

Demonetisation: Its Effect on Indian Economy

Abstract

After 1947 and 1978 the "Demonetisation" of 2016 a sensational economic move designed to make India a cashless economy targeting black money, forged currency stocks fuelling anti-state activities shook every stratum of the society. It lacks factual support to a great extent to put it as the only possibility and loses transparency to evaluate its short run and medium-term impacts on the economy depending on the extent of remonetisation. This paper aims to find out the positive and negative aspects and implications of demonetisation on the mass and the economy as a whole.

Keywords: Demonetisation, A.T.M, Bank, Currency, Denominations, Transactions, Government, R.B.I.

Introduction

This is not the first time the Indian government had demonetised bank notes. On two prior occasions—once in 1946 and in 1978, the goal was to combat tax evasion by "black money" held outside the formal economic system. In 1946, the pre-independence government anticipated demonetisation would penalise Indian businesses that were concealing the fortunes amassed supplying the Allies in World War II. In 1978, the coalition government demonetised banknotes of 1000, 5000 and 10,000 rupees, again in an expectation to curb counterfeit and black money

From the midnight of 8 Nov, 2016 Prime Minister Narendra Modi announced the stripping of Rs 500 note and Rs 1000 as legal tenders and announced the introduction of higher Rs 2000 denomination bank note from November 10 and gradual introduction of new 500 rupee notes in a broader anticipation to combat the evils of our nation.

Table 1

Arithmetic Of Demonetisation of High Denomination

Notes in circulation (value in INR billion)	7854	6326	14180
Notes with government sectors and banks @ 30%	2356	1898	4254
Notes with PUBLIC @ 70%	5498	4428	9926
Conversion of new notes by old notes by public	60	40	-
Total value of converted by Public INR billion)	3299	1771	5070
Scenario 1: Total value not converted by Public @ 50%(INR billion)	2199	2657	4856
Scenario 2: Total value not converted by Public @ 50% of 20% of black money (INR billion)	-	-	4520
Scenario 3: replicating 1978, with 25% not coming back	1374	1107	2482

Source: SBI Research, RBI

The table depicts the public holding of high denomination notes worth Rs. 9926 billion as on March 2016. There are 3 scenarios. In scenario 1 and 2 it is assumed that 50% of the notes of higher denomination do not return to the system. It is also reasonable to expect that 60% of Rs. 500 notes and 40% of Rs. 1000 notes would be exchanged at banks/ post offices and RBI before March 31, 2017. Based on such estimates, roughly round Rs. 4.5 lakhs crore of money could be taken away from the system.

Objective of the Study

There are multiple reasons why a country demonetizes its currency, such as to check inflation, to curb corruption, to put a check on forgery and to promote cashless transactions, which in turn creates an unanticipated shock and pulls the levers of an economy down. Whether



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such demonetisation is successful and much needed in the short and long run for our economy is the subject of investigation.

Review of Literature

1. 'The Demonetisation Decision: Event, Impact, Narrative and Meaning', Suyash Rai, "The Wire", 2016. - a detailed study on the impacts of demonetisation which thoroughly explains its success in curbing out the black economy, holds a cost benefit analysis of the move and opines that the original assumptions underlying the decision remain unclear and it seems to be causing considerable harm to commoners in general.
2. "Theoretical Analysis of "Demonetisation", Dipankar Dasgupta, the Economic and Political Weekly, 2016. -The paper analyses the implications of the recent demonetisation exercise in India with the aid of simple tools on various sectors of the economy.
3. "Demonetisation and its impacts on India", Sandeep Kaur, International Journal of Research, 2016.- The paper emphasises on the history and background of demonetisation in India and focuses on the volume of the higher denomination, analyses the causes, costs and benefits of demonetisation.
4. "Demonetisation: Impact on the Economy", No. 182 14-Nov-2016, Tax Research Team, National Institute of Public Finance and Policy, New Delhi, NIPFP, Working paper series, Working Paper No. 182- The paper strongly puts forward the fact that arguments posited in favour of demonetisation lack factual support to a great extent to put it as the only possibility and loses transparency to evaluate the short run and medium-term impacts on the economy depending on the extent to which the government decides to remonetise. This paper elucidates the impact of such a move on the availability of credit, spending, level of activity and government finances.
5. "Macroeconomic Impact of Demonetisation- A Preliminary Assessment", Reserve Bank of India, March 10, 2017.- The analysis in this paper suggests that demonetisation has impacted various sectors of the economy in varying degrees; however, in the affected sectors, the adverse impact was transient and felt mainly in November and December 2016. The impact moderated significantly in January 2017 and dissipated by and large by mid-February, reflecting the fast pace of remonetisation and suggests that the impact of demonetisation on GVA growth was modest. Currency squeeze due to demonetisation along with seasonal factors pushed food inflation significantly down but has not had much impact on inflation excluding food and fuel. A surge in deposits led to a sharp expansion in the consolidated balance sheet of scheduled commercial banks and created large surplus liquidity conditions which were managed through a mix of conventional and unconventional

