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Impact of Demonetization in Indian Economy

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Abstract: *The government has implemented a major change in the economic environment by demonetizing the high value currency notes – of Rs 500 and Rs 1000 denomination. The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. The original objectives are eliminating fake currency, inflicting losses on those with black money, and disrupting terror and criminal activities. The New objectives are enabling the growth in bank credit and turning India into a cashless economy. A cost benefit analysis suggests that the benefits were relatively small when compared with the costs. This paper aims to study the impact of demonetization on the different sectors of Indiaand its economy. Both primary and secondary data collection methods have been used to study the objectives. The study concludesthat thedemonetization needs to be done something to prevent recurrence of black money and parallel economy.*

Keywords: Demonetization, banking sector, Indian economy, currency.

Introduction

Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit. There are multiple reasons why nations demonetize their local units of currency. Some reasons include to combat inflation, to combat corruption, and to discourage a cash system. The process of demonetization involves either introducing new notes or coins of the same currency or completely replacing the old currency with new currency. Gold was demonetized in this way when it ceased to be used as an everyday currency. The Indian rupee (INR) is the official currency of India. The recent sudden move to demonetize Rs 500 and Rs 1,000 currency notes is not new. Rs 1,000 and higher denomination notes were first demonetized in January 1946 and again in 1978. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data.

In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denomination notes. These notes accounted for 86% of the country's cash supply. The government's goal was to eradicate counterfeit currency, fight tax evasion, eliminate black money gotten from money laundering and terrorist financing activities, and promote a cashless economy. By making the larger denomination notes worthless, individuals and entities with huge sums of black money gotten from parallel cash systems were forced to convert the

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money at a bank which is by law required to acquire tax information from the entity. If the entity could not provide proof of making any tax payments on the cash, a tax penalty of 200% of the tax owed was imposed.

In the past many countries have attempted demonetization, some successfully and some unsuccessfully, but all of them were done when their economies were having major problems like hyper-inflation in Germany in the 1920s. This is the first time that a perfectly healthy economy has attempted it and that too to target black money. Because this is a first, there are varied opinions amongst economists on what the impact will be in the future.In 2015, the Zimbabwean government demonetized the Zimbabwean dollar as a way to combat the country's hyperinflation that was recorded at 231,000,000%. The 3-month process involved expunging the Zimbabwean dollar from the country's financial system and solidifying the US dollar, Botswana pula, and South African rand as the country's legal tender in a bid to stabilize the economy.

Another example of demonetization occurred when the nations of the European Monetary Union adopted the euro in 2002. In order to switch to the euro, authorities first fixed exchange rates for the varied national currencies into Euros. When the euro was introduced, the old national currencies were demonetized. However, the old currencies remained convertible into Euros for a while so that a smooth transition through demonetization would be assured.The Coinage Act of 1873 demonetized silver in favor of adopting the gold standard as the legal tender of the United States. The withdrawal of silver from the economy resulted in a contraction of the money supply, which subsequently led to a 5-year economic depression in the country. In response to the dire situation and pressure from silver miners and farmers, the Bland-Allison Act demonetized silver as legal tender in 1878.

Objectives of the study

The main objective of the study is to study the impact of demonetization (November 2016) by the present government on Indian economy.

Methodology

The study is based on the secondary data. The secondary data were collected from various published sources like reports, magazines, journals, newspapers and websites. Primary data were also collected through personal interview method from the public people, small business traders, retailers, road side vendors and food stalls.

Impact of Demonetization

Impact on government finances

The effects of demonetization on government finances can be divided into three categories:

1. The impact through RBI's finances.
2. The impact through taxes.
3. The impact through credit available to finance deficits.

Through RBI's Finances

The RBI earns seignior age through the printing of currency. In the demonetization, a part of the currency will be extinguished. For this part of the currency, the RBI can print the notes given the assets on its books, but there would be no takers. In other words, this part of the currency would be like new money that can be introduced into the economy and hence yields seignior age to the

RBI once again when released into circulation. RBI, however, cannot lend this to the government since that would involve additional liability buildup on its balance sheet. So, this currency can only be released when foreign exchange is being converted to rupees for instance and not sterilized thereafter. At this point there would accrue some dividends to the government as well. However, to the extent the government and the RBI seek to move the economy towards digital instruments, this option might not be exercised and the dividend might not accrue.

Impact through Taxes

There are multiple channels through which taxes will be affected: At the point of transition to the new regime, people have attempted to convert cash balances into commodities like gold or luxuries. On these transactions the governments would have a spurt of taxes. This would however not last beyond the transition phase. In the subsequent period, the impact on indirect taxes would be negative because of the compression in demand. On property taxes, some local bodies have given people a window of opportunity to pay old as well as current taxes in the scrapped notes. This would result in an increase in revenue collections in property tax.

