

# Demonetization : It Short, Medium and Long Term Result in Indian Economy

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## Abstract

The argument posited in favors of demonetization is that the cash that would be extinguished would be Black Economy or Black money. Black money in the form of cash are either ill-gotten money or the earning on which tax has not been paid. The steps will enforce those who have this kind of money to either bring

Money into the system and declare the earning sources and pay the taxes which will considerable increase the coffer of government which can be used for various social sector development which already has been announced by the government that the entire amount earned from the penalty and taxes will be used for Garib Kalyan or the undeclared earning become valueless. Demonetization should be rightfully extinguished to set right the perverse incentive structure in the economy. when the facts are not available to anybody. It would be foolhardy to argue that that is only possibility. Therefore, it is imperative to evaluate the short and term impacts of such a shock is expected to have on the economy. The impact of such a move would vary depending on the extent to the government decision, on the availability of credit, spending, level of activity and government finance.

**Keywords:** Black economy, Corruption, Compressive, Demonetization, Extinguish, Evaluate, Scam, Sowing, Squeezed, Threat

## Introduction

On 8<sup>th</sup> Nov 2016 Indian prime minister Narendra Modi announced the government of India's decided to cancel the legal tender of 500Rs and 1000Rs bank notes with effect from 9<sup>th</sup> Nov.2016. He also announced to issued of new 500Rs and 2000Rs banknotes in exchange of old banknotes. Whole India is shocked by his decision. PM mentioned it's strike on Black Money. He said it was necessary to take this demonetization step suddenly. BJP and its supporters are praising and the opposite parties are claiming demonetization as a scam. Public response is mixed some are saying it's a good decision against the black money while other are opposed. The proposal by the government involves the elimination of these existing notes from circulation and gradual replacement with a new set of notes. It is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. Demonetization has two main two fold 1<sup>st</sup> is to control counterfeit notes that could be contributed to terrorism and 2<sup>nd</sup> to estimate the black economy.

## Reasons for Demonetization

We knew terrorism is a frightening threat, but terrorist is not found. Because our enemies they use the fake currency to sponsor terror this was proven many a times. Corruption and black money are major obstacles in our country is rapidly increasing in terms of growth and we are in no 1 position in terms of growth but we are ranked 76<sup>th</sup> in global corruption perception ranking. It clearly shows how corruption and black have spread their tentacles.

## Impact of Demonetization in Indian economy

### Very short term impact of Demonetization on Informal sector

By demonetization 86% of the currency in circulation is removed and it resulted to contraction of money supply in the economy.this contraction by wiping out cash balance in the economy will eliminate a number of transaction for a while, its result there is no cash as a medium of exchange. Since income and consumption are intrinsically related to transactions in the economy. This effect would be more servers on individuals who earn income in cash and spent it in cash. A lesser extent would also affect individuals who earn his income in non-cash forms but need to withdraw in cash for consumption purpose .

The sectors of the economy also adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing for example transport services, fruits and vegetables and all other perishables goods would face compression in demand which is backed by purchasing power. This is tern can have two effect:- 1<sup>st</sup> supply exceeds the demand hence there would fall in prices. 2<sup>nd</sup> if supply too gets curtailed for want of a medium of exchange prices might too rise. Thus it seems that people expect prices to fall, it is quite possible that prices would instead rise.

**Demonetization Short Term Effect on Agriculture**

This is the season for Rubi crop in the country and harvesting season for the Khريف crops. Most of the sale and purchase of the crops in cash. With eliminate of cash from the economy sale of khريف crop would be difficult unless the crop is sold on the promise of payment in future. The limited bargaining power of the farmer compel to realize the crop at very low rate. On the other hand sowing activity people would not get access money to purchase the required inputs. They seek the access to credit from the supplier. It means with demonetization there would be a significant strengthening of the informal sector credit market in the rural area. If the farmer and informal sector do not get access credit from the market their sowing activity are effected Hence their income in the next season would be adversely affected. In spite of a good monsoon in the large part of the country farmer not might not get the benefits.

**Demonetization and its Short Effect on Construction and Real Estate**

Construction the biggest informal jobs sector very adversely effected by the demonetization. Most of the construction sector works with a significant amount of cash. Payment of worker as well as construction material is purchased in cash. So on demand and supply side market adversely effected. The demand for houses and buildings would appear as a demand for non essentials and might be pushed on back burner until the economic situation normalizes. On the other hand it is expects to see that adverse effect on real estate. With construction in demand form one set of agents who have earned earn unaccounted income and placed them with the

real estate. Prices of the house and building were fall. In India it is traditionally that the real estate sector involved a significant level of informal fund in the form of cash transaction. it is expected that in long term promote transparent pricing in the real estate sector decreasing liquidity resulting lower informal funding source is expected to significantly weaken the demand for real properties. Hence it could lead to a compression in investment in the construction and real estate sector.

**Medium and Long Term Effect on Indian Economy**

The direct and positive effect will be felt on the government tax revenue collection and its ability to spent on infrastructure investments and the resultant impact on growth. Inflation, we believe, we will see downward pressure in the short term because cash transactions will reduce. In long run though, as government rise pushing up employment and incomes, demand will revive. Therefore, we expect inflation to be neutral in the medium to long term.