policy instruments. There has not been any significant impact on the external sector. There has been a sharp increase in the number of accounts under the PradhanMantri Jan DhanYojana and the deposits in such accounts have also surged. Financial re-intermediation may have received a boost following demonetisation. An important consequence of demonetisation has been the sharp increase in the use of digital transactions

6. "A Study on People Impact on Demonetization", K. Veerakumar, International Journal of Interdisciplinary Research in Arts and Humanities, Volume 2, Issue 1, 2017.- In this paper, an attempt has been made to find impact of demonetization on the public. Samples of 100 respondents were randomly selected from Coimbatore District. It is found that four variables namely gender, age, annual income, occupation have significant association with the impact of demonetization. It also results that demonetization helps to destroy black money is the first ranking given by the respondents and it is followed by corruption and terrorism.

Hypothesis

Demonetisation (2016, Nov.) Will eliminate the counterfeit currency, boost up the process of transaction digitisation but will not be able to curb the unaccounted transactions of the black economy satisfactorily and will adversely affect the primary and secondary sectors of the economy in short and medium terms.

Methodology

Research Question

Does a sudden demonetisation achieve its goals without bringing down the economy and its people pulling down in dire straits?

Type of Research

It is a mixed (i.e. both qualitative and quantitative) type of research. Qualitative includes the explanations quantitatively we have analysed the various obtained data and numerical figures.

Methods of Data Collection

The method is mixed (i.e. both quantitative and qualitative) and deals with the secondary data set. The data are collected from reference articles, newspapers, bulletins and magazines, The Economic and Political Weekly, The Hindu, Times Network and diverse official sources like SBI research, RBI, The World Bank, Bloomberg etc. some of which have been accessed online.

Questionnaire/Survey/Testing/Observation Report

No surveys or tests were conducted. Hence, no reports on observation or questionnaire are attached herewith.

Methods of Data Analysis

It is mixed, textual, statistical, pictorial and tabular. Simple analysis has been done on the basis of data available online and is represented through a series of tables, graphs, pie charts, line and bar diagrams.

Inference

The paper infers though demonetisation is able to curb the counterfeit currency and boost digitisation of the economy at a blink, it was unable to curb the black economy satisfactorily, with adverse impacts on primary and secondary sectors of the economy.

Research Design

The paper describes the impacts and explores the pros and cons of demonetisation. It is explanatory, exploratory, descriptive and involves textual reading.

Analysis and Findings/Results

Impact of Demonetisation

To understand the effect of demonetisation we need to first understand the importance of cash in our economy. There are four kind of transaction in the economy: accounted transaction, unaccounted transaction, informal sector transactions and those associated with illegal activities. The first two categories belong to whether the transactions and thus the corresponding income reported under the tax schedule. The third category mainly consists of the incomes of the agents whose income is below the exemption thresholds and therefore does not have tax liabilities. Finally, there would be demand for cash for illegal purposes like under table transactions, election funding, spending over sanctioned limits, dealing in crimes and corruption.

