



Demonetization and its impact on Indian economy

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Abstract

On 8th November 2016 the entire nation was taken by surprise when the Prime Minister Sri Narendra Modi announced that on the stroke of midnight all 500 and 1000 banknotes would cease to be legal tender in India. In one go around 86 percent of the currency in circulation amounting to Rs. 14.18 lakh crore of money became just a piece of paper having no purchasing power. The aftermath of the decision of demonetization was that there was rush and long queues outside the banks, people trying to exchange old denomination notes for new and that too to a maximum limit of Rs. 4000 only at a time. At same time ATMs ran out of cash. People were left with almost with no cash to spend and all over a panic wave could be witnessed.

The objective demonetizing high denomination notes was on one hand to curb the black money, control corruption and cut the supply base of terrorist activities. On the other hand the motive of this decision was to cleanse the economy of all illegal and unaccounted transactions and to promote digital transactions so that all transactions made by the people are monitored effectively thereby minimizing the chances of tax evasion putting a big dent to parallel economy.

In this background the paper tries to analyze the reasons for withdrawal of 500 and 1000 denominated notes from circulation and its impact on economy post demonetization. The paper is based on secondary source of information collected from various websites, research articles, magazines and newspapers.

Keywords: demonetization, black money, digital transactions, parallel economy

1. Introduction

Demonetization simply means change of national currency from old to new, implying that the old unit of currency is replaced with new currency. When the government of any country announces demonetization of certain or all denominations of currency then the in circulation currency loses its legal status from a certain given date and time. The basic purpose of this demonetization act is to control inflation, black money, corruption and to control terrorism activities faced by the country concerned.

To India demonetization is not new, the currency has been demonetized two times earlier as well. The first was on 12th January 1946 when notes of denominations Rs.1000 and 10000 rupees were withdrawn from circulation and new currency notes of Rs.1000, Rs.5000 and Rs.10000 were introduced in 1954. On 16th January 1978 Janta Party

coalition government again demonetized banknotes of denominations Rs.1000, Rs.5000 and Rs.10000 to curb counterfeit currency and black money. In both these demonetizations the Indian economy was not so vibrant, because very few people have access to these high denomination notes, and was not popular to common man.

However the present demonetization announced on 8th November, 2016 had widespread repercussions because Rs.500 and Rs.1000 notes being very widely circulated denominations.

With the current demonetization the entire scenario related to currency in circulation changed drastically as the economy was left only with 14 percent legal tender money thus squeezing the cash available in the hands of people to be utilized for transactions.

Table 1: Status of Currency in Circulation – Post Demonetization

Money in Circulation	17.77 lakh crore			
Money Becoming Invalid (86percent of Legal Money)		14.18 lakh crore	7.85 lakh crore (Rs 500/- Note)	6.33 lakh crore (Rs 1000/- Note)
Currency Back with Banks (97percent of Invalid Currency)		13.75 lakh crore		
Govt Expectations (Failed)			3 lakh crore will not come back to banks	
JD Accounts Deposit before Demonetization	45636 crore			
JD Accounts Deposit after Demonetization (January 2017)	87000 Crore			

Source: Compiled from various government websites

The above table reveals that total money in circulation as on 8th November 2016 prior to announcement of demonetization

was to the tune of Rs.17.77 lakh crore. The decision of demonetizing Rs.500 and Rs.1000 currency notes resulted in

withdrawing the legal status of Rs.14.18 lakh crore consisting of 7.85 lakh crore of Rs.500 denomination currency notes and Rs.6.33 lakh crore of Rs.1000 denominations. As such only 14 percent currency notes of small denominations were left in the economic system for performing monetary transactions in cash terms. The act of demonetization resulted in flushing out of undeclared and hidden black money back into the banking channels and as on 28th December 2016 almost 97 percent i.e. 13.75 lakh crore of demonetized currency had been deposited with banks.

