

Demonetisation: An Analysis of Intended Benefits and Unintended Consequences

Pratibha Giri¹, Dr. Yogendra Singh²

¹Assistant Professor, Dept. of Management Studies, JSSATE, Noida, Uttar Pradesh, India

²Associate Professor, Dept. of Management Studies, JSSATE, Noida, Uttar Pradesh, India

Abstract: - Demonetisation is the mechanism by which the government states to withdraw the money which is current legal tender. The government being sovereign can take such decision. The effect of this announcement is that the currency notes in circulation will now cease to be valid tender and can only be exchanged at the banks. India's Prime Minister Narendra Modi announced to the citizens on Nov 8, 2016 that 500 and 1000 rupee notes are worthless, effective immediately – and they had until the end of the year to deposit or exchange them for newly introduced 2000 rupee and 500 rupee bills. The move by the government is to tackle the menace of black money, corruption, terror funding and fake currency. The total value of old Rs.500 and Rs.1000 notes in the circulation is to the tune of Rs.14.2 trillion, which is about 85% of the total value of currency in circulation. This means that the total cash has to now pass through the formal banking channels to get legitimacy. There are higher chances of larger proportion of this unaccounted currency getting extinguished as the tax rate and subsequent legal issues could be prohibitively high for such money.

The paper elucidates and analyses the various economic aspects of the recent demonetization move with an attempt to draw out critical derivatives of the decision on various economic variables.

Keywords: Demonetization, currency, Black money, corruption.

I. HISTORY AND BACKGROUND

Demonetization is a move not new to the Indian scenario. Infact the wider scope of demonetization can be understood when the respective countries of European union (EU), were replaced by the Euro, but in its present state of demonetization the Indian government still retains its legality of the old notes. On 12th January 1946 and 16th January 1978, a period of pre and post-independence era, the Indian currency was demonetised to serve similar requirements similar to the present move, which included objectives of checking black money circulations, tax evasions and further to add printing of counterfeit currency which are used to fund terrorism and anti-social activities.

The rationale for the present move also includes, improving financial inclusion, preventing stashing of money, improving the gross domestic product (GDP), increase social welfare like Swachh Bharat (Clean India), Jan Dhan Yojana (Prime Minister Money Scheme), building a pathway towards a

cashless society and improving India's position on transparency & corruption in the global stage.

The last demonetisation was done in 1978 and notes of high value of Rs 1000, 500 and 10000 ceased to be a legal tender.

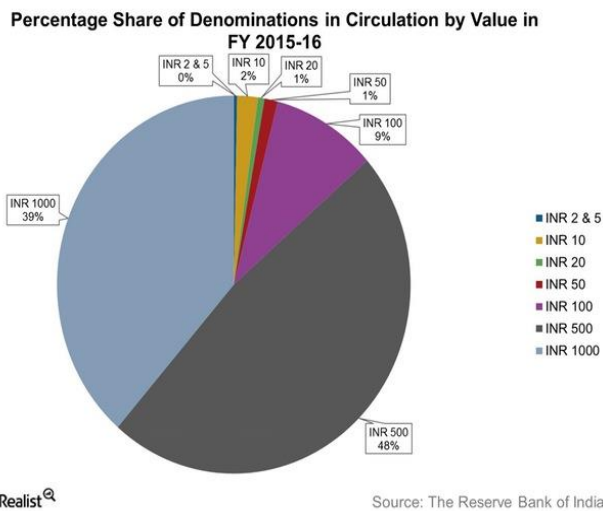
At that time not even 2% of the population of the country was hit as the salary of the common man was within Rs 500 to Rs 2000 per month. It was only the rich and the richest who were affected and those who could not account for their money lost all their cash. Truck loads of demonetised notes were burnt in 1978 across India.

II. INTRODUCTION

The government has implemented a major change in the economic environment by demonetising the high value currency notes of Rs 500 and Rs 1000 denomination. The present Indian Prime Minister Narendra Modi announced that 86% of the higher denomination currency notes worth some 14 trillion rupees in circulation will no longer be considered as legal tenders at the stroke of midnight. These ceased to be legal tender from the midnight of 8th of November 2016. People have been given up to December 30, 2016 to exchange the notes held by them.