Black Economy

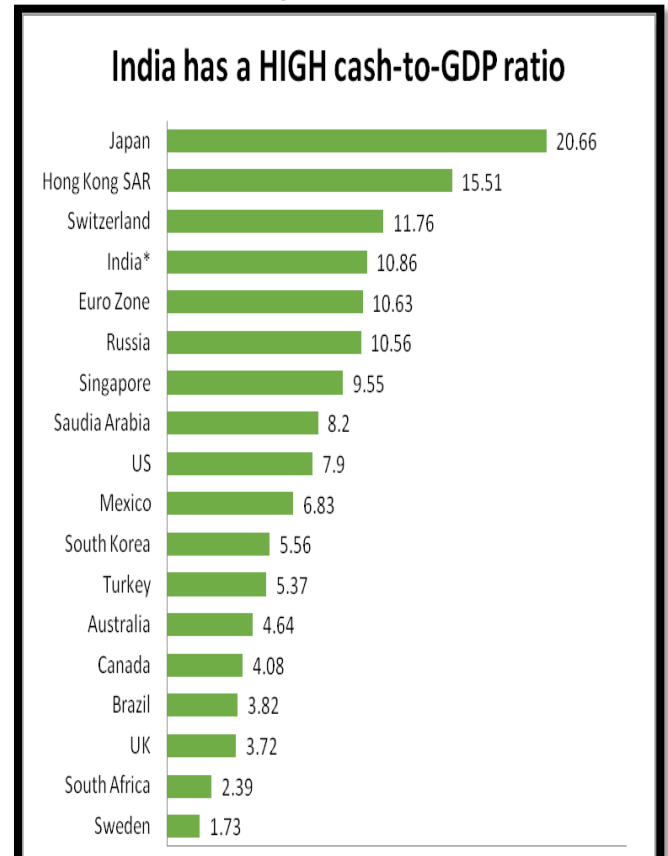
It is being assumed that all the money i.e. being extinguished is used in either of the two categories of unaccounted transactions, anti-national and illegal activities. If this assumption is correct then the impact of extinguishing the currency will be limited. On the other hand, if the currency is being used up for any of the other means of transactions in the economy then the impact on the economy and on the agents, would be substantial. If for example the extinguished cash was used up in financing the unaccounted accounts and illegal activities, then demonetisation will result in shrinking of the activities and in curbing down the incomes and employment associated with the activities. The spillover effect will thus be felt by the organised sectors as well since the consumption from the incomes generated would extend to the formal sector as well. Thus the removal of 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 and Will temporarily stall the circulation of large volume of counterfeit currency and - curb the funding for anti-social elements like smuggling, terrorism.

Digitization and Demonetisation

Cashless Economy is what India seeks for with the eve of demonetisation and the lapse of the highest currency denomination which comprised of 86% of the liquidity of the cash reserve has been stumbled. Diagram 1, depicts- India is a country with high cash: G.D.P ratio. While the government focussed on digitizing India after launching the

programme Digital India, most of the citizens preferred using cash as the mode of transaction than E-Wallets or Plastic Money.

Figure-1



Source: The World Bank.

Demonetisation acted like a vital weapon in the scenario of digitizing India. A digital economy is the one in which all transactions are accounted, all the information is made available to government and thus all services comes under tax liability without any exemption of tax. Until this campaign India was incredibly a cash centric economy. Cash accounted for 95% of all transactions, 90% of the vendors didn't have card readers or the means of accepting electronic payments, 85% of workers were paid in cash, and almost half of the people living in India didn't have bank accounts. Post Demonetisation the entire business of India has gone significant structural changes. Though it paralysed the economy in the initial few days, but has been a catalyst and a much-needed fuel to the mobile payment ecosystem (E-payment services) driving India into a cashless one. At the time of demonetisation, the mobile payment processing companies had to deal with a heavy traffic, due to the immense spike in downloads and usage. Data shows that during the recent movement of demonetisation, PAYTM has reported a three time surge of new users- tacking on over 14 million new accounts since November 2016. Mobile wallet biggies like PAYTM had a 435% increase, MOBIKWIK had a 15 time increase in the total business, while Oxigen Wallet daily average users has increased by 167%.

Hence Demonetisation has been an initiative, a boon for India's e-payment providers. With the common man like even the vegetable vendors, or the tea shop owners and various other shopkeepers accessing to PAYTM and other digital wallets for payment modes, demonetization proves to be fruitful in digitizing India. There was a steady rise in daily transaction, adding up of money, app downloads and transaction per user/week leading to an overall increase of 700% traffic. Following the path, The government of India recently launched BHIM app developed by NATIONAL PAYMENT CORPORATION INDIA. BHIM allow users to send or receive money to other UPI payment addresses or scanning QR code or account number with IFSC code or MMID (Mobile Money Identifier).