The long terms benefits for the economy is to extinguishing of the major portion of the unaccounted currency would reduce from the liabilities of the government and would add to its finances. This can have very strong implication as the government would get money to spend without borrowing from the market. This would mean that while interest rate can be low the government spending on large on infrastructure project would kick start capex cycle and push economic growth higher in the medium term.

Demonetization impact in Indian populous is also likely to have a habit changing there could be keeping cash in the banks rather than stashed at home and use formal banking channels for their spending needs. With a large part of the cash moving through the banking channels, the banking sector is likely to be flush with funds in the near term and would help them reduce cost of fund for such period.

Demonetization would be reduction in cash transaction in the real estate. It reduce the price to real estate and make it affordable to some extent. This may be visible in rural area more than urban. The demonetization consequently reduce the shadow economy that would bring the demand for farm land and real estate.

Variables	Immediate impact	Medium and long term effect on economy	Overall Long term impact
Impact on GDP	Consumption and investment demand decline due to cash based eco. hence AD fall and -ive effect	Direct tax collection increase and create room for invest. disposable Y go up in long run, emp.go up.	Good for GDP
Inflation	Downward pressure due to less AD specially in rural area. Where share of cash transaction is high sharp fall of inflation inR&Urban area.	Min. impact in long run as DD will bunch back up with increase G spending & +ive effect on emp. Output& Y.	Natural

## Shrinkhla Ek Shodhparak Vaicharik Patrika

Liquidity	Increasing liquidity in the banking led by higher deposits. It help mitigate any short term liquidity concern on account	RBI's stance is to maintain neutral liquidity in the banking system.RBI will suck out any excess liquidity through OMO.	Natural
Currency in circulation	On31march2016,500, 1000Rs notes constituted around 86% of total currency in India, reeducation the uses of these notes, along with imposition of withdrawal limit will lead decrease in currency in circulation	As new currency notes are introduce in circulation is expected to revert to normal levels. However, if people are averse to holding cash and if there is a greater move towards accepted electronic payments in future that can bring down in circulation.	Natural

Fiscal deficit	To take time for tax officials to claim tax on the deposits made by people. The impact of tax collections could be high. In long run better tax compliance and some initial disincentive to hoard cash could push up direct tax collection in the medium term.	Income tax collection expected to see a kick up as fund earlier unaccounted for enter the banking system and eventually get taxed, about 23%of the eco .estimated to be unaccounted for plus this involuntary declaration of Y to invite 30 to 120% rate, depending on the source of income	upwards
Digital payments	Individuals substitute towards digital payment	Because the unified payment interface gains greater acceptance and a larger proportion of the population gets incorporated into the digital financial ecosystem	upwards
Current account deficit	Gold demand decline due to policy restriction .this step will additional bring down gold import because demand is mostly driven by cash.	Pent up demand for gold may lead to higher imports. People might chose to hoard gold instead of cash.	downward

### Advantage and disadvantage of demonetization

#### Advantages

1. The major decision which is made by the government will help us to eradicate black money, corruption to some extent.
2. Due to lack of funding there will be no arms smuggling and all the terrorist activities will also be checked.
3. Financial Intelligence unit will track all details of the transactions from the bank. So now it is really difficult to get rid of the black economy.
4. Real estate industry is totally corrupted and now by this stringent decision the real estate sector will bring in more transparency. By doing it in this way we will have more credibility, making it more

attractive to the foreign investors as well as domestic investor.

#### Disadvantages

1. It will cause great inconvenience to common man who will start running to bank to exchange 500, 1000Rs notes.
2. By replacing all the 500 &1000 Rs demonetization notes ordered by the government could cost the RBI at least 12000 crore.
3. It will be very difficult for half of the population who are not well versed with the card transaction.
4. The major problem is that big fishes will be left out whose black money is in the form of foreign currency, gold and property and stashed in tax havens.

**Conclusion**

It is well accepted the decision has been taken with the intention of removing various ills from Indian economic system. It has various side effects in short terms for India. More than 86% of the Indian currency were in the form of 500 Rs and 1000Rs and sudden suspension of its status of legal tender has caused havoc in banking system. People not converted with digital payment methods are finding it hard to day to day work resulting slowdown in informal sector. In villages the entire population is depending on cash transaction and they are not able to purchase things from the old notes which have been demonetized and small shopkeepers are finding it hard to go with. Most of the economic reform has immediate costs effect but the demonetization has very low cost and much gains for the economy. Modi has staked his position as a leader to capable of making bold decisions. The unexpected and boldness decision itself seems at least in urban and semi urban India, to have played in his favor. In my own interaction with individuals from various walks of life and income levels, there is clearly a willingness to suffer through the inconveniences so that corruption can be brought under control. This support is not unconditional and depends on the speed with which the current liquidity crunch is resolved, and also how the battle is played out in the media. Success of the demonetization depends on the next steps of that the government would introduce to tackle black money. In other words demonetization is the 1<sup>st</sup> step. In economics, When we evaluate the cost and benefits of a new policy, we ask if those that are harmed can be compensated adequately. It is clear that Modi government has come up and short and one wonders why he did not put in place an action plan to help those who were likely to be the most inconvenienced. The one who were likely to suffer are also the one who are most vulnerable to vote buying. If things go downhill, his political foes may have no need to buy vote.

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