

# SHORT TERM IMPACT OF DEMONETIZATION ON INDIAN ECONOMY

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## **Abstract**

*On 8<sup>th</sup> of November 2016, India witnessed a groundbreaking event, which affected thousands of people of this country. The Indian Prime Minister announced the ban of Rs. 500 and Rs. 1000 notes from use as legal tender commonly termed as Demonetization. The main objectives for demonetization was to restrain corruption, to curb the use of high denomination notes for terrorist activities, destroy fake currency and making black money to flow into the main stream of the economy by declaring their income to the tax authorities. But this action caused chaos in the economy as people had to face the deficiency of liquid cash for day-to-day transactions resulting in long queues in front of the ATM. The informal sector and the primary producers were highly affected by demonetization. This paper aims to analyze the short-term effects of demonetization on Indian Economy.*

## **Keywords:**

*Demonetization, fake currency, black money, informal sector, Indian economy*

## **Introduction**

One of the major problems of any country is the existence of black money. Black money is the income, which is unaccounted for, as the government does not know the sources of the income or it is the income, which is not declared for tax purposes. To tackle the situation of circulation of black money in the economy the government can take drastic steps like demonetization, which will force the holders of black money to deposit their money in banks or forgo their wealth. Before 2016, India has gone through the situation of demonetization twice. First time in the year 1946 and second time in the year 1978. In the year 1946, Rs. 1,000, Rs. 5,000 and Rs. 10,000 notes were discontinued from circulation. But all the three denominations were reintroduced in the year 1954. Then again in the year 1978, the ruling party deemed Rs. 1,000, Rs. 5,000 and Rs. 10,000 notes as illegal for the second time.

In the year 2016, Rs. 500 and Rs. 1,000 notes we demonetized which comprised nearly 86 per cent of value of notes in circulation (RBI annual report Aug 30, 2017). The main focus of RBI was then directed towards printing of new currency and transfer it from the printing presses to then currency chest and from there to the bank branches and ATMs in the least possible time. The Reserve Bank of India induced 23.8 billion pieces of bank notes, which values up to Rs. 5,540 billion in circulation from November 9 to December 31, 2016. By March 31, 2017, the notes in circulation increased close to 74 per cent of the notes in circulation as of November 4, 2016. In table 1, we can see that in the year 2016 the total currency in circulation was Rs. 16,415 out of which notes of Rs. 1,000 denomination accounted for 38.6 per cent (Rs. 6,326 billion) and Rs. 500 accounted for 47.8 per cent (Rs. 7,854 billion)

For the process of demonetization to be successful, proper management system is required. It will help the economy in various ways like, improve economic growth, achieve a stable inflation rate and change the financial holdings of the citizens. Without a proper management system the result of demonetization can be catastrophic.

Banknotes in Circulation						
Denomination (₹)	Volume (million pieces)			Value (₹ billion)		
	Mar-15	Mar-16	Mar-17	Mar-15	Mar-16	Mar-17
1	2	3	4	5	6	7
2 and 5	11,672	11,626	11,557	46	45	45
	(13.9)	(12.9)	(11.5)	(0.3)	(0.3)	(0.3)
10	30,304	32,015	36,929	303	320	369
	(36.3)	(35.5)	(36.8)	(2.1)	(1.9)	(2.8)
20	4,350	4,924	10,158	87	98	203
	(5.2)	(5.4)	(10.2)	(0.6)	(0.6)	(1.5)
50	3,487	3,890	7,113	174	194	356
	(4.2)	(4.3)	(7.1)	(1.2)	(1.2)	(2.7)
100	15,026	15,778	25,280	1,503	1,578	2,528
	(18.0)	(17.5)	(25.2)	(10.5)	(9.6)	(19.3)
500	13,128	15,707	5,882	6,564	7,854	2,941
	(15.7)	(17.4)	(5.9)	(46.0)	(47.8)	(22.5)
1,000	5,612	6,326	89	5,612	6,326	89
	(6.7)	(7.0)	(0.0)	(39.3)	(38.6)	(0.7)
2,000	-	-	3,285	-	-	6,571
	-	-	(3.3)	-	-	(50.2)
Total	83,579	90,266	100,293	14,289	16,415	13,102

Note: Figures in parentheses represent the percentage share in total volume/value.

