



A STUDY OF DEMONETIZATION AND ITS IMPACTS PULLS DOWN INDIAN GDP

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Abstract

Demonetization refers to the withdrawal of a particular form of currency from circulation. Demonetization is required whenever there is a change of national currency. The old currency units must be removed and replaced with a new unit of currency. The currency was demonetised premiered in 1946 and the second time in 1978. November 2016 currency is demonetised third time since Government of ways present. This is the bold step taken by the Government for the improvement of the economy and of the country. In this article I will discuss the impact of the recent demonetization the Indian system. Was performed the demonetization is leading to a riot as the situation in the country. We demand that the Government guarantee that ordinary people have instant access to enough money to pay for their daily needs and health emergencies. Failing that, we roll back the demonetization or pausing demonetization to enable the everyday person to take appropriate measures for daily needs and a more orderly phasing out old notes. The Government's role is to undertake internal revenue service honest and not to treat the ordinary person as a criminal by making him/her stand in line and filling forms to access its own legitimate money.

Keywords: *Demonetization, Black Money, Counterfeit Currency, Corruption GDP.*

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 Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it.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 denomination¹. 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 Process of removing a currency from general usage, or circulation is known as demonetization. For example, 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. To check undisclosed black money, corruption and fake currency the Government of India on the 8 November 2016 announced demonetization of high denomination currency notes Rs 500 and Rs1000. A new redesigned series of Rs 500 and Rs 2000 banknote is in circulation since 10 November 2016. With demonetization effort 86% of India's currency was nullified that aimed to wash the stock of 'black market's cash supply' and counterfeit notes out of the economy and convert it into the licit, banked and taxable, part of the economy. To reduce the impact of sudden commercial collapse, a 50 day period ensued where the population could (ideally) exchange their canceled cash for newly designed 500 and 2,000 rupee notes or deposit them into bank accounts. Irrespective of the widespread anguish and household disturbances, an optimistic sentiment shown in favour of the decision. Cash is the preferred mode of transaction in India and only less than half the population uses banking system for monetary transactions. An immediate public anger appeared against the mismanaged and unprepared banking system. The banks didn't have enough of the newly designed banknotes (Rs 500 and Rs 2000) to distribute in exchange for the cancelled notes. The move has also led to a shortage of lower denomination notes such as Rs 100 and Rs 50 that are still legal tender, as people have taken to conserving whatever cash they have in hand². The demonization initiative has caused a sudden breakdown in India's commerce and the unbanked and informal economy is hard hit. Trade across all aspects of the economy has interrupted, and sectors like agriculture, fishing, and the huge informal market were almost shut down during the initial days of announcement. The informal sector in India employs more than a majority of the workers and most transactions are in cash. Disruption to this system could endanger the employment and livelihood of weaker sections of society. The change disturbed the lives of ordinary people, led to widespread need and major job losses for the poor.



Nevertheless, although India's demonetization move was apparently mismanaged in the beginning, the effects at micro level look advantageous. For instance, all sorts of illegal activities, like terrorist financing, etc. have been completely hit after the announcement. The demonetization process has also repaired India's counterfeiting problem for the near to mid-term. The cash-centric black market for the most part ceased to function with the nullification of the bulk of its currency. It has also been reported that the new 500 and 2,000 rupee notes are less vulnerable to counterfeiting, having advanced security features. It is also thought that the drive will wipe out a measure of corruption and tax evasion in India's real estate market. Growth in cash-intensive sectors such as real estate, construction and FMCG is likely to take a hit in the short term as consumers are deferring purchases. The real-estate market is likely to come to a standstill with property prices likely to fall and the possible tax inquiries following demonetization will affect both consumption and investment in the formal and informal sectors. However, there is a positive side to the story, over the medium term, there would be benefits through higher government spending and greater financial inclusion. Also, the movement of household savings from physical to financial will help boost growth, according to Yes Bank BSE 0.90 % report. With exchange of the old currency notes coming to an end, many people are forced to open accounts to save their money³. It is estimated that banks have opened about 30 lakh (and still counting) new accounts since the demonetization drive began on November 8. India's largest bank, State Bank of India (SBI), with its 17,097 branches -- half of which are in the rural and semi-urban areas -- is opening 50,000 accounts a day. The leading consumer internet companies in India (Flipkart, Snapdeal, Shopclues, CCAvenues, Ola and Oyo Rooms) have applauded the move, saying it will pave the way for digital payments, aid the process of financial inclusion and the overall transformation in the economy will translate into long-term benefits for the industry. Payments companies Paytm and Free charge saw a surge in adoption of their digital wallets. According to market experts, the growth of digital payments and wallets is the first phase of the impact and will give big boost to lending and credit as the digital records of merchants will expand and create more demand in the second phase. Even though demonetization move created adverse short-term policy impact the real impact of must be assessed in the medium/long term. The reduction in overall investments, both in the formal and informal sectors, would certainly reduce economic growth potential. However, the move need to be followed up with ensuing actions to remain effective. These actions relate primarily to structural changes to make the system more lawful, reducing too much bureaucracy, make the tax system simple and transparent.