As regards amount deposited with Jan Dhan Accounts is concerned there were deposits to the value of Rs.45636 crore in 19.88 crore active accounts on the date of announcement of demonetization which swelled to Rs.87000 crore as on January 2017. This shows that the money has been brought back to the white stream.

2. Review of Literature

K. Veerakumar (2017) ^[6] in his paper titled “A study on people impact on Demonetization”, tried to find out the impact of demonetization on general public in Coimbatore district. For this the researcher did the survey on 100 respondents and came up with that variables like gender, age, annual income, and occupation have significant association with the impact of demonetization. The result of survey was that demonetization helps to destroy black money was the first ranking given by respondents followed by control on corruption and terror activities.

Sandeep Kaur (2016) ^[2] published in his paper titled “Demonetization and Its Impacts in India”, elaborated the effect of demonetization on black money and corruption, funding of terrorism and smuggling activities, real estate funding, promotion of digital payments, attack on fake currency, control on inflation to name a few.

Vedashree Mali (2016) ^[3] in her paper titled “Demonetization: A step towards modified India”, focused on the reasons for demonetization decision and its impact on various sectors of the economy with special reference to its impact on Micro Businesses, E-Wallet businesses, online retail stores and others.

3. Objective of the Study

- To understand the concept of demonetization
- To understand the objectives of demonetization
- To study the impact of demonetization

4. Objectives of Demonetization

4.1 Crackdown on Black Money

The prime objective of demonetization was to destroy the black money which was running the parallel economy and resulted in huge loss to the government in the form of evasion of tax revenue. This decision was made to curb the black money chain by making hoarders of black money to suffer loss when the unaccounted cash becomes a paper piece. The government was of the view that by withdrawing high value notes around 4 lakh crore worth of cash i.e. almost 12 percent held in black money and fake currency will become worthless. This could not happen as by December 2016 almost all the currency which lost its legal status due to demonetization has returned back to banking system. Nearly 97 percent of the outlawed

Rs.500 and Rs.1000 notes has been deposited with banks as on December 30, according to Bloomberg news service. Thus the entire exercise seems to be futile which gives an impression that either there existed, no black money in the form of cash in the system and most of it has been converted in real estate or gold. The other remedy that the tax evaders might have put all their black money deposited back in banks through several bank accounts or through benami accounts of relatives and poor people having Jan Dhan accounts. These ways adopted by the black money holders are very much exposed and government is talking tough on these issues through conduct of raids and sealing of benami accounts. However the positive is that this demonetization exercise has resulted in generation of huge deposits with banks. Now, with government acting tough and imposing limits on cash transactions, with possibilities to further squeeze cash transactions in future time to come, more recorded transactions can be promoted which will certainly put effective brakes on generation of black money.

4.2 Control on Terrorist Activities and Hawala Operations

Internal Maoist disturbances and cross border Pakistan fuelled terrorist attack in Srinagar followed by hawala funding was hurting most the Indian Government. It was expected that the demonetization of high value currency will cut the funding for these disturbing activities based on counterfeit currency supply and hawala funds. Within the 50 days of demonetization there has been drop in hawala transactions and with funds drying up terrorism-related violence in J&K dipped by 60 percent post the cash ban, with only one major blast reported from the valley in December. The impact of the government's decision is even more pronounced in areas hit by Left-wing extremism. According to intelligence estimates, over Rs.90 lakh has been seized from Maoist cadres/supporters since demonetization kicked in on November 9. Demonetization has also made around 700 Maoist cadres to surrender. However, of late since March 2017 the separatist activities and pelting of stones on army have once again started which needs to be tackled firmly else the positive impact of the demonetization drive in controlling terrorism will be lost.