Table: 1- Source: RBI Annual Report, Aug 30, 2017

### Objective of the Study:

This paper seeks to study the impact of demonetization on Indian economy. This paper also tries to analyze the success rate of demonetization.

### Literature Review:

Litvack and Vigne (2017) in their paper “Demonetization in India and Emerging Challenges” states that demonetization had an impact on many areas of the economy. It had a major impact on the labor market and resulted in increased uncertainty and decrease in employment elasticity. Businesses had to shut down, farmers faced trouble buying seeds, auto and rickshaw drivers didn’t have any other payment option other than cash, employers couldn’t pay their employees, hospitals denied service to patients who had old bank notes, fishermen couldn’t sell their fishes on time, families had to face the difficulty of purchasing food and weddings were cancelled throughout the country.

According to Kushwaha, Kumar and Abbas (2018), demonetization was an effort to handle the threat of illegal money, corruption, terror funding, and counterfeit currency. This action was considered as a surgical strike against the undeclared money in the history of Indian economy. Demonetization caused severe cash shortages with harmful effects on various small business, agriculture and transportation. The positive impact of demonetization is it encouraged digital mode of payment like e-wallets and apps, online transactions using e banking, usage of plastic money etc. The benefits of demonetization will be seen in the medium and long term.

Veerakumar (2017) argues that demonetization was a big shock to Indian society. This drastic step was taken for several measures such as tax evasion, counterfeit currency and funding of illegal activities. People who have deposited money in their bank accounts beyond the specified limits, showed unaccounted income and was subject to higher tax and other penalties. This action helped the economy to move efficiently towards cashless infrastructure with alternative payment methods like e-wallets, online transactions and usage of debit and credit cards.

Kumar and Bumra (2017) says that demonetization caused short-term implications for cash intensive sectors like consumer market and agriculture sector. Due to shortage of cash with the farmers there was delay in payments, which affected the related companies for a short period of time. As the economy shifts towards a cashless platform, demand will be back from the unorganized sector to the organized sector.

According to Swami and Jain (2017), demonetization was a right move taken by the Prime Minister Narendra Modi, but the execution could have been better. The supply of the new currency should have been faster so that people could have adjusted to the new system easily. The rural class especially the women who were not accustomed with the system of electronic cash had to face the major problems of liquidity crunch. Another problem was the high denomination of Rs. 2,000 which was difficult for the public to use that note purchases as no one was willing to give back change to the customer.

## Research Methodology

The study is descriptive in nature. It uses descriptive method of analysis based on genuine secondary data taken from government reports, online journals, research papers, newspapers etc. The data collected on various aspects of demonetization are mostly in the textual and tabular form. Each point has been explained separately to get a clear analysis of the work done.

## Impact of Demonetization on:

**Black Money:** One of the major objectives of demonetization was to fight back against black money and corruption in the economy. Out of the total currency in circulation, which is Rs. 17 lakh crore, approximately Rs. 3 lakh crore is black money (Kushwaha, Kumar & Abbas, 2018). People are holding cash in hand to avoid tax payment. Demonetization was a step taken to counter tax evasion. An article in India Today on demonetization (August 30, 2018) says that according to RBI report, out of Rs. 15.41 lakh crore of demonetization currency notes of Rs. 500 and Rs. 1,000, Rs. 10,720 crore was not returned to the banks or the RBI, i.e., only 0.7 per cent of the demonetized currency notes were junked in the process. These figures might also indicate that black money held in the form of cash was very low or the execution of demonetization was not effective because of which most of the banned notes were laundered back into the banking system.

**Terror Funding and Counterfeit Notes:** Prime Minister Narendra Modi said that demonetization has destroyed the terrorist activities, drug mafia, human trafficking and the underworld instantly (GN Bureau, November 23, 2017). Finance Minister Arun Jaitley also said in an interview to Doordharshan that demonetization resulted a reduction in terror activities. The number of stone-pelters on the streets of Kashmir also reduced post demonetization and similar situation was seen in Chhattisgarh (The Hindu, November 08, 2017). Counterfeit currency or fake currency formed the major chunk of terrorist funding which turned worthless after demonetization. Thus, demonetization led to a positive impact on reduction of terror funding and violence in the country. Table 2 shows a significant rise in the number of counterfeit notes detected in the year 2016-17.