Driving Wheels of The Economy

Primary Sectors

Agriculture

Demonetization can affect agriculture directly in four ways. These include area sown, crop pattern, productivity and market.

Area Sown

Demonetisation didn't had much impact on the area sown since at the end of December, area sown in fact exceeded the normal rate by 2.66% Up to November 11, which can be considered as the first stage of demonetization, Rabi sowing was complete on 14.6-million-hectare area which was 5.7 per cent lower than the normal crop coverage. During the week ending 30th December, 2016, net sown area under Rabi crops exceeded the normal area by 2.77 per cent.

Effect on Productivity

Farmers use cash to buy quality seed, fertilizers, chemicals, diesel, to hire labour and machinery. As Rabi season crops are mainly self-pollinated, farmers need not buy fresh seed in Rabi season every year. More than 70 per cent seed used in Rabi crops is self-produced and rest is purchased from public sector agencies, research institutes and private sources. Sale of seed on the year by public institutions is reported to be much lower than normal sales which had some impact on productivity.

Fertilizer off take during the current Rabi season (till 21 December 2016) was lower than the fertilizer off take in the corresponding period during 2014-15 and 2015-16 by 7.47 per cent and 7.0 percent.

Effect on Prices

No such effect of demonetization was reported on prices of major crops like paddy, soya bean, and maize in the month of November and their wholesale prices in APMC 'Mandis' of the country were around 3 per cent higher as compared to the month of October. However, prices of maize and soya bean fell in the month of December but paddy prices ruled higher than previous two months and also as compared to 2015. There might be some delays in payment to the farmers due to cash crunch but that should be treated as a temporary bottleneck.

Effect on Output Growth

The situation prevailing at the end of December 2016 implied Rabi crop output will increase by 6.02 per cent over last year due to higher area sown. Lower use of fertilizer, as observed from the first point sale, can cause 1.06 per cent decline in output of the same. Lower sale of quality seeds due to cash crunch would also affect the growth but this impact was expected to be minor in nature.

Secondary Sectors

Real Estate

Real estate is a complex, less opaque market where price movements in the next few months depend on how several price- drivers play out in this period: supply, sentiment, interest rates, rental yields, liquidity, taxes, transaction volume, etc.

"Asking Price" From Owner/Landlord Segment Dropped By 4%

While rise in the secondary market had dropped only 4% at an aggregate level (as compared for the post Nov 8 period to pre-Nov 8). In urban areas, the drop is up to 5%. Landlords were largely holding onto prices and there is no evidence of any knee-jerk fall in price levels. In the primary markets, developers bundled deals to attract buyers and refrained from giving outright cash.

There was an 11% drop in supply of new ownership properties for sale, further reinforcing the observation that some sellers, probably with high holding power, have deferred their decisions to sell. Breaking it down at a budget-level, the data suggests that properties in the less than 50Lacs segment were hit less with a 7% drop in supply volume; while properties valuing more than a crore showed a 17% drop.

This corroborates with the fact that segments with low-cash show lesser drops in supply as compared to higher-budget segment where cash played a relatively larger role, 7% of buyers shifted from "Buying" to now "Renting", at a Pan-India Level. There was a shift in preference for about 7% buyers whose initial choice was to buy a property but started to look for rental options after demonetisation. These buyers chose to go for a rental solution in the interim period while they deferred purchases for property to wait and watch how the pricing/supply unfolds. The other interesting insight is that the ratio of rent seekers: buyers- changed in this period from 1:1.1 to 1:1.6; indicating a relatively more demand for rental segment in the period.

Metal Industry (Gold)

After demonetization, searches for the query "gold" reached their highest point in a year, but have been restored to their original levels. After the announcement, backdated gold purchases were thought to be a clever way to evade the tax authorities, but repeated raids on jewellers across the country, and the government's move to ask for PAN details dampened the trend.

