

Impacts of Demonetisation on Indian Economy- Issues & Challenges

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Abstract: India has amongst the highest level of currencies in circulation at 12.1% of GDP. Cash on hand is an estimated at around 3.2% of household assets, higher than investment in equities, or roughly around \$ 220 billion. Of this cash, 87% is in the form of Rs 500 and Rs 1,000 notes or roughly Rs 14 lakh crore (\$190 billion). A significant portion of the household cash on hand is generated by economic transactions that are not reported to tax authorities or generated through corruption. Scrapping the higher denomination money would either result in these being brought into the system or the money just disappearing. The present paper highlights the probable consequences of this decision on various economic variables and entities.



I. Introduction

Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes, there occurred huge gap in the currency composition as after Rs 100; Rs 2000 is the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination.

Objectives of paper:

- To study the experience of impact of demonetization in various countries in past years;
- To analyze the current the immediate impact of demonetization on Indian economy;
- To workout the probable consequences of the demonetization.

II. Research Methodology

The paper is based on secondary data. The data has been collected from internet.

Impact of Demonetization Issues & Challenges

Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts.

1. Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.
2. **Liquidity crunch (short term effect):** liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49% 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 indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 mnRs 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 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

3. **Welfare loss for the currency using population:** Most active segments of the population who constitute the 'base of the pyramid' uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class.

There will be a trickle up effect of the liquidity chaos to the higher income people with time.

4. **Consumption will be hit:** When liquidity shortage strikes, it is consumption that is going to be adversely affected first.

Consumption ↓ → Production ↓ → Employment ↓ → Growth ↓ → Tax revenue ↓

5. **Loss of Growth momentum-** India risks its position of being the fastest growing largest economy: reduced consumption, income, investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.
6. **Impact on bank deposits and interest rate:** Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply take place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.
7. **Impact on black money:** Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depend upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. such a nationwide awareness and urge will encourage government to come out with even strong measures.
8. **Impact on counterfeit currency:** the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the unmeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

III. Positive Effects Of Demonetization?

In what could be termed as the mother of all reforms, Prime Minister Modi's demonetisation move will have far reaching implications. This is not to dispute that the transformative step has brought some hardship for the citizens, but those are temporary and will blow over soon. For the larger benefit of the nation, we the citizens can bear such hiccups with a smile. After all, this is how we as citizens can contribute in policy making and nation building. While bank employees are working overtime to make Modi's ambitious demonetisation drive a success, let's discuss its many-fold impacts.

1. **Black money:** At one stroke the Prime Minister has choked the supply of black money stacked inside the country. Of the Rs 17 lakh crore of total currency in circulation in the country, black money is estimated at mind-boggling Rs 3 lakh crore. Black money is nothing but a plunder of the nation. Black money operators run a parallel economy which shakes the very foundation of the Indian economy. With Modi's demonetisation move, all domestic black money will either be deposited into the banks with heavy penalty or be simply destroyed.
2. **Economy:** Demonetisation will have a huge resultant effect on the Indian economy. The clean-up of illegal cash will help turn around the economy. First, it will bring more borrowings to the exchequer, improve inflation outlook and increase India's gross domestic product (GDP). Second, it will revive investment opportunities and give a fillip to infrastructure and the manufacturing sector. Third, it will help reduce interest rates and lower income tax rate.

3. **Note bank politics:** In the run up to the crucial assembly elections in Uttar Pradesh, Punjab, Goa and Uttarakhand, Prime Minister Modi's demonetisation announcement has come as a shock and awe for the political parties and politicians for whom black money is a lifeline. The pulling out of the old Rs 500 and Rs 1,000 currency notes will help make the election process clean and transparent. But it has brought tough times for the political parties and politicians who believe in the idea of purchasing votes in exchange for notes. That is precisely the reason a rainbow coalition of a galaxy of regional parties and the Congress is building up against Modi, because their political interests are badly hurt.
4. **Real estate cleansing:** It is said that real estate is an industry built on black money. The extent of black money floating around in the sector is huge. According to an estimate at least 40 per cent of real estate transactions in Delhi-NCR are in black. Modi's demonetisation move will curtail the flow of black money into the real estate sector. This will help in making the much needed correction in the sector. The impact: An unexpected dip in land and property prices.
5. **Hawala transactions:** Demonetisation has crippled the hawala rackets. Hawala is a method of transferring money without any actual money movement. Hawala route is used as a means to facilitate money laundering and terror financing. Hawala rackets run again on black money. With black money suddenly being wiped out of the market, thanks to demonetisation, hawala operations have come to a grinding halt. According to an India Today report, one of the hawala operators in Mumbai has destroyed currency notes worth about Rs 500 crores.
6. **Counterfeit currency:** Demonetisation has dealt a death blow to the counterfeit Indian currency syndicate operating both inside and outside the country. Counterfeit currency seriously devalues the real worth of Indian currency. A study conducted by Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency (NIA) suggests that fake Indian currency notes (FICN) amounting to Rs 400 crore are in circulation in the country at any given point of time and around Rs 70 crore fake notes are pumped into Indian economy every year. The estimation is based on recovery and seizure made by various agencies. But the actual figure could be much larger. A One India report, quoting an Intelligence Bureau dossier, says fake Indian currency worth Rs 12 lakh crore has pumped into Indian financial system over the years. Needless to say that most of the fake currencies circulated in India are of Rs 500 and Rs 1000 denominations. It is also pertinent to mention that the fake currency floating inside the Indian financial system is not counted within the Rs 17 lakh crore of total currency in circulation in the country.

