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## DEMONETISATION IMPACT ON INDIAN ECONOMY: SHORT TERM

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### ABSTRACT

The argument posited in favour of demonetization is that the cash that would be extinguished would be “black money” and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy. Further, the impact of such a move would vary depending on the extent to which the government decides to remonetise. This paper elucidates the impact of such a move on the availability of credit, spending, level of activity and government finances. On 8th November 2016 night at 8.15 P M Prime Minister of India Mr. Narendra Modi in his unscheduled television address to the nation announced that the currency notes of ₹ 500 and ₹ 1000 denomination will not be a legal tender money from midnight. Government took this step of demonetising the currency as a tool to fight against black money and corruption in Indian Economy. The Reserve Bank of India (RBI) data suggests that the proportion of ₹ 500 and ₹ 1000 notes were 86.4% of total value of notes in circulation on March 31, 2016, amounting to ₹ 14 trillion.

**Keywords: Cashless transactions, credit, tax evasion, demonetization.**

### INTRODUCTION

On 8th November 2016 night at 8.15 P M Prime Minister of India Mr. Narendra Modi in his unscheduled television address to the nation announced that the currency notes of ₹ 500 and ₹ 1000 denomination will not be a legal tender money from midnight. Government took this step of demonetizing the currency as a tool to fight against black money and corruption in Indian Economy. The Reserve Bank of India (RBI) data suggests that the proportion of ₹ 500 and ₹ 1000 notes were 86.4% of total value of notes in circulation on March 31, 2016, amounting to ₹ 14 trillion. A lot of this money was also considered to be fake money pumped into the economy to fund terrorist activities. At the stroke of midnight of 8th November 2016, India lost 86.4% of its monetary base. In this single move, the Government has attempted to tackle all the three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing.

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. These ceased to be legal tender from the midnight of 8th of November 2016. People have been given upto December 30, 2016 to exchange the notes held by them.<sup>1</sup> The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat. The reasons offered for demonetisation are two-fold: one, to control counterfeit notes that

could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the “black economy”.

There are potentially two ways in which the pre-demonetization money supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange. The empirical extent of these two components will be unravelled only over the next six months. These two would have different effects on the economy in the short term and in the medium term, as will be explored below.

To understand the effects of these dimensions, it is important to first understand what is it that cash does in the economy? There are broadly four kinds of transactions in the economy: accounted transactions, unaccounted transactions, those that belong to the informal sector and illegal transactions. The first two categories relate to whether transactions and the corresponding incomes are reported for tax purposes or not. The third category would consist largely of agents who earn incomes below the exemption threshold and therefore do not have any tax liabilities. The uses that cash is put to for these various segments of the economy can be summarized in the form of Table 1. Finally, there would be demand for cash for illegal purposes like bribes in elections, spending over sanctioned limits, dealings in crime and corruption. If one takes a snapshot of the location of cash at any given point of time, it is difficult to predict what the breakup of the cash according to these categories would be, but it would be safe to say that each of these components would be represented in that snapshot.

### **Concepts of Demonetisation**

Demonetization is the process of removing currency from general usage or circulation. In India’s case Government completely withdrawn the currency with the denomination of ₹ 1000. Along with ₹ 1000 currency notes 500 rupee notes were also withdrawn from circulation. For the old 500 currency notes new 500 rupee notes will be issued and a new currency note of 2000 denomination has been introduced in the economy. New currency notes issued to the public through commercial banks and post offices across India by depositing the demonetized currency notes by the people.

### **Demonetization in India:**

This is not for the first time Government Demonetizing the currency. Earlier to this India has witnessed demonetization twice. For the first time demonetization took place in pre independence period. In January 1946, for the first time demonetization took place in India. During this demonetization currency notes of ₹ 1000 and ₹ 10000 rupees were withdrawn from the circulation and new currency notes of 1000, 5000 and 10000 denomination rupees were introduced in the year 1954. On 16th January 1978, Government of India Demonetized the currency notes of 1000, 500 and 10000 rupee notes as a means to counterfeit money and black money. The present demonetization is the third occurrence in Indian Economy and it is the second Demonetization in the post-independence period.