However, this is the first time that Rs 2,000 currency note is being introduced. The demonetization campaign launched by Modi was based on a strategy called "Surgical strike over black money" referring to a campaign pledge to fight against black money in the country: the illicit proceed which is often held as cash-of tax evasion, crime and corruption.

The demonetization move by the central government has hit the trade and consumption very hard, as the Indian economy is heavily dependent on cash because banking system for monetary transactions is used by only less than half of the Indian population. Around 56% of India's GDP is summed up by the consumption of citizens, but during this current fiasco caused by demonetization people are scrambling for cash to pay for goods and services hence, the move is likely to take a big charge on the country's growth and output and the growth of the country will surely be pulled down by the sudden drop in spending. A lot of behavioural changes in household's savings and their consumption pattern can also be seen as an effect of demonetization.



III. CRITICAL ANALYSIS OF THE IMPACT OF DEMONETISATION ON VARIOUS SECTORS OF THE INDIAN ECONOMY

• AUTOMOBILES

The automotive industry in India is one of the largest in the world with an annual production of 23.37 million vehicles in FY 2014-15, following a growth of 8.68 per cent over the last year. The automobile industry accounts for 7.1 per cent of the country's gross domestic product (GDP). There will be a short term impact of the move on passenger vehicles due to purchase deferment but the demand will revive in medium term. The demand for Tractors is likely to be materially impacted. Due to decrease in bank lending rates, the sales might be boosted as the Bike and Car EMIs become much more affordable. There will be high impact on 2 wheeler sales as large % of rural 2W transactions are in cash and percentage transactions backed by loans is lower.

Luxury cars and SUV sales will see significant impact due to wealth deterioration and decline in rural transactions (cash based). Commercial Vehicles will be negatively impacted. The second hand truck sales which had higher % of cash transactions will decline sharply (both number of transactions and pricing).

• CONSUMPTION

Indian consumer segment comprises of a huge middle class, relatively large affluent class and a small economically disadvantaged class with spending anticipated to more than double by 2025. The move should benefit the organized retail and hamper the market for local counterfeit goods. The sales of consumer durables through online retail should pick up relatively. Given the need based demand and small purchase tickets, the impact on demand would be muted. Consumer durables sales is likely to be hampered over short-term,

especially sales through unorganized channels as cash purchases (-70-75% of the overall sales) take a hit. The adverse wealth effect will likely hurt higher end discretionary demand.

• HOSPITALITY AND TOURISM

There will be major gain for online forex marketplace companies like Book My Forex that have introduced online forex and have been promoting plastic hotels. Demand to be impacted due to slowdown in Domestic Travel. There will be temporary slowdown in Corporate travel due to cash crunch whereas Inbound demand will more likely to remain unaffected. The domestic leisure Travel will be severely impacted as majority of spending is in cash. Outbound travel through unorganized players will be impacted as foreign exchange usage abroad is mostly in cash.

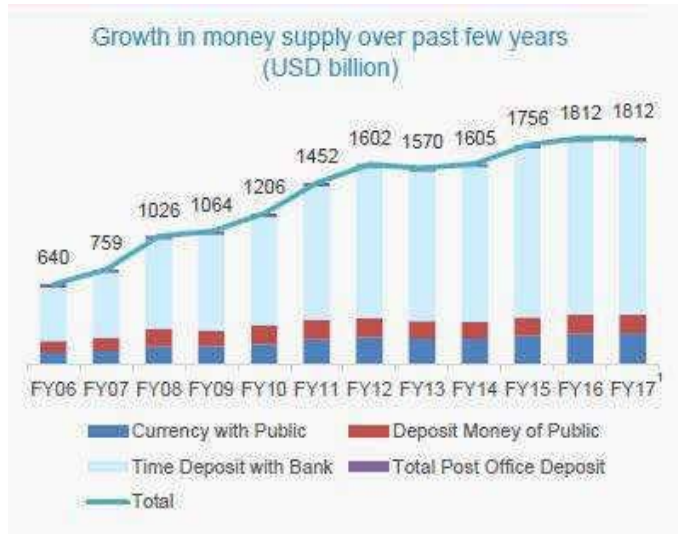
• INFRASTRUCTURE

To curb black economy in present situation is almost impossible since India does not have infrastructure enough to deal with it. Going towards cashless economy is best method to tackle black economy but since large numbers of Indians are actually employed in informal sectors or as contract labours in formal sector, cashless economy will only be a myth. It will require several years to tackle the black money situation in India. First important thing therefore would be to bring all Indians into formal economy and to provide them with fair wage, which is still a distant dream.