Automobile Sector

This Demonetization definitely had an Impact on the Automobile sector because a good chunk of buyers of automobiles still use cash (that is

unaccounted) for their transactions. The demand from the middle-income group seeking car loans continued to be the same. However, the percentage of cash only transactions was higher than Real Estate sector. The used car market had a much bigger impact due to the higher proportion of cash transactions.

Figure: 2

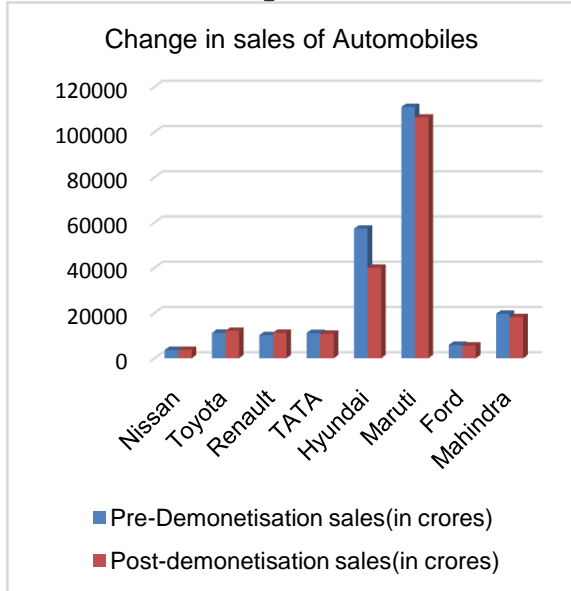
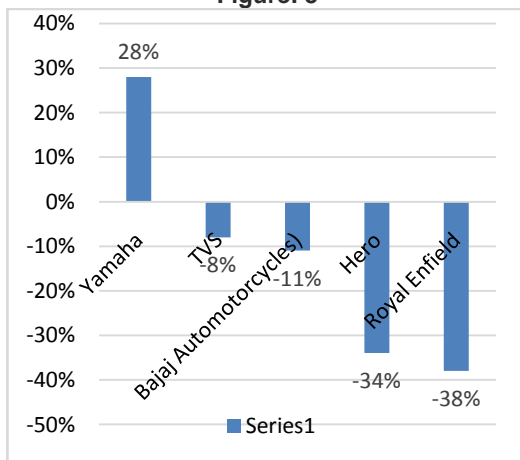


Figure: 3



Source: livemint.com Source: HDFC bank investment advisory group.

The above two diagrams 2 and 3 respectively illustrate the various automobile companies and their sales for the month of December with the two biggest and key car companies of India 'Maruti Suzuki' and 'Hyundai' suffering a significant decline in their auto sales.

Similarly, in the case of two-wheelers, Hero being the largest Indian company suffered the highest decline (-34%) in their sales.

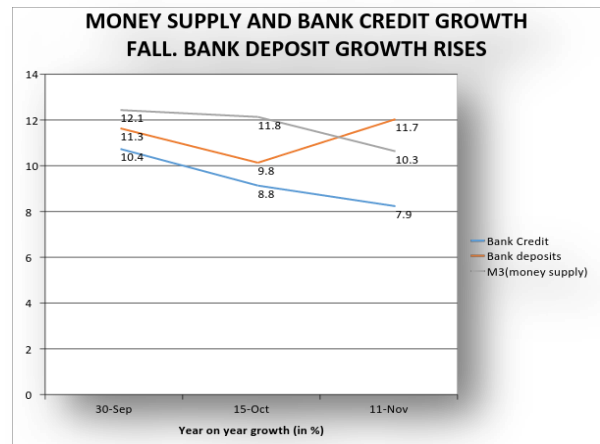
**Tertiary Sectors
Banking Sector**

With large amount of cash formalized into the banking stream, banks empowered by a high

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amount of current account and savings account (CASA) deposits, reduced dependence on high cost borrowing. It was estimated that India has a parallel economy with almost INR 4500 billion in the form of unaccounted cash. So even, if some decent portion of this money comes to the banks, it can boost the deposit base and savings, which may push up G.D.P by 0.5 to 1.5%. Banks were expected to curtail deposit rates by 25-50 basis points. That will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. Which in turn will enhance the liquidity position of the banks that 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.

Figure 4



Source: RBI.