On income tax there can be two potential effects: first, with compression in the economy, there could be a reduction in the tax collection. In the unlikely event of people choosing to deposit unaccounted balances in the bank and pay taxes and penalty on the same, or if the tax department through investigation finds that some of the deposits are not explained income tax collections would increase. For any individual depositing balances above Rs 10 lakhs, the tax and penalty together would absorb the over 90 per cent of the deposited amount. This would serve as a disincentive for people with large balances to come and deposit the same into accounts. In other words, the government cannot expect to get major collections in terms of the tax and penalty on unaccounted incomes revealed.

Through financing of Fiscal Deficit

The generation of additional deposits and credit, as a result of the statuary liquidity ratio requirements can make more credit available to governments. Given the FRBM (Fiscal Responsibility and Budget Management) limitations, the amount of borrowing that governments can take on may be limited and the additional supply can mean a decline in the interest rate that governments pay on their debt. This could be a positive spin-off for the government.

Impact on Banking Sector

Everybody can understand that demonetization would have a pretty bad impact on SME’s, small traders, real estate, transport sector, consumer durable goods industry. Not only these sectors but it would major affect the rural areas of business as over there, majority of the transactions are made in cash. The ban of Rs.500 and Rs.1000 currency notes will impact those industries where hardcore cash transactions are made. Demonetization will affect the liquidity, but for a short term.

A clear picture of all the banks and ATMs is present which depicts today’s reality. Long queues of people waiting for currency exchange or deposit outside the banks and for cash withdrawals outside ATMs. But definitely this is for a short time. The biggest beneficiary from this policy will be banking sector. The reason behind being called the beneficiary is very obvious because as lot of people are depositing cash in the banks. There will be a lot of liquidity with banks. As the deposits with the banks will increase so will increase the current account savings account, which will increase the net interest income and net earnings of the banks.

Impact on Agriculture

Reports of stress in agriculture have begun to appear because of demonetization. Cash is the primary mode of transaction in agriculture sector which contributes 15% to India's total output. Formal financing in many parts, especially Punjab, Uttar Pradesh, Odisha, Maharashtra, Gujarat and Kerala is significantly from Cooperative banks, which are barred from exchange-deposit of demonetized currency. Notably, this is a time of kharif harvest and start of rabbi sowing, partly explaining why this period is dubbed the 'busy season' from a standpoint of credit demand, the other being bunching of festivals and weddings.

Agriculture is impacted through the input-output channels as well as price and output feedback effects. Sale, transport, marketing and distribution of ready produce to wholesale centers or mandis, is dominantly cash-dependent. Disruptions and breaks in the supply chains feedback to farmers as sales fall, increased wastage of perishables, lower revenues that show up as trade dues instead of cash in hand and when credited into bank accounts with limited access affect the sector.

Currently, many of these networks are operating sub-optimally or altogether at a standstill, depending upon location, market links and other item-specific factors. The input side is equally affected as many payments/purchases, such as seeds, fertilizers, implements and tools, are outright in cash. Borrowing-financing operations of larger farmers and organized producers are also cut off or severely clipped.

Impact on Small Traders

The Confederation of All India Traders said businesses "in markets across the country has reduced to 25 per cent" since the government announced the surprise move on November 8 night.CAIT explained that Indian retail trade is worth about Rs 42 lakh crore annually. Retail trade per day is approximately Rs 14,000 crore per day, of which about 40 per cent trade is conducted through business-to-business ventures. The rest 60 per cent is conducted directly with consumers.It said that agriculture wholesale markets across the country "had very less business" because farmers couldn't sell their produce as there is no cash due to unavailability ofsmallerdenominationnotes.

Shopkeepers and small business owners narrated their harrowing tales of cashlessness that has drastically reduced their trade. They said there were fewer buyers and those who come to purchase also carry the newly-minted Rs 2,000 currency notes."Some people buy items for Rs 100 and give Rs 2,000. They have to return Rs 1,900. This consumes a large number of small value currencies, which are already in short supply. The people owns a small Chinese eatery , handicraft shop, road side food stalls, street sellers, tea vendors, cigarette vendors and news paper sellers are said they did not have the facility to accept card payment and the cash crisis "has led to a huge decline in their business".

Impact on Real Estate

Real estate is expected to be one of the worst-hit sectors because of the government's demonetization move as cash forms a major component in most transactions in the sector.Many property advisers have predicted land and property prices particularly that of luxury houses could fall as much as 30% in the next three to six months. However, several developers and brokers said there is little room for any major price cuts due to rising input costs, and also given that property prices in key markets have remained stagnant due to a three-year slowdown in the real estate sector.Some other developers said as banks are awash with money following demonetization as customers deposited tones of cash, home loan rates may come down in the months, helping push property sales. “Sales have fallen in these months.

Impact on Retail Industry

Demonetizationhas impacted the retail industry due to a liquidity crunch. As the Indian retail industry generates a lot of cash transactions, a reduction in sales will continue in the short-term.Small traders and vendors have been affected the most as they are facing a huge slump in sale. Many of these small retailers are not equipped enough to make provisions of digital payments for their customers, and for this reason are having to go through a lot of hardships. Organized, large retailers and malls too are facing a drop in sales and decreasing amount of store footfalls, but in the long run can expect normalcy to be restored as customers increasingly adapt to making payments digitally.