• BANKING

There will be adverse effect on banks' NPAs: NPAs or Non Performing Assets are loans that have run into default after 90 days. Right now market sentiments are such that customers are not going to banks for taking loans but are flocking in large number to make deposits. This may end up increasing burden over the banks which are already suffering with huge NPAs, since every deposit made with bank will attract interest on the sum which banks must pay. According to Asset Quality Review (AQR) Report by the RBI, in September 2015 the gross NPAs of the banking sector stood at 5.1% of total loans disbursed. This stands at 7.6% as on March 2016. The difference between bi-annual status shows that there has been an increase of 2.5% of total NPAs. The NPAs otherwise would have increased at the average rate of 0.3% if previous reports were to be analyzed. This is because in September 2014 it was at 4.5%, in March 2015 at 4.6% of the total loan disbursed. According to current market mood, no one is going in bank for taking loan but only to make deposits. Long lines in front of banks would only mean that stress to deposit will only multiply by several times and banks will not be able to make earnings by giving out loans. RBI's AQR estimates that NPA will further rise to 8.5% under ordinary circumstances by March, 2017. This may be hit by demonetization move and will further increase NPAs share by several percentage points. Liquidity in market is bound to be

heavily reduced due to deposit of high circulation notes in bank.

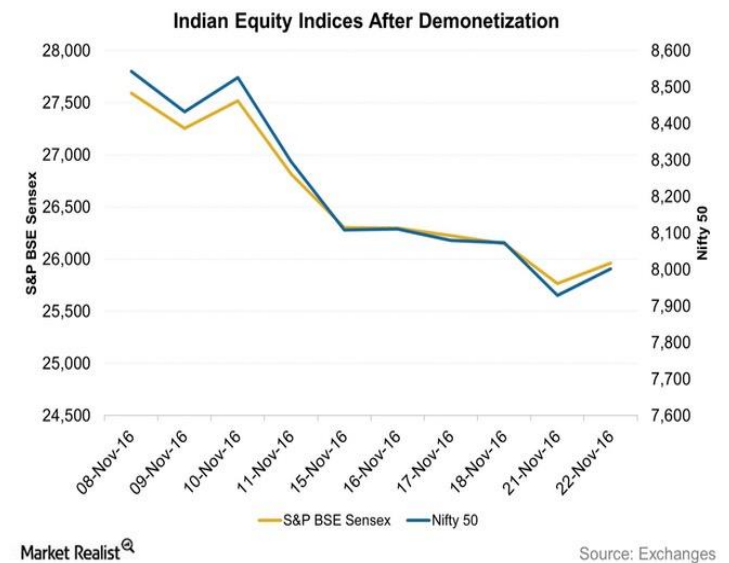


• **PRODUCTION**

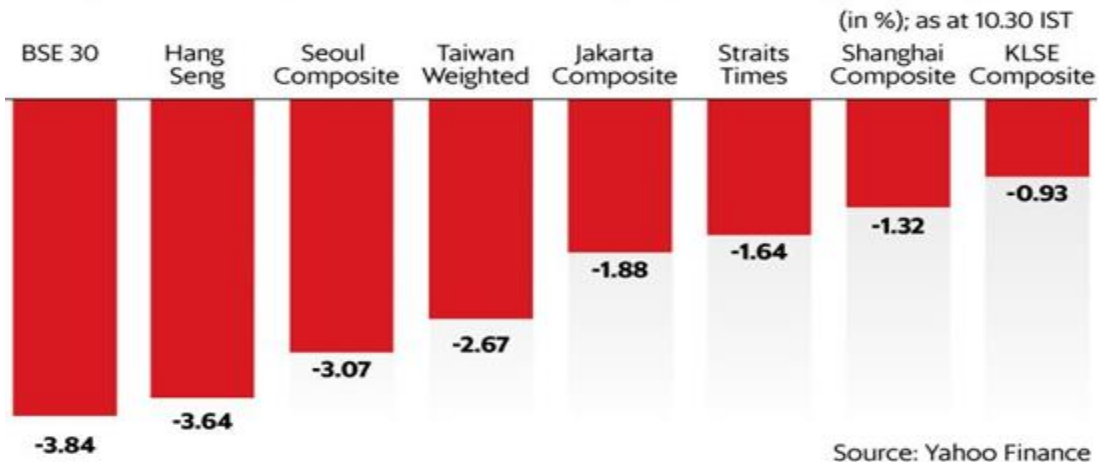
The timing would have not been much worse as this is the month when farmers start sowing Rabi crops. Due to demonetization, farmers are facing lot of difficulties in paying for labour charges. They could not purchase seeds and fertilizers conveniently, since most farmers have cash in form of high-denominated currency. Kharif produces too have gotten hit due to the buyers turning down in low numbers at Mandis and APMC delaying the process. Already farmers have been complaining about the mal-practices at the Mandis where they would receive price lower than MSP and now they are facing trouble of lower demand due to liquidity crunch.