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### **Impact of Demonetization on Indian Economy**

Government of India demonetized the currency as a tool to fight against corruption and black money, which are the major problems of Indian economy. The present demonetization will be having some effects on Indian economy. Some of the major effects of demonetization is as follows.

One of the major objectives of the demonetization is to fight against the black money. With the demonetization the black money within the economy will be blocked as the owners of the black money in the form of 500 and 1000 rupee notes cannot replace it and deposit it in the banks as it is not having the proper documents. In this way the parallel economy will be affected to a greater extent which is the positive impact of demonetization.

The study aims to understand the impacts of demonetization on the small and marginal traders and the change that has arisen in their daily business and innovative ideas that they have undertaken to overcome this problem.

### **Short-term and medium-term impacts**

#### **Very short-term impact**

The demonetization, by removing 86 per cent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy. This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash.

In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing. For instance, transport services, *kirana*, fruits and vegetables and all other perishables, would face compression in demand which is backed by purchasing power. This in turn can have two effects: while it is expected that supply exceeds demand, there would be a fall in prices, however, if supply too gets curtailed for want of a medium of exchange, prices might, in fact, rise. Thus, while generally people seem to expect prices to fall, it is quite possible that prices would instead rise.

Alternatively, to keep the flows going, people might take recourse to credit - both the retailers and other agents in the economy might make supplies on credit in the hope that when the liquidity status is corrected, the payments can be realised. In these cases, the price of commodities might rise instead of falling. In other words, the impact of an incremental reduction in money supply where the demand and the supply chain remain unaffected would be different from a case where there is a drastic reduction in money supply and outputs might adjust rather than the adjustment being in prices. In other words, the expectation that inflation would decline might be belied.

A further impact would be a compression of the demand for non-essentials by all the agents in the economy in the face of uncertainty in the availability of cash. The demand from segments which have access to digital medium of exchange would remain unaffected, but that from the rest of the economy would get compressed. This would transmit the effect to the rest of the sectors in the economy as well.

Another sector where one expects to see effects in the very short run is the real estate space. With contraction in demand from one set of agents – say agents who have earned unaccounted incomes and placed them within the real estate space – either prices within this segment would fall or transactions would cease to happen. While of itself, this would be considered a positive development and evidence of a correction in the unaccounted incomes, it could lead to a compression in investments in the construction sector which can have adverse income and employment consequences for the economy.

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**Short Run Effect on Money Supply**

Money supply will be reduced in the market due to withdrawal of currency notes from circulation. This effect will be the short run impact of demonetization. The problem of money supply will be solved when the new currency notes widely circulated in the market.

**Effect on Consumption:**

Decrease in money supply as a result of demonetization is also having an impact on production and consumption. Due to decrease in money supply production decreases and it affect the consumption negatively.

**Fall in the Prices**

Prices for different goods will fall with demonetization of currency. The prices of consumer goods and the prices of real estate sector are expected to fall.

**Increase in Bank Deposits**

The demonetization increases the deposits in current account and savings bank account. As government announced the demonetization, the money held by the household sector for the emergency purposes will be deposited with the banks, which will increase the deposits in the banks.

**Increase in Alternative Modes of Transactions**

Due to demonetization the cash transactions are facing a reduction, which increases the other alternative modes of transactions like use of credit cards, debit cards online payments and transactions etc.

**GDP will Decrease in the Short Run**

GDP will be hurt due to the demonetization. GDP of India may fall as a result of demonetisation. The extent of fall may be very less and it exists only for a short duration of time. This fall may not affect the growth of the economy.

**Effect on Anti-Social Activities**

Demonetization is a mighty blow on the anti-social activities. Due to the demonetization funding of anti-social activities, smuggling can be curbed. These anti-social activities weaken the economy. It is difficult to the anti-social activists to recover from this. So the anti-social activities can be curbed to a greater extent.