Objectives of the Study: The main objective of this paper is to study the impact of demonetization on 8th Nov. 2016 by the present government on Indian economy and system.

Research Methodology: The paper is based on the secondary data. The secondary data was collected from various published sources like reports, magazines, journals, newspapers and the like etc.

History and background

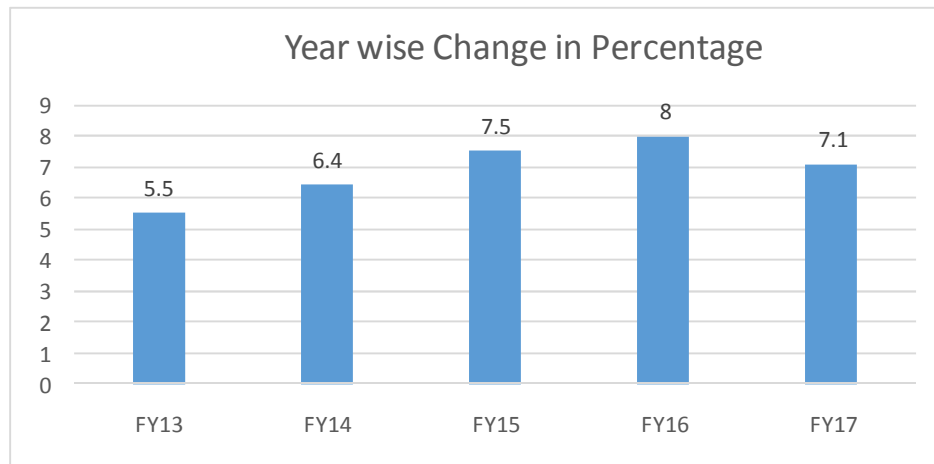
The sudden move to demonetize Rs 500 and Rs 1,000 currency notes is not new. Rs 1,000 and higher denomination notes were first demonetized in January 1946 and again in 1978. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data. Rs 1,000 and Rs 10,000 bank notes were in circulation prior to January 1946. Higher denomination banknotes of Rs 1,000, Rs 5,000 and Rs 10,000 were reintroduced in 1954 and all of them were demonetized in January 1978. The Rs 1,000 note made a comeback in November 2000. Rs 500 note came into circulation in October 1987. The move was then justified as attempt to contain the volume of banknotes in circulation due to inflation. However, this is the first time that Rs 2,000 currency note is being introduced. While announcing currently circulated Rs 500 and Rs 1,000 notes as invalid from midnight 8 Nov, Prime Minister Narendra Modi said new Rs 500 note and a Rs. 2,000 denomination banknote will be introduced from November 10. Bank notes in Ashoka Pillar watermark series in Rs 10 denomination were issued between 1967 and 1992, Rs 20 in 1972 and 1975, Rs 50 in 1975 and 1981 and Rs 100 between 1967-1979. The banknotes issued during this period contained the symbols representing science and technology, progress and orientation to Indian art forms. In the year 1980, the legend Satyameva Jayate— 'truth alone shall prevail' was incorporated under the national emblem for the first time. In October 1987, Rs 500 banknote was introduced with the portrait of Mahatma Gandhi and Ashoka Pillar watermark. Mahatma Gandhi (MG) series banknotes 1996 were issued in the denominations of Rs 5, (introduced in November 2001), Rs 10 (June 1996), Rs 20 (August 2001), Rs 50 (March 1997), Rs 100 (June 1996), Rs 500 (October 1997) and Rs 1,000 (November 2000)⁴. The Mahatma Gandhi Series – 2005 bank notes were issued in the denomination of Rs 10, Rs 20, Rs 50, Rs 100, Rs 500 and Rs 1,000 and contained some additional/new security features as compared to the 1996 MG series. The Rs 50 and Rs 100 banknotes were issued in August 2005, followed by Rs 500 and Rs 1,000 denominations in October 2005 and Rs 10 and Rs 20 in April 2006 and August 2006, respectively.



Impact of Demonetization

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.

India's GDP growth in 2016-17 came in at 7.1%,



Gross domestic product (GDP) growth slowed to 6.1% in the fiscal fourth quarter from 7% in the third, according to data released by the government. The slowdown may put pressure on the Reserve Bank of India, whose monetary policy committee meets next week, to cut policy rates to balance its inflation-targeting focus with the need to stimulate economic growth⁵.

Year Wise Change %	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
GAV at Basic Price	7.6	6.8	6.7	5.6
Private Consumption	8.4	9.7	11.0	7.3
Investment Demand	7.4	3.0	1.7	-2.1
Agriculture	2.5	4.1	6.9	5.2
Industry	7.4	5.9	6.2	3.1
Services	9.0	7.8	6.9	7.2

Source: Central Statistics Office

Real gross value added (GVA), another measure of economic activity that is arrived at by excluding net indirect taxes from GDP, slowed to a growth pace of 5.6% in the March quarter, also the fourth consecutive quarterly decline. The Central Statistics Office maintained its earlier full-year growth estimate for 2016-17 at 7.1% on top of revised 8% growth in the previous financial year. The growth numbers reflected the lingering effects in the March quarter of the government's demonetisation of high-value banknotes with effect from 9 November, which triggered a cash crunch and disrupted business, especially in the unorganized sector. The labour-intensive construction sector contracted as a result of the cash shortage and regulatory changes, and financial services grew at an anaemic single-digit pace.