• **STOCK MARKET**

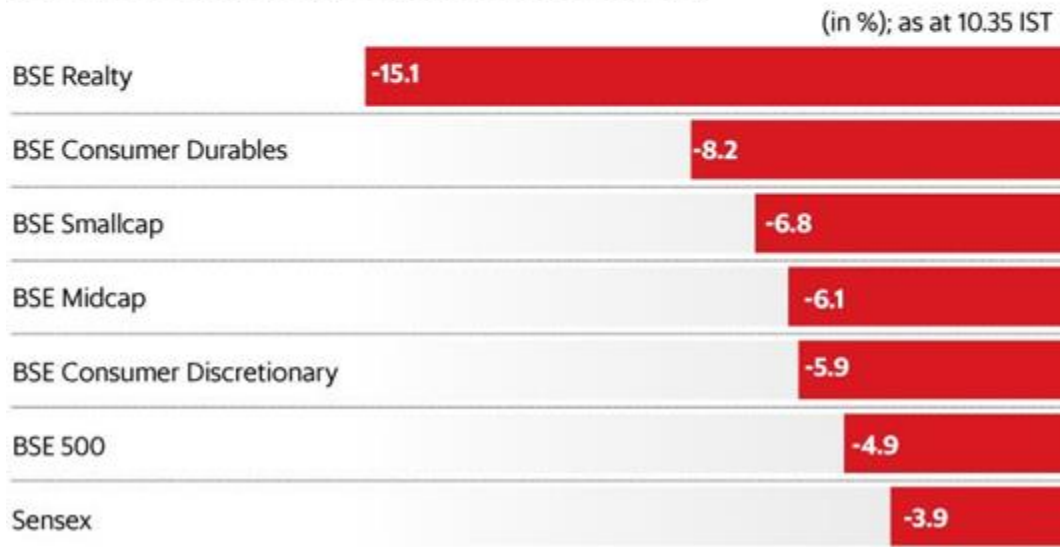
Indian equity markets have been on a near secular falling trend since the government demonetized the 500 rupee and 1,000 rupee currency notes after midnight on November 8, 2016. The two benchmark equity indices—the Nifty 50 and the S&P BSE Sensex—fell on each trading day since the demonetization except for November 10 and November 22. While the Nifty 50 fell 6.3% from November 8 until November 22, the S&P BSE Sensex fell 5.9% during the same period. Due to the rise in the US dollar, the dollar equivalents of the Sensex and the Nifty fell more than 8% each.



Indian shares have fallen slightly more than other Asian markets



The real impact of the demonetisation process is seen in mid-and small sized stocks and some sectoral indices



IV. THE EFFECT ON STOCK MARKET ON THE DAY OF ANNOUNCEMENT THE DEMONETIZATION

- *NBFC AND FINANCE*

The impact on Gold finance and micro finance positive in medium term. The near term disbursements are likely to get hit as high cash dealing however positive in medium to long term. Asset finance impact is negative as large chunk of cash based business of asset financing suffers a set back.

Auto finance impact is negative as 70% transactions are done in cash. Resale values likely to come down for vehicles. Asset quality issues to worsen.