4.3 Cleansing Real Estate

It is a common assumption that real estate runs on black money i.e. people park their unaccounted money by investing in real estate and property. The objective of demonetization was to check this practice and to promote fair prices for this sector back from the highly inflated one. Post demonetization, there has been crunch of cash in the economy as almost all the unaccounted cash is back with the banks, thus the general practice of paying 20-30 percent of the value in black money (cash) can no more be exercised. This impacted the demand for property as well and developers have been witnessing a drop of around 50 percent in their sales and are estimated to have incurred a revenue loss of Rs.22600 crore because of the cash ban as predicted by property consultant Knight Frank India. Even the genuine buyers are not coming forward to purchase hoping that the interest rates are going to fall further and are viewing cleansing of this sector further which has been infested with illicit funds. The buyers are thus enjoying

demonetization decision as far as purchase of property is concerned.

4.4 Combating Counterfeit Currency

The Financial Action Task Force (FATF) report 2013 Indian rupee was the ninth most counterfeited currency in terms of its value and stood third in terms of the number of FICN detected around the world. In India, the circulation of fake Indian currency notes (FICN) has been on the rise, according to the Reserve Bank of India's (RBI) annual reports. The year 2014-2015 saw a steep rise, with 5,94,446 FICN detected, up from 4,88,273 in the year 2013-14. When it comes to the type of notes counterfeited in 2014-15, RBI data showed that counterfeited Rs.500 notes were most common. The fake notes are basically printed in Pakistan and smuggled to India directly or basically through Bangladesh, Nepal and Dubai route. This is a grave concern to India and if not dealt with would have had serious implications as counterfeit currency can reduce the value of the currency and increase inflation. With this objective in mind Prime Minister announced the decision regarding demonetization of high value currency notes. The impact of demonetization has been that Javed Khanani termed as fake currency king committed suicide on 4th December 2016. Now the control on printing of fake currency has been imposed and Pakistan is finding it difficult to print new notes of Rs.500 and Rs.2000.

4.5 Check on Note Bank Politics

There is no hidden fact that the huge amount of money is spent for election campaign which is mostly funded by black money accepted by political parties as party donations in cash form, without having records of donors. To check the flow of black money in politics and eyeing on the upcoming elections in Uttar Pradesh, Goa, Punjab, and Uttarakhand the Prime Minister announced demonetizing Rs.500 and Rs.1000 currency notes with new currency. This announcement came as a shock to all the political parties giving no time to manage their funds. This demonetization brought tough times for the political parties and politicians who believe in the idea of purchasing votes in exchange for notes. The objective has been met as many parties have been ruined due to demonetization and to certain extent cleansing of politics has initiated.

5. Impact of Demonetization

5.1 Impact on Stock Market

Before analyzing the impact of demonetization on Indian Stock market it is necessary to take into consideration that the demonetization of currency has been adopted by countries in the past to tackle the uncontrolled high inflation rate and where economies were facing problems. On the other hand India was the first country which resorted to demonetization of high value currency notes which constituted around 86 percent of the total money in circulation and that too when the economy was growing strong, just to make a dent on black money. In this background it was generally felt that shortage of liquidity arising due to demonetization will affect the stock market adversely that too for long period of time to come. The market plunged 1689 points with BSE slipping below the crucial 26000 mark to be at 25902 while NSE fell 541 points

to be at 8002. The market within few days discounted the demonetization effect and again regained its strong position to close at record high of 29910 on BSE and 9237 on NSE on April 3, 2017. The story did not end here and the BSE closed at ever record high at 34592.39 and NSE at 10681.25 on 12th January, 2018. The point to be made is that the overall market sentiment is bullish and the timing of demonetization was well accepted by the markets on the background of strong economic signals.

