INDIA IN THE PHASE OF DEMONETIZATION

Gunjan Dwivedi*
Archana Jadon*
Dr. Subeer Banerjee***

*Asst. Prof. Management & Commerce, Maharaja Institute of Management and Technology
**Dean Academics, Maharaja Institute of Management and Technology

ABSTRACT

Demonetization is the act of stripping a currency unit of its status as legal tender. It happens whenever there is an alteration of national currency in which the current form of money is drag from circulation and go off, often to be replaced with new notes or coins. Sometimes, the old currency entirely replaces with new currency. In this study, with the help of simple theoretical tools the implications of the latest "Demonetization" exercise in India are analyzed. It reached on conclusion with the help of available data like other studies and articles. We took this study as an opportunity to find out the situation arises in the phase of demonetization.

Keywords: Demonetization, Black Money.

CONCEPTUAL FRAMEWORK

In the second last month of 2016, a major economic decision was taken by the Indian Government, which was Demonetization. It was an immense announcement made by our honorable Prime Minister Mr. Narendra Modi, which affect the Indian Economy and Indian citizens a lot. All ₹ 500 and ₹ 1000 bank notes of the Mahatma Gandhi Series ceased to be legal tender in India from 9 November 2016.

The government claimed that the demonetization was an effort to stop counterfeiting of the current banknotes allegedly used for funding terrorism, as well as a crack down on black money in the country. The move was described as an effort to reduce corruption, controlling black money, fake currency circulation and terror financing. In other words, it was a step for anti money laundering.

However, in the days following the demonetization, banks and ATMs across the country faced severe cash shortages. Also, following Modi's announcement, the BSE SENSEX and NIFTY 50 stock indices crashed for the next two days. The term demonetization has become much more than a household name since the old Rs 500 and Rs 1,000 notes were pulled out of circulation. While as per dictionary demonetization means "ending something (e.g. gold or silver) that is no longer the legal tender of a country", one needs to understand that there is much more than the literal meaning to the word. One need to understand that 80% of India's labour force is employed in the informal sector, which comprise of 45% of the GDP of our country. Over 60% of population of India lives in below the international poverty threshold line of 1.9$ per day. Since our economy is an under banked economy, present demonetization move, would no doubt cause a severe social experiment, across the segment of our population.

History & Brief Introduction of Demonetization in India

India has a long-standing relationship with demonetization. On January 16, 1978, Rs 1,000, Rs 5,000 and Rs 10,000 currency notes were scrapped through an ordinance, impacting 0.6 percent of the total currency in circulation at the time. Before that, India had experienced demonetization of high-value currency in January, 1946. In Jan 1978 episode, currency worth INR 1.46 bn (1.7% of total notes in circulation was demonetized. Of this INR 1.0 bn (or 68%) was tendered back. In 1978 the value of demonetization was very small (only 0.1% of GDP). However, the 2016 demonetization effort covers 86% of the total currency in circulation (11% of GDP).

On both occasions, it impacted only a miniscule segment of the society and economy. Because the salary of an entry-level government officer in 1978 was well below Rs 1,000

Rs 100 was the highest denomination in circulation until October 1987, when Rs 500 notes were re-introduced, followed by the re-introduction of Rs 1,000 notes in November 2000. However, until 2000-01, the share of high value notes (i.e notes with value greater than Rs 500) was only 26.7 percent of the total currency in circulation.

In India, up until now the highest denomination note was Rs 1,000 and this was 1,000 times the smallest denomination note of Re 1 (Note: Re 1 notes are issued by the ministry of finance).

DEMONETIZATION

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency: The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with new currency.

The need of Demonetization arises due to following reasons:

- The fake Indian currency notes in higher denomination have increased.
- Unaccounted money, often used in any form of corruption and illegal activities.
- The Financial Action Task Force, a global body that looks at the criminal use of the international financial system, notes that high-value bills are used in money laundering schemes, racketeering, etc.

BLACK MONEY

Black money is money which is earned through any illegal activity controlled by country regulations. Black money proceeds are usually received in cash from underground economic activities and on which tax is not paid. Recipients of black money must hide it, spend it only in the underground economy, or attempt to give it the appearance of legitimacy through money laundering. Possible sources of black money include drug trafficking, weapons trading, terrorism, prostitution, selling counterfeit or stolen goods and selling pirated versions of copyrighted items such as software and musical recordings.