<b>Denomination-wise Counterfeit Notes Detected in the Banking System (April to March)</b>			
(No. of pieces)			
<b>Denomination (₹)</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
2 and 5	0	2	80
10	268	134	523
20	106	96	324
50	7,160	6,453	9,222
100	181,799	221,447	177,195
500 (MG series)	273,923	261,695	317,567
500 (New design)	0	0	199
1,000	131,190	143,099	256,324
2,000	0	0	638
Total	594,446	632,926	762,072

Table 2. Source: RBI Annual Report August 30, 2017

**Taxes:** According to Crisil, India witnessed an increased growth from 8.2 per cent in FY16 to 26.8 per cent in FY17 and 21.0 per cent in FY18. The corporate tax also increased in the corresponding years from 5.7 per cent to 7.0 per cent to 16.3 per cent respectively (Financial Express, May 29, 2018). An increase in the number of new tax filers has also been recorded due to demonetization. According to a report assessed by Press Trust of India (PTI) there has been a sustained increase in the income tax returns (ITRs) filed in the last four financial years as compared to 3.79 crore ITRs filed in 2013-14 fiscal and it increased to 6.87 crore during 2017-18 fiscal, i.e., by 81 per cent (The Times of India, PTI Dec 3, 2018). The report said that it was a positive impact of demonetization. A report of Central Board of Direct Taxes (CBDT) said that the Income Tax Department has collected more than Rs. 6.63 lakh crore for the fiscal year 2018, which is recorded as high growth rate of last seven years.

**Gross Domestic Product:** Around 6 months after demonetization the Gross Domestic Product (GDP) growth rate, which is a measure of all the final goods and services produced in a period of time, mostly annually or quarterly, slumped down to 6.1 in the January - March 2017 period, which is the lowest in more than two years. This figure was not expected as the Central Statistics office had estimated a growth of 7.1 per cent as compared to 7.6 per cent in 2015-16. With March 2017-quarter report, India lost its status as world's fastest growing major economy.

**Digitalization:** Another major objective of demonetization was to enhance digital or cashless transactions. According to RBI annual report, August 30, 2017 the total volume of retail electronic payments averaged around 37 per cent during April to October 2016, and it shot up to nearly 70 per cent in November and up to 123 per cent in December 2016. After this the growth rates have been moderate but it remained high. Demonetization led to the growth of digital payments and according to RBI it would continue its efforts to move towards a cashless economy as well as ensuring safety and enhancing the online payment system. Demonetization thus helped the country to take a step forward towards cashless economy. This will help to solve the economic and security problems usually associated with cash.

**RBI's printing of notes:** According to RBI's annual report Aug 30, 2017, the total amount spend for printing of notes during 2016-17 was Rs. 79.65 billion compared to Rs. 34.21 billion in 2015-16. The supply of higher denomination notes in the year 2016-17 was 13,702 million pieces as against 5,268 million pieces supplied in 2015-16, which is higher by 160 per cent. Due to urgent supply of notes across the country during demonetization, notes were also remitted by air, which resulted in increased expense on freight charges.

**Common man:** As demonetization was announced it caused a disturbance in the minds of the people thinking about the consequence of this action taken. People had to face liquidity crunch, which means they were not able to get sufficient volume of cash for day-to-day transactions. A high percentage of the population uses currency to meet their daily needs. The informal sector of the economy, like daily wage earners, laborers, small traders etc. use cash frequently. These sections lost their income at the time of liquidity crunch. In a series of tweets by former Finance Minister P Chidambaram said that 100 lives were lost and 15 crore daily wage earners lost their livelihood for several weeks. Many Small and Medium Sized Enterprises (SMEs) were shut down and many jobs were destroyed (India Today, August 30, 2018).

## Conclusion:

The news of demonetization came as a shock to the people of India. Though the intension of this action was noble, its impact on common man was rough. It did help the economy to curb black money and counterfeit currency and decrease terrorism but it was not fully successful, as most of the black money is not held in the form of cash. If it was implemented in a better way, the common man and mostly the poorer section of the society who deals with cash for their day to day transactions wouldn't have suffered the problems due to lack of liquid cash. Demonetization was definitely a step towards cashless economy, which will make our lives more convenient and secure. Other strong and effective policies should be implemented to achieve the targets of the government. The short-term impact of demonetization was bad for the economy of India with fall in GDP and consumer demand and most importantly, the sufferings of the common man.

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