**Effect on Other Units of the Economy**

Demonetization will have short run impact on agriculture, small traders, small vendors etc. as agriculturists are dealing with the perishable commodity, not having other mode of payment other than cash transactions and lack of demand will affect the farmers negatively. The same kind of situations faced by the small traders and small vendors. This also a short run effect of demonetization. These are some of the major impact of demonetizations on Indian economy

There are likely to be two spin-offs from this change – one, there would be some increase in tax collections in the short term, and second; various IOUs could emerge as currency substitutes. To the extent people attempt to get rid of unaccounted cash balances through purchase of goods and services and/or payment of property taxes, one should witness a spurt in tax collections in indirect taxes as well as property tax in the month after demonetization which would disappear thereafter. There is evidence already that property tax collections in some cities are higher than last year. Similarly, in the case of currency substitutes, at MCD tax collection centers at the border, people are being given IOUs in lieu of the balance they were entitled to, which would be valid for six months.

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**Short-term effect with complete replacement:**

The short-term effect on the economy would depend on the speed with which and the extent to which the cash is replaced by the authorities. If the entire cash is replaced within a short duration of time, the effects beyond the very short term of 1-2 months might be little. But a few sectors are likely to be seriously affected. To give an example from two sectors which are supposed to have large employment effect on the economy, we can talk about agriculture, automobiles and construction.

This is the sowing season for the Rabi crop in some parts of the country and the harvesting season for the Kharif crop. Most of the purchases and sales in this segment of the economy are carried out through cash. With the elimination of cash from the economy, sale of kharif crop would be difficult unless the crop is sold on the promise of payment in future. Given the limited bargaining power of the farmer, the price they can realize for the crop can be adversely affected. On the other hand, in the sowing activity, people would not get access to the inputs required since most of the inputs are now purchased from the market unless they seek access to credit from the supplier.

In other words, with demonetization, there would be a significant strengthening of the informal sector credit market in the rural economy. Further, if there are agents who do not get access to credit from the informal sector agents, their sowing activity and hence their incomes in the next season would be adversely affected. Thus, in spite of a good monsoon in large parts of the country, the farmer might not get the benefits.

The second sector which could be adversely affected would be the construction sector. The sector, it is often argued, works with a significant amount of cash. Payments to workers as well as a variety of purchases might be carried out in cash. So, on the supply side, this sector can be adversely affected. On the other hand, on the demand side, the demand for houses and buildings would appear as a demand for non-essentials and might be pushed on to the back burner until the economic situation normalises. Thus, to the extent there are agents in the economy whose demand was backed by savings from unaccounted incomes held in the form of cash which got extinguished on demonetization, there would be a compression of demand.

**Short-term effect with incomplete replacement:**

If, on the other hand, the authorities choose to replace only a fraction of the total cash that was surrendered by the people to the banking sector, then one would witness some other changes/effects in the economy. For transactions to be restored to the pre-change level, a number of agents who are using cash as a medium of exchange have to move to using digital versions of money as the medium of exchange. While this change is gradually happening in the economy, if it is forced by making cash inaccessible, the compression in demand as well as in income generation in the economy would continue for a longer period until people get familiar with the functioning and use of these media.

**Medium-term effects:**

In the medium term, the effects would be related to the extent to which the currency is not replaced within the economy. If the entire currency is replaced, there would not be any major effects on the economy. However, it is to be expected that the entire currency would not be replaced – to the extent currency is extinguished and to the extent some of the currency remains as bank deposits, there would be some impact on the economy. The first effect would be a compression of the economy to the extent the extinguished currency was working as a medium of exchange.

The currency that is placed in the banks but not withdrawn, it is argued, would generate an expansion in deposits in the economy. In the discussions on demonetization, there is a consistent reference to the resultant increase in credit creation in the economy. Like Finance Minister Arun Jaitley says, “Bank deposits will increase and they will have more capacity to support the economy.”<sup>4</sup> The total cumulative

credit that can potentially be generated is defined in terms of the reserve ratio. Total credit potential = incremental deposit generated.