The diagram illustrates that bank credit plunged to 7.9% and money supply decreased significantly, whereas Bank deposits increased to 11.7% as people rushed to deposit their legal tender which ceased to exist

Retail Business

The demonetisation of Rs 500 and Rs 1,000 notes left many with severe cash crunch and led to long ques outside banks and ATMs. The lack of liquidity also hit the retail businesses. Retailers in India witnessed a 50-70% drop in sales with in the first 5 days [Kumar Rajagopalan, MD of Retails Association of India (RAI)]. Not only the retail activities but even the wholesale trade was affected severely because of low volume of transportation. Sales of essential consumable goods sold by supermarkets, wholesale markets and neighbourhood stores through online/digital payments had a good weekend sale. Cash on delivery sales and transactions involving cash declined by 30% where as pre-paid orders such as card sales and through PoS machines rose by 20%. The overall result is negative since the decline in cash sales is bigger than the rise in card sales.

Key Instruments in Economy Affected By Demonetisation Liquidity

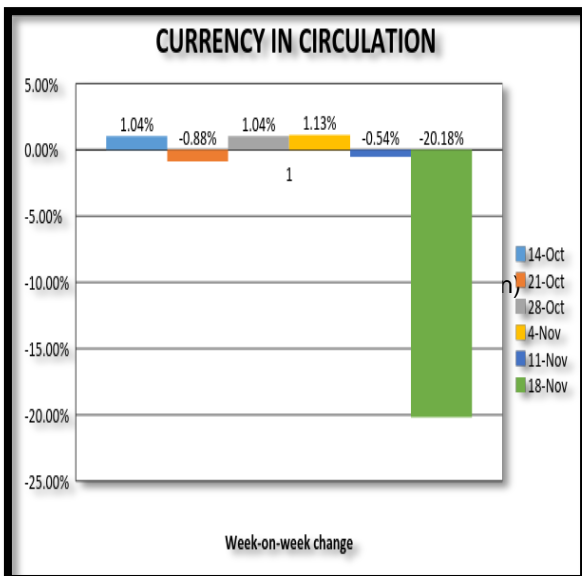
Movement of goods and money were hit over a short span. A Bank of America (Merrill Lynch) note says that wholesale channel forms over 40% of the

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sales for the Indian consumer firms. This channel works mainly on cash transactions and were likely to witness liquidity constraints in the near term that could disrupt the supply chain and impact growth in the December quarter. The report further adds that as consumer firms typically provide tight credit terms to the distributors in the near term one can expect an increase in their receivables in the December quarter.

Liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500 and Rs.100 necessary in daily life. It constituted to nearly 48% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Current reports indicated that all security printing presses can print only 2000 million units of RS 500 notes by the end of the year. Nearly 16000 million Rs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 million units were to be printed and replaced. All these indicated that currency crunch would be in for the next four months since November 2016.

Figure. 5



Investments

Mutual Funds witness huge inflow. Demonetisation leads to an increase in cash flow in banking system. This liquidity is also expected to move to mutual funds as investment. Mutual funds are proven instrument to generate food tax efficient returns. In long term this will benefit the mutual fund industry and the investors as a whole.

Equity market is expected to be volatile in short term because of uncertainty and slowdown in economy but in long terms, GDP and corporate earnings are expected to do well which will lead to a higher growth in equity market.

Employment

Employment in organized sectors was mostly unaffected as the re monetisation was handled

adroitly by government and did not take too long. If the re monetisation does not keep pace as promised and by December end the organised sector will also see layoffs. Industry underwent temporary job losses due to demonetisation, as production gets hit, especially in labour-intensive sectors like textiles, garments, leather and jewellery.

As many as 4 lakh people, mostly daily wagers, may have either lost their jobs or shunned work temporarily due to the lack of payment, and the number is only going to grow if the cash crunch persists. Roughly a fifth of the almost 32 million people employed in the textile and garment sector that are paid wages either daily or weekly were affected. While some of them had already lost their jobs, many are apprehensive of such a fate.

For the unorganised sector the effect on employment had been terrible. A large part of the unorganised sector deals only in unaccounted cash. This came to a grinding halt and is expected as a permanent halt. The vacuum left by this type of enterprise will be filled by mainstream enterprises but the switchover will take a long time. The poor will bear the brunt since unemployment will lead to a contraction in wages.