5.2 A Move towards Cashless Economy

One of the prime objective of demonetization was to make people less dependent on cash transactions and rely more and more on digital way of making payment so that the transactions gets recorded in bank books and black money can be checked. With demonetization squeezing almost major chunk of money in circulation from the economy people were willingly or unwillingly made to take the route of electronic mode of payment. Many those who till date were relying only on cash transactions and were feared of electronic portals gradually started enjoying this new mode of making payments as well. The result of demonetization has been that within 30 days of note ban digital payments have showed an increase of almost 300 percent. As per government data the number of daily transactions through e-wallet services such as Oxigen, Paytm and MobiKwik has shot up from 17 lakh, recorded on November 8 when demonetisation was announced, to 63 lakh as on December 7, 2016 showing a growth of 271percent. In terms of value, the surge has been 267percent, from Rs.52 crore daily to Rs.191 crore now. Transactions through RuPay Cards (e-commerce and point-of-sale) were up 316percent at 16 lakh daily as against 3.85 lakh on November 8, while in terms of value the growth has been 503percent at Rs.236 crore from Rs.39 crore. The government has launched many applications such as UPI, BHIM, Aadhaar Pay, Paytm, MobiKwik, HDFC PayZapp, SBI Buddy, PayU, Tez etc. to make payments digitally. The efforts have started yielding results with 965 million digital transactions recorded in October 2017 which is the second highest volume recorded in December 2016 post demonetization.

5.3 Demonetization and India's Economic Growth

With the announcement of demonetization of high value currency it was expected that there will be a big economic slowdown in the Indian economy. International Monetary Fund (IMF) lowered the growth rate of the economy to 6.6 percent from the projected 7.6 percent for the fiscal year 2016-17. Even IMF stated that India will lose the tag of fastest growing major economy to China which is expected to register an economic growth of 6.7 percent. Strong economic fundamentals backed by good monsoon faded away the ill effects of demonetization and the economic data published by Central statistics Organization (CSO) revealed that the economic grew at 7 percent in the October-December 2016 quarter despite demonetization. However demonetization followed by rollout of GST resulted in steep fall in the pace of GDP growth as it fell to a 3 year low of 5.7 percent in the April-June 2017 quarter. This gave critics to raise their voices against the government and they started pointing out that the Government has fooled and cheated the public and in fact they

termed their demonetization and GST polices as “Organized Loot.” The point to be noted is that whenever any hard policy decision is implemented to cleanse the economy and the system it will always have adverse impact on the economy in the short run but will definitely yield positive and fruitful results in long run. Thus one should give cooling time to the economy to settle down and absorb jitters of tough decisions. Things started changing from September onwards and economy started showing the signs of revival much before the expected time period when in July-September 2017 quarter the GDP growth rate re-bounced to 6.3 percent signaling that the country has taken the two major decisions in the right spirit and are ready to adapt the new way of doing business in the changed tax regime and are accept the digitization mode of payment for purchases rather than completely depending on cash dealings. Citizens of India have started given acceptance to more transparent system. The impact of revival of economy have been so effective that International rating agency Moody's Investors Service raised India's sovereign rating for the first time since 2004 to Baa2 from Baa3 and changed its rating outlook to stable from positive, saying that at the Baa2 level risks to India's credit profile were broadly balanced. This reflects that the tough decisions of the Government have been appreciated at international levels as well. Add to it Moody's

forecast GDP growth of 6.7 percent for the fiscal year ended March 2018, with a pick up to 7.2-7.5 percent in the following year and "similarly robust" levels from 2019 onward. India, which had the mantle of world's fastest growing major economy, slipped below China in terms of growth which reported a growth rate of 6.9 percent for the quarter ended June 2017 against India 5.7 percent for the same period. With recovery signs again emerging in Indian economy it is expected that India's GDP growth rate will overtake China's in the next financial year as per the Interim Economic Outlook report released by Organization for Economic Co-operation and Development (OECD).The OECD report maintains that the economy will regain its momentum and achieve a growth of 7.2 percent in 2018, overtaking China that will see a growth rate of 6.6 percent during the same period.

5.4 Demonetization in India - A Success Case Story

India is not the first country that has demonetized its currency. There have been several instances world over where countries have gone for demonetization of their national currency. The point that needs to be underlined is that demonetization has not been so smooth and successful in other countries as is the case with India. The following table reflects instances of demonetization world over and its outcome.