In India, the cash reserve ratio is 4 per cent while there is a statutory liquidity ratio of 22 per cent. In determining the credit creation, it is important to take into account only the CRR and the additional credit creation can be 25 times the amount of money deposited in the banks as a result of the proposed demonetisation. This amount however, will be generated only if there exists an equivalent demand for credit in the economy.

### **Transition Issues**

There are a number of transition issues that need to be managed for this transition to be effective:

1. **Infrastructure Issues:**
2. **Consumer behavior Issues:**
3. **Accessibility in language:**
4. **Transition issues for banking sector**
4. **Mode of payment and spending behavior**

There is growing literature that points out to the possibility of changes in spending behaviour as a result of moving to instruments other than cash. There are many substitutes for cash in the modern economy ranging from cheques, debit cards, pre-paid cards, credit cards and mobile wallets. When compared to cash, these instruments differ in a number of key characteristics. Temporal separation or degree of coupling is the extent to which a purchase and the payment for the transaction from resources are separated in time. If the two are de-coupled, people may not perceive a sense of separation from money at the time of incurring the expenditure and hence may overspend.

The second characteristic is related to the pain of payment flowing from salience. It is argued that people perceive the pain of payment depending on the tangibility or salience of the outflow. A third feature is the stringency of budget constraint – while cash limits one's ability to spend to the amount of cash in hand, a debit card expands it to the balances available in the account and a credit card further relaxes it to include future earnings as well.

### **Impact on Macro Variables**

Apart from the transition issues faced by banks, in judging the impact on the economy, it is important to differentiate between the two changes that the demonetization can bring about in money supply. The first change, i.e., cash being extinguished, to the extent it was being used as medium of exchange, would result in a compression in incomes, employment and consumption in the economy. On the other hand, the effect of the second change, i.e., cash being only partially replaced in the system would have the opposite effects of expansion in potential credit creation. The potential credit creation would translate into actual credit creation provided there is sufficient demand for credit. If the demand for credit in the economy is large enough, the potential credit can be realised. Of the credit created, other things remaining the same, it can be expected that at least a part of the credit, will be for productive purposes. This would mean expansion in investment in the economy and subsequently an increase in GDP and employment.

### **CONCLUSIONS**

Demonetization in Indian economy is having negative impact on the different sectors of the economy. Majority of the negative effects are short run effects. All these effects are solved when the new currency notes are widely circulated in the economy. On the other hand people are facing some problems in the

exchange of currency notes. Even though people are facing such a problem people are ready to bear these problems for its positive effect on the economy. If government successfully clears all the problems, drawbacks associated with the demonetization, this demonetization will become the successful economic revolution in India and we can expect a better tomorrow with corruption free India. Consumer footfall in the markets is very low businessmen are sitting idle. Small and rural retailers, who generally visit wholesale markets for procurement of goods, couldn't do so for want of sufficient funds of acceptable denomination. The all-new 2000 is creating more scare among small businessmen because they do not know where to get the change for the same. Small and marginal business owners narrated tales of cash lessens that has drastically reduced their business. All said that there were fewer buyers and those who come to purchase also carry the newly-minted Rs 2000 currency notes. "Some people buy items for Rs 100 and give Rs 2000. We have to return Rs 1900. This consumes a large number of small value currencies, which are already in short supply," at this rate shopkeepers were able to sell goods to only a few. The government has asked people to encourage paying through cards or e-wallets. But given the poor penetration of such facilities, it is not possible for everyone to get used to cashless transactions; generally people are frightened of their money disappearing from their account. With huge cybercrimes people have read about people losing their money in cyber hacks and banks and the Government not helping them in any way thus the mistrust. As far as e-wallets go most of them are operated by non-banks and people feel that they may run away with their money. People are not per say against demonetization they are happy that the Government has woken up to the corruption in the country and somebody has the guts to tackle it, but the problem is about non availability of cash in smaller denominations in the economy. The economy was not readied fully for being cash less society. People who operate on small margins and scales are hit the most.

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