GDP

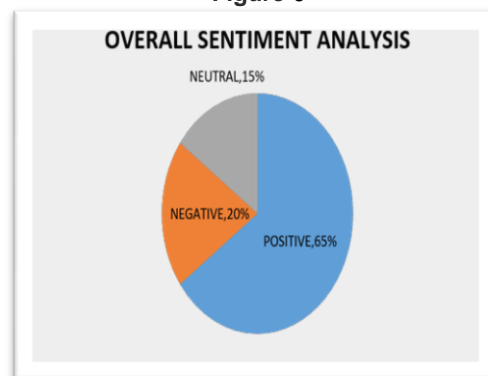
With reduction the consumption demand, following demonetization, what is generally expected is that a major part of currency in circulation will be exchanged with new notes and some part of it will end up as deposits as well. This, through money multiplier, could enhance the economic activity substantially. As per theory, the impact of change in money supply is expected to be significant on output in the short run. However, in the long run its impact could be highest on the prices but less on the output.

Many of the international financial firms have assessed India's GDP growth projections post demonetisation and all of the firm's' projections have shown a pretty significant decline in the GDP. As demonetisation would reduce the money supply due to incomplete replacement in the system, this is expected to reduce the GDP growth not only in the shock year but also in the coming periods.

Conclusion And Suggestions

So far, the move of demonization has been considered as the boldest in the history of Indian economy.

Figure 6



Source: BHIM APP

Diagram 6 depicts 65% of the total population has welcomed the decision, while 20% people don't seem so keyed up about it. And as usual, there are some people who don't find it obligatory to react in a situation and these 15% stay neutral. Behind the shining face of the story of Demonetisation there lies some naked truth. So far from equity market perspective this move has been beneficial for sectors like banking over medium or long term. The move has led to better tax compliance, better fiscal balance, lower inflation, lower corruption, elimination of counterfeit notes and thus anchors as a stepping stone for sustained growth of the economy. The move undoubtedly had an adverse impact on sectors like consumer goods, luxury items, gems and jewellery, real estate in the near to medium term. The initial days of demonetisation was enough painful stirring people's anxiety and snatching away precious time. The sudden hibernation of cash flow affected the daily wage earners the most. We observe the overall negative impacts surpassed the positive effects in the short term leading it to a move with the very limited success along an excess burden on common man

Table-2
Indent And Supply Of Bank Notes

Denomination(Rs)	2013-14		2014-15		2015-16		2016-17
	Indent	Supply	Indent	Supply	Indent	Supply	
1	2	3	4	5	6	7	8
5	0	0	0	0	0	0	0
10	12,164	9,467	6,000	9,417	4,000	5,857	3,000
20	1,203	935	4,000	1,086	5,000	3,252	6,000
50	994	1,174	2,100	1,615	2,050	1,908	2,125
100	5,187	5,131	5,200	5,464	5,350	4,910	5,500
500	4,839	3,393	5,400	5,018	5,600	4,291	5,725
1000	975	818	1,500	1,052	1,900	977	2,200
TOTAL@	25,362	20,918	24,200	23,652	23,900	21,195	24,550

The table shows the money circulation and denomination in Indian economy. If there was a plan in advance to demonetise these denomination, then RBI must print and disburse such large quantities of SBN into circulation. This is nothing but sheer wastage of exchequer's money. If RBI had an advance plan to replace the above SBN, they should have devoted their time and energy to print lower denominations instead of SBN.

To make demonetisation a huge success the government should have rightly channelized the credit flow to the wildest corners of the country. There was serious issue regarding cash delivery in the system due to inferior planning and poor judgement on the

part of RBI. The government should have taken measures that the banks have an adequate amount of lower denomination of cash prior to the announcement of demonetisation so that people could have easy cash exchange. The government should implement strict policies to set up 1:1 person-bank accounts along with an increase in setting up and usage of ATMs in sub urban and rural areas. Time should have been spent on making the use of debit, credit cards easier and popular. Spreading awareness about the benefits of digitizing transactions hence moving towards a cashless and transparent India was much in need.

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