Table 2: List of Countries that Implemented Demonetization

Sl. No	Country	Year	Decision	Outcome
1	Ghana	1882	To reduce tax evasion, curb corruption and manage liquidity 50 cedi currency notes were demonetized.	Public lost faith in the banking system and switched over to physical assets and foreign currency.
2	Nigeria	1984	Banning old currency and introduction of new currency to take care of debt and inflation.	Economy collapsed
3	Myanmar	1987	Military invalidated around 80percent value of money to curb black market.	Decision led to economic disruption and mass protests. Government resorted to crackdown killing thousands of people.
4	Soviet Union	1991	Mikhail Gorbachev withdrew 50 and 100 ruble notes to eliminate black money and increase the currency value. These notes accounted for a third of the total money in circulation.	The move was not accepted by citizens and resulted into a coup attempt which brought down Gorbachev's authority and the led to Soviet breakup.
5	Zaire	1993	Dictator Mobutu Sese Seko's administration laid out back-to-back currency reforms along with a plan to withdraw obsolescent currency from the system in 1993.	The reform was not well received by the public and resulted in increasing economic disruptions. Mobutu was ousted in 1997.
6	North Korea	2010	Kim-Jong Il removed two zeros from the face value of the old currency in order to check black market.	People unrest made Kim to apologies.
7	India	2016	Demonetization of 500 and 1000 rupee notes with new 500 and 2000 rupee notes.	The decision of demonetization was well accepted by the citizens of the country. The process completed successfully in time bound manner.

Source: <https://www.boldsky.com/insync/pulse/2016/list-of-countries-that-have-tried-demonetisation-before-india-108166.html>

6. The Road Ahead

After successful introduction of Demonetization the onus lies on the government to ensure the following so that the ultimate positive impact on the economy is experienced for long period of time and the crackdown on black economy is witnessed and experienced by general public. The following possible suggestions may be fruitful in this regard.

- Since 97 percent of the money in circulation has come back with the banking channels government is facing huge criticism and it is been queried that where is the black money. The government sine now all the money has been recorded in books and has been converted into white should put a squeeze to business transactions in cash terms and should allow all business dealings only through

banking channel so that all transactions are recorded and black money is halted from being regenerated.

- The Government should come up with action plan and thoroughly scrutinize the Jan Dhan Accounts in terms of balances prior to and after demonetization announcement. Those accounts swelling beyond the acceptable limits should be blocked if the accountholder fails to justify the deposits or fails to disclose the source of deposits. This will result in counter attack on people who surrogated the Jan Dhan Accounts of poor and parked their unaccounted money.
- In order to promote digitization of transactions government should not only lift the transaction charges but also come up with concessions to those who opt for digital

transaction over cash transactions. The point to be made is that there should be difference in rates for cash payments and digital payments right from manufacturer level to ultimate consumers.

- The next step should be to make all investments in terms of insurance policy premium, stock markets, mutual funds, fixed deposits, property and others to be acceptable only through banking channels with no cash transactions being accepted.

7. Conclusion

The above analysis leads to conclude that there is an old saying that hit the iron when it is hot. Based on this saying the Government of India planned and decided to implement decisions related to Demonetization of high denomination notes as the economy was growing at 7+ percent growth rate and was in a situation to absorb the short term shocks arising out of such strict economic decision. The economy showed positive response and after experiencing the short term jitters is now again on the growth path and soon it will start steaming in full strength, regain its strong economic position on the world economic forum. To say that demonetization has failed is not correct as though almost 97 percent has come back to banks but, the point to be noted is that now once the black money after been recorded on bank accounts is now liable to be taxable on any financial transactions taking place. As a closing remark it is submitted that demonetization will be remembered as wise decisions on the part of government in making honest efforts to cleanse the economy and promote higher economic growth and transparency.

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