 by filling up a requisition form along with a valid ID proof.
- All ATMs were dispensed banknotes of only 100-rupee denominations. Banks presented all money withdrawal transactions at their ATMs free of cost to their customers till 30 December 2016. Cash withdrawals from ATMs were limited to Rs.2000 per day per card up to 18 November 2016 and the limits were raised to Rs.4000 per day per card from 19 November 2016.

However, exceptions are given to petrol/CNG pumps, hospitals, train and airline booking stations, and ration shops, which are permitted to accept the 500- and 1000-rupee notes until 14 November. International airports were also informed to allow an exchange of notes amounting to a total cost of Rs.5, 000 (US\$74) for overseas tourists and outbound passengers.

Immediateupset of demonetization on the Indian economy

Very short-term impact-- By taking out 86 percent of the notes in circulation has resulted in a very severe tightening in the money supply in the economy. This economizing, by wiping out cash balances in the economy, eliminated several transactions for a while, since it is not a sufficient medium of exchange available. Since income and consumption are related to transactions in the economy, the above would mean a harsh contraction in income and consumption in the economy. This effect would be more severe on entities that earn income in cash and spend it in cash.

In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing. For example, transport services, Kirana, fruits and vegetables, and all other perishables, would face a compression in demand which is backed by purchasing power.

Short-term effect with absolute substitution -- The short-term effect on the economy would depend on the speed with which and the extent to which the cash is replaced by the

authorities. Few sectors were likely to be seriously affected. To give an example of two sectors that are supposed to have a large employment effect on the economy, we can talk about agriculture and construction.

Most of the purchases and sales in this segment of the economy are carried out through cash. With the elimination of cash from the economy, the sale of the Kharif crop would be difficult unless the crop is sold on the promise of payment in the future. Given the limited bargaining power of the farmer, the price they can realize for the crop can be adversely affected. Thus, despite a good monsoon in large parts of the country, the farmer might not get the benefits.

The second sector which could be adversely affected would be the construction sector. The sector, it is often argued, works with a significant amount of cash. Payments to workers as well as a variety of purchases might be carried out in cash.

Medium-term effects--In the medium term, the effects would be related to the extent to which the currency is not replaced within the economy. The currency that is sited in the banks but not withdrawn, it is argued, would create an expansion in deposits in the economy. In the discussions on demonetization, there is a consistent reference to the resulting increase in credit creation in the economy. Like Finance Minister Arun Jaitley says, "Bank deposits will increase and they will have more capacity to support the economy."

The Possible Consequences of the Demonetization

The following likely impacts on the economy will be observed if an extensive portion of the cash is either reported or devoted to the economy.

Tax: Having closed the voluntary disclosure window for unrevealed money, it has been reported that government will continue a close observation of credits over Rs 2 lakh in cash. This would mean an enhanced tax net, higher tax collection as well a healthier tax to GDP ratio. As the money gets accounted for and more taxes are collected, the government might be tempted to shrink tax rates going ahead.

Rate of Interest: One of the major impacts of demonetization would result in lesser inflation, tempting the central bank to reduce interest rates. But the bigger impact on interest rates will be the liquidity with which banks will be flushed.

GST: Demonetization would boost the tax net and along with GST result in a decrease in black money generation. Along with GST, demonetization will lead to a higher tax/GDP ratio.

Fiscal Assets: As idle money lying comes in the main economy it would move to higher yielding and liquid assets. Money is likely to move to monetary assets from gold, valuable metals, real estate, and simple cash. Equities might reflect the panic in the economy in the short term, but the move is will be helpful in the long run say most of the broker's reports and expert comments.

Effect on the parallel economy: The removal of old Rs. 500/1000 with new Rs. 500/2000 notes are anticipated to remove black currency from the economy as they will be blocked

since the title-holders will not be in a position to deposit the same in the banks, which will halt the backing for anti-social elements like smuggling, terrorism, espionage, etc.

Effect on Money Supply: With the elimination of old currency and adding a new one, the money supply is likely to condense in the short run. However gradually but surely as the new notes get dispersed in the market and the mismatch gets corrected, the money supply will pick up.

Effect on Prices: The Price level is anticipated to be lowered due to moderation from the demand side. Prices in Real Estate and Property sector are largely expected to fall, especially for sales of properties where the foremost part of the transaction is cash based, rather than banks or cheque transactions. In the immediate future, the sector will be under pressure with the quantity and number of transactions in land markets considering a sizeable downward movement. This decision regarding real estate regulatory law, GST, and Real Estate Investment Trusts would further pick up transparency and increase investor confidence in this market.

Effect on GDP: The GDP structure could be impacted by this measure, with a reduction in consumer demand. Besides this expected impact on GDP may not be significant as some of this demand will only be postponed and re-enter the flow once the cash situation becomes normal.

Effect on Banks: After demonetization, automatically leads to more amounts being deposited in the Savings and Current Accounts of commercial banks. This in turn will improve the liquidity position of the banks, which can be utilized additional for lending purposes. However, the household for their urgent situation would be withdrawals at the second stage.

Effect on Online Transactions and alternative modes of payment: With cash transactions facing a drop, Digital operation systems, E-wallets and apps, online transactions using banking, usage of Plastic money (Debit and Credit Cards), etc. will see a significant increase in demand.

Positives Impacts	Negatives Impacts
1) Payment gateways	1) Agriculture
2) Cards	2) Luxury goods
3) Mobile wallets	3) Real Estate
4) Online retail	4) Commodities Traditional Retail
5) Net and payment banks	a) Consumer durables
6) e-marketplace	b) Consumer non-durables

Conclusions

The government's action on demonetization is a large upset to the economy. The impact of the surprise in the medium term is a function of how much of the currency will be restored at the end of the replacement process and the extent to which currency in circulation is

quenched. While it has been argued that the cash that would be extinguished would be “black money” and therefore, should be correctly extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be unwise to argue that this is the only possibility.

As argued above, these cash balances were probably used as a medium of exchange. In other words, while the cash was facilitating valid economic activity, if this money is extinguished there would be a tapering of financial activity in the economy and that is a cost that needs to be factored in while reviewing the impact of the demonetization on the economy and its agents.

There would likely be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits was earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances for transactional purposes has been scrapped, it would be incorrect to interpret this as the success of the program in bringing the public who were hiding black money; nor can they be interpreted as extra balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in the financial statement for much shorter periods than deposits based on savings would be.

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Conflicts of Interest

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Data Availability

The data used to support the findings of the study can be obtained from the corresponding author upon request.

Note

This research has been done within year after Demonetizations in India, hence there is scope of further study

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