- *MISCELLANEOUS*

ATMs need re-calibration: An ATM requires 4 hours of one man-power to be recalibrated. Hence one man will do an average of two ATMs a day. This will lower down the rate of ATMs disposal of new currency notes.

Impact on Real estate sector: Experts believe that in real estate dealings, it is only secondary market, those involved in resale, which will be affected as it is mostly cash driven. While Primary market, which involves big contractors and builders, will not be affected or less affected since they transact mostly on non-cash components. It is also pointed out

that in short to medium term the real-estate prices in luxury homes would come down since it involves major component of cash-based black economy.

The decision won't help much in pumping out un-accounted cash into formal economy: The ceiling of 2.5 lakh per household as an exemption allowed to avoid tax scrutiny is actually on the basis that IT is not applicable on annual income of 2.5 lacs for AY 15-16. The exception is Rs. 3 lacs in case of senior citizen. Thus govt. is ready to ignore this sum as black money and will consider it as an earning of housewife. But, considering a huge population of India, this amount is bound to run into trillions and will provide a safe passage to black money hoarders to retain back other allowed denominations (like 100s and 50s) and deposit 500 and 1000 notes to the total sum of 2.5 lakh in the bank and escape tax scrutiny. This is a huge fallacy. Think of a situation in which there is a joint family with two married brothers, two unmarried daughters who take tuition and a widow mother who is senior citizen. If all 5 women are assumed to be earning or saving, this means that one family can successfully legitimize their total of 13 lakh by depositing 500 and 1000 rupee denominated notes while still retaining the other denominations of 100s and 50s. This they can further do by also using drivers, servants and other relatives. Hence,

demonetization can actually become a route to legitimize their certain portion of black money, especially for rich families.

Parallel economy underway: IT, CBDT and customs departments are scrutinizing the huge transactions in gold done immediately after the demonetization was announced. According to one media report, a jeweller sold 201 kg of gold in just three days, leaving a minuscule balance in its coffers. In India, there are estimated 2.5 million jewellers and half a million goldsmiths. It is believed that these people have indulged in huge illicit transactions by converting the demonetized notes. According to several reports, in black market 10 gram of gold has been sold at price as high as 50,000/- as against the market price of 31,000/- at present. Though the govt. has required all jewellers to require pan card on sale made above 2 lacs, but authorities believe that jewellers involved in black marketing may reflect it in their balance sheet in part payment at below 2 lacs, avoiding PAN card requirement. Several money exchangers function across major cities in India, many even just behind the Main office building of RBI in Fort Road where they charge 10% to 15% of commission in exchanging and legitimizing the black money. These people have been exchanging the demonetized notes at such commission and helping escape the rich without hardships, though the modus operandi is still not known.

Supply shock in economy: Current market behaviour is 'low-denominated notes saving' driven. This seconded with huge demand for such low denominated notes has created a chaotic situation. Right now people have stopped doing purchases and are moving towards digital methods to make necessary payments while hoarding low-denominated currency notes. This will create more trouble for the economy due to drain of low-denominated notes. The RBI has been trying to cope up with the situation by re-infusing the soiled notes into the economy. These are mostly the poor people who queue up in front of the ATMs. All these people are panic stricken and they have commitment more towards savings. A person is visiting an ATM with 3-4 debit cards and most ATMs across the country are disbursing only 100 denominated notes. Since people are right now in savings mood, they will not willingly spend Rs. 100 denominated notes which in turn will drain economy of low denominated currency notes and eventually lead to all the stagflationary inflationary and deflationary conditions.

V. CONCLUSION

The demonetisation undertaken by the government is a large shock to the economy. This move is a vital step to curb the circulation of black money and counterfeit notes in the economy but in the near term this move will hurt economic activity across sectors irrespective of the extent of usage of cash. Risk aversion is likely to inch up manifold. Most sectors (except IT & Pharma) will face growth challenges, and in particular hurt discretionary spending, gold and real estate purchases. The discretionary consumption slowdown is likely

to impact non-oil non –gold imports. There is also a risk of the two-thousand rupee note again starting the vicious circle of black money at a much higher rate this time. Therefore, a digital infrastructure and its coordination with the Income tax department would help achieve the desired goal of the government.

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