This is an open secret that Pakistan has been printing fake Indian currency at its government printing press in Quetta and its security press in Karachi. The enemy nation funnels the counterfeit currency through the frontier at Jammu & Kashmir and via India's porous border with Bangladesh and Nepal. With Prime Minister Modi's decision to pull out the old Rs 500 and Rs 1,000 notes and replace them with new Rs 500 and Rs 2,000 series has completely stalled the circulation of counterfeit Indian currency. Experts say the new currency notes have come with advanced security features which are almost impossible to replicate. So Pakistan has no option but to shut shops of its fake Indian currency.

7. **Terror financing:** Terror financing is sourced through counterfeit currency and hawala transactions. This is how terror financing works. Fake currency circulation is routed through a multi-layered network of hawala operators which are closely linked to satta (gambling) and smuggling of drugs, opium and arms. Indirectly, they all end up financing terrorism. In addition, the terrorists collect huge donations and then route the money through hawala transactions. With the circulation of counterfeit Indian currency completely stalled and hawala transactions stopped, all windows for terror financing are closed.

8. **Maoism:** Maoist sympathisers call Modi's demonetisation move an "undeclared financial emergency". There are reasons to it. Demonetisation has hit the Maoists and their movement hard.

Black money is the oxygen for Maoists. According to an estimate, Maoists manage to raise Rs 300 to Rs 400 crore annually through donations, levy and extortions. The illicit money is used to purchase arms and ammunition, food and medicine and daily essentials, apart from distributing it among the ranks and the cadre.

Police sources in both Chhattisgarh and Odisha have told the writer that the Maoists have stashed old high denomination notes to the tune of over Rs 10,000 crore at their dumps in the dense jungles of Odisha-Chhattisgarh border. No wonder, with Modi's demonetisation drive, all those illegal money are reduced to paper scrap. Maoists are in a state of coma and Maoist activities see a crippling blow. Ever since the demonetisation announcement was made, no major violence was reported from the Maoist infested states like Chhattisgarh, Odisha, Andhra Pradesh and Telangana.

9. **Kashmir unrest:** The four-month-long unrest in Kashmir valley is on a backburner, thanks to demonetisation. No stone pelting on security forces has been reported in Kashmir ever since the demonetisation announcement was made. An intelligence estimate suggests that Pakistan sends Rs 1,000 crore annually to the separatists for fuelling unrest in Kashmir. The money is transferred through hawala route. With hawalatransactions completely choked up, the separatists are now clueless. It won't be wrong to say that "stone pelter" Modi completely shattered the Kashmir unrest with his stone called demonetisation.

10. **North-East insurgency:** Demonetisation has severely affected the multiple militant groups operating in the North-East.

According to intelligence estimate the north-eastern insurgent groups together have a corpus of Rs 400 crore annually.

The insurgents source their funding in two ways. They raise funds through levy and extortions like the Maoists do. But unlike Maoists, the leaders of North-East militant outfits do not live in the jungle. Their English speaking high ranking leaders run operations from their dens in Myanmar, Bangladesh and Nepal. From there they also transfer huge illegal money via hawala route to their cadre for running the militancy. With the extortion money stopped completely in the absence of cash inflow and hawala operations coming to a complete halt, all activities of North-East militants have shuttered down.

IV. The Short-Term Vs. The Longer-Term Implications

The Short-term Impacts: There will be a disruption in the current liquidity situation as households are likely to get affected by the note exchange terms laid by the government. Though clarity is unfolding on this, commodity transactions and general cash market transactions are likely to feel an immediate impact. Unorganized sector proceedings, including small trade market activities, will remain volatile in the short-term. Roadside vendors, cab drivers, *kirana* stores, etc., have already stopped accepting Rs 500 and Rs 1,000 notes. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which is likely to be affected by immediate liquidity issues. Overall, negative impact on disposable income is expected along with likely disruption in the consumption patterns of the general populace. It is estimated that there will be a negative GDP impact in the current quarter as consumption gets a shock in the immediate term. However, quantum and degree of this impact cannot be ascertained at this time.

The Longer-term Implications:

This essentially represents a change in regime for the real and financial economy. Domestically, there could be some turmoil as the effect will be disproportionately felt by the lower and upper income classes. Internationally, the government is likely to get thumbs up for the move and more countries could potentially see this as a viable option to curb black money and stem illegal financial activity. Last, though this move by the government may not be a first, having being tried by earlier governments as a tool to fight corruption. Such an action achieves larger significance for a globally connected India as it shows boldness in tackling an issue which has remained a thorn in the growth success story of this generation.

The Sectoral Impacts

While sectors with linkages to the unorganized economy are likely to be affected, technology and financial services are expected to gain in the medium to long term. On a sectoral basis, the commodities and agricultural sector, including the market for consumer durables and non-durables is expected to feel the heat. In the short to medium-term, large denomination purchases will likely be made via electronic purchases rather than through brick and mortar outlets. This will impact the retail sector adversely.

The real estate sector is likely to see a significant negative impact in the medium- to long-term, particularly in the repurchase market. There are expectations of a revaluation of current real estate transactions across the board representing possible losses to players in the sector. The luxury goods market is also likely to get affected as this move represents an erosion of real wealth to a large Areas of sub-sectoral impact will be felt in luxury cars, SUVs, gems, jewellery, gold and high-end branded products.

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On the positive side, there is likely to a reset of spending patterns as this move represents indirectly a significant push towards a cashless economy. Businesses in the fin-tech sector, including payment banks, mobile wallets, electronic transfer providers, etc., are expected to see gains.

V. Conclusion

If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries shows that the move was one of the series that failed to fix a debt-burdened and inflation-ridden economy.

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