Fiscal fourth-quarter growth in the \$2.3 trillion Indian economy, the third largest in Asia, trailed the 6.9% pace at which China grew in January-March, putting it at the risk of losing its status as the world's fastest expanding major economy. India's per capita income in real terms in 2016-17 also slowed to a growth pace of 5.7% to Rs82,296 (\$1,276) against 6.8% growth last year. Chief economic adviser Arvind Subramanian said the fourth quarter numbers had been expected to reflect the biggest impact of demonetisation. "We can see some signs of bottoming out on account of the remonetisation, and recovery in the nominal aggregates which picked up in the fourth quarter. The construction sector shrank 3.7% in the March quarter, compared with a 3.4% growth in the preceding quarter. The announcement that a real estate regulator will be appointed to ensure higher accountability in the sector may have also contributed to the slowdown. Mining picked up to grow 6.4% and so did public expenditure, rising 17%. Agriculture output growth slowed but stayed robust at 5.2% and financial services grew by just 2.2%. The manufacturing sector (5.3%) as well as trade, hotels and transportation (6.5%) also slowed from their levels in the preceding quarter. Excluding agriculture and public expenditure, core GVA grew 3.8% in the fourth



quarter, revealing the deeper impact of demonetisation and suggesting that economic activity would have been much slower without a substantial push in public expenditure. Growth in gross fixed capital formation, which is a proxy for investment demand in the economy, slowed sharply in FY17 to 2.4% from 6.5% a year ago. Private final consumption grew 8.7% in FY17 against 6.1% a year ago. The statistics department also revised GDP data since 2012-13, incorporating the new wholesale price index and index of industrial production series which showed the economy grew marginally faster in 2014-15 and 2015-16 than earlier thought. Credit rating agency Moody's Investors Service on Wednesday projected India's economy to accelerate to grow at 7.5% in 2017-18 and 7.7% in 2018-19 as the government has been able to limit the negative impact of last year's demonetisation on the economy. The World Bank also expects the Indian economy to grow at 7.2% in FY18 and gradually gather pace to touch 7.7% by FY20, a year later than Moody's projection⁶.

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.

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.

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 income⁷. Such a nationwide awareness and urge will encourage government to come out with even strong measures.

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 immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

Black Money and Corruption: By demonetization, Black money will be taken out of Indian system. As predicted by ICICI Securities Primary Dealership the government's plan to remove INR 500 and INR 1,000 notes from circulation will disclose up to INR 4.6 lakh crore in black money⁸. Corruption will also be automatically reduced by removing black money from economy.

Funding: Funding for smuggling and terrorism will take a blow since all the money will get back to bank and from there it is easy to identify the fake currency. Demonetization thus affects the funding of terror networks in Jammu and Kashmir, North-eastern states and the other areas.

Real estate: Another impact of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable. In the short term, prices of real estate would come down for the same reason above. There will be fewer suitcases moving.

Elections: Demonetization has shocked political parties. Many states like Punjab and Uttar Pradesh, cash donations are a huge part of "election management". Political parties will find themselves helpless as cash hoards are often undeclared money. So upcoming elections 2017 will be transparent to the some extent.



Gold/Silver and Jewellery: After demonetization the demand for gold and other precious metals rise greatly. Because people are trying to invest their black money in gold to make it white in short period. But demand for gems and jewellery to decline in the next two to three quarters.

Digital payments: People adopting online payments system such as Paytm etc. after ban for high denomination currency in India. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increases in demand. This behavioural change could be a game changer for India in the near future.

Fake Currency: The impact on the fake currency would be more significant. Many dealers with the existing counterfeit notes would be trapped as they would have to take the notes to the bank and have better chances of getting their racket exposed. Thus, they have only option to destroy their notes and incur losses.

GDP: The sudden decline in money supply and increase in bank deposits is going to adversely impact consumption demand in the economy in the short term. This, coupled with the adverse impact on real estate and informal sectors may lead to lowering of GDP growth.

Markets: There will be positive move in markets in long run that could bring confidence of overseas investors in Indian stock markets. Market goes a bit down in the short and medium term. India is still a very attractive destination on a long-term basis. It is not the best market in the next three months⁹.

Conclusion

So far, it can be said that this is a historical step by the ModiGovt. and should be supported by all. This decision of govt. will definitely fetch results in the long term. From an equity market perspective, this move would be positive for sectors like Banking and Infrastructure in the medium to long term. This could be negative for sectors like Consumer Durables, Luxury items, Gems and Jewellery, Real Estate and allied sectors, in the near to medium term. This move can lead to improved tax compliance, better fiscal balance, lower inflation, lower corruption, complete elimination of fake currency and another stepping stone for sustained economic growth in the longer term. While it has been argued 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, this argument is based on impressions rather than on facts. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity. It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. If a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods than deposits based on savings.

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