Online Retail sales have also taken a beating in the month of November, immediately after the demonetization announcement. According to the data from ETRetail.com, the monthly gross sales (November) is expected to take a 50% hit in comparison to the month of October. The cash on delivery (COD) volumes were down by 60% than usual. Generally, the leading e-commerce companies register returns of about 13-15%, but have doubled up ever since demonetization took effect, with most cancellations arising out of cash on delivery orders due to the growing reluctance of customers to give out cash.

Impact on Automobile Sector

There will be a temporary disruption in the auto industry in the near term due to the ban on currency notes. But a larger impact will be in the rural markets as the number of cash transactions is highMotorcycle sales in the rural areas could also slow down since a majority of two-wheelers here are bought with cash. Besides, two-wheelers are exempt from disclosure of Permanent Account Number which is mandatory for larger vehicles.Sales of luxury cars and premium SUVs, along with the unorganized used car market could also witness a slump due to the demonetization, according to industry watchers.

The unorganized used car market could also be hit due to scrapping of the currency notes. In fact, some dealers are known to encourage cash transactions. “It will impact buying power for about 4-5 months since there many cash transactions take place. The delay in buying decisions too, will result in a lot of unsold cars being carried forward to next year which will make them cheaper,” a used car dealer said. However, the impact on small car sales may be minimal as most of the transactions occur through bank financing or loans, an executive at Maruti Suzuki said.

Impact on Export and Import Sector

Growth of any Country depends up on its Export Import Trade. Indeed it is very crucial for India too. Especially after demonetization the Exports have slowed down due to currency crunch. True to its core that instability in the Exports leads to inflation and that in turn leads to an uncertainty of internal purchasing power and unstable economy.India’s import and export business is hugely affected by the recent and shocking announcement of demonetization. The Foreign Trade industry is suffering in the aftershocks and shall continue to suffer for a further period, though for limited time.However the influx of money from the black market shall certainly improve to be beneficial in the long run for Export Import Trade. The fact lies at the moment that plunge in money supply with overflowing bank deposits ring an alarm in consumption demands, means decline in imports.

The Indian Government has always paid incentives and promoted export with easy policies. Nonetheless the exports market is taking a toll at the moment. Make in India projects need easy flow of currency for manufacturing, hence the import and export both trade have got their bottlenecks. This has changed the algorithm in today's economical situation. However stable exchange rate is an idle situation as volatility vitiates the Trade for India. For a few months India's exports may be slow but consider that for any acceleration, the vehicle must be slow to begin with.

Impact on Gold

Demonetization of currency is making the investors go gold. Instead of consumption motives, they are routing black money via gold purchases. This has escalated the demand for gold in economy.

Impact on FDI

The demonetization is going to trigger the rise in FDI inflows in the country. A significant increase in government revenue would enhance its expenditure in crucial areas especially infrastructure. A low corruption, greater transparency and a check on the parallel economy would boost the GDP rates. Better infrastructure and GDP growth would attract large number of investors to India thereby raising the FDI inflows.

Impact on Luxury items

The black money is spent on luxury items like cars, interior décor, clothing, antiques; electronics etc. demonetization would directly impact the demand for luxury goods.

Impact on Entertainment and Leisure

Entertainment forms one of the ways to splurge black money. Black money is splurged on movies, dining out, and exotic vacations, personal grooming at salons, etc. the scraping of currency will now make such extravagant expenditure out of bounds. Consequently this sector may witness a fall in demand from the customer.

Conclusion

There are both positive and negative impacts of demonetization on different sectors. Demonetization would have a bad impact on SME's, small traders, real estate, transport sector, consumer durable goods industry and agriculture. The demand of gold and luxury items was increased in the beginning period of demonetization.There is no doubt that demonetization is a great move for a better future of India and its economy. It will definitely influence many more shoppers to start using plastic money in the long-term. Already, malls see usage of credit/ debit cards and e-Wallets go up during big sales, when banks and fin-tech start-ups offer cash backs or discounts. This trend will raise substantially in the long term as such payment methods become more main stream.

In the short term, GDP will be down for at least a 1-2 quarters before recovering.A lot of black money will be converted to white and be deposited into the banks which will in turn help in the NPA problem that banks are facing.In the longer term, reducing of black money economy in the future should bring more people in the tax net and hence lower taxes as well as interest rates which will bode well for the overall economy.The overall retail demand for goods and services have taken a hit owing to demonetization. At this junction, the government needs to speed up the currency replenishment measures. Else the danger of deflationary pressures looms large. Again with the infusion of new currency notes, hoarding tendencies may crop up. There needs to be done something to prevent recurrence of black money and parallel economy.

Although this was what is called a surgical strike on black money and will have immediate impact on the existing black money, most economists agree though, that this move is not sufficient and several other reforms like tax reforms, real estate reforms etc need to be undertaken to curb the black money generation in the future.

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