LITERATURE REVIEW

Arpit Guru and Shruti Kahanijow (2010) analyzed the "Black Money Income - Need for amendment in DTAA & ITEA" and analyzed that black money is spread everywhere in India up to a large extent which continuously stashed towards abroad in a very large amount. The researcher also identified how black money had caused nuisance in our economy and in what ways it is used.

Sukanta Sarkar (2010) conducted a study on the parallel economy in India: Causes, impacts & government initiatives in which the researcher focused on the existence of causes and impacts of black money in India. According to the study, the main reason behind the generation of black money is the Indian Political System i.e. Indian govt. just focused on making committees rather than to implement it .The study concludes that laws should be implemented properly to control black money in our economy.

Tax Research Team (2016) in their Research Paper stated the findings in favour of demonetization. Its main objective is to analyze the impact of demonetization on Indian economy. This paper shows the impact of such a move on the availability of credit, spending, level of activity and government finances.

OBJECTIVES OF THE STUDY:

- To describe the Demonetization concept.
- To analyze the Demonetization phase in India.

RESEARCH METHODOLOGY:

The study is based on secondary sources. The data has been collected from other research studies and articles. Conceptual and theoretical method has been used to analyze the data.

IMPACT OF DEMONETIZATION ON INDIAN ECONOMY:

So, what is the immediate impact of the current demonetization on the people and economy? To be precise: Unsettling. One can see long queues before banks and ATM machines. Workers in the unorganized sector, petty shopkeepers and small businesses are finding it difficult to cope. There is a visible tendency to hoard available legal tender in denominations of Rs 100 and below as emergency funds. In the absence of government statistics, if one relies on news reports, there seems to be some dip in immediate consumption expenditure. Given the scale of demonetization, this was anticipated. The move was expected to create temporary problems as acknowledged by the prime minister himself.

However, minor inconveniences apart, what will be the macro-economic impact? Demonetization will reduce money supply in the economy. A cursory look at the Reserve bank of India's data on money supply as on 11th of November shows that M3 (i.e., Broad Money) has shrunk by Rs 38,300 crore on a fortnightly basis and currency available with the public has shrunk by Rs 1.75 lakh crore, while demand deposits and time-deposits have increased.

Reduction in money supply resulted as falling in consumer spending, investment spending and net exports, leaving aside government spending. It is likely to translate into a decline in nominal GDP in the immediate term. RBI has increased the Cash Reserve Ratio (CRR)—the share of total deposits that commercial banks have to hold as reserves either in cash or as deposits with the central bank—to 100 percent on additional deposits. Hence, hopes of a reduction in interest rates have already been diminished with short-term negative impacts on bank profitability. The unorganized sector, which forms a major part of the Indian economy, is likely to take a transitory hit as this sector operates mainly on a cash basis.

While there will be an immediate dip in demand and negative short-term impacts on the economy coupled with hardships for citizens, demonetization, as a policy measure, certainly has large-scale positive effects. This move is likely to improve tax compliance, given that the Goods and Services Tax (GST) is also on its way to become reality.

Government would now have increased funds available for capital spending owing to higher tax collection. Moreover, the availability of funds would reduce the need for the government to borrow from the market, thus making available more credit for the private sector. The RBI may also be in a position to give a one-time bonanza to the government on account of untendered currency.

The better fiscal position might also allow the government to reduce income tax rates, which would subsequently lead to higher disposable incomes with tax payers. All this would aid the consumption-multiplier effect.

As with any policy decision, this move too will have multiple direct as well as indirect effects. The biggest positive certainly seems to be the eradication of some stocked and staked up money, perhaps earned through illegitimate means or tax evasion.

The key here is patience. When 86 per cent of a country's legal tender becomes illegal, it is but expected that finding 'a new level of equilibrium' would require time. If the smaller short-term risks, especially those emanating from the demand side are addressed carefully, if we undertake a holistic net cost benefit analysis, the expected results seem to be promising.

The following likely impacts on the economy will be observed if a substantial portion of the cash is either reported or is consumed in the economy.

Tax: Having closed the voluntary disclosure window for undisclosed money, it has been reported that government will keep a close watch on deposits over Rs 2 lakh in cash. This would mean increased tax net, higher tax collection and a better tax to GDP ratio. Philips Capital in a report says that the extent of parallel economy, which was 23.2% of GDP, is now around 25-30% of GDP. As the money gets accounted and more taxes are collected, government might be tempted to reduce tax rates going forward.

Interest Rates: One of the biggest impacts of demonetization would be high value transactions, especially land and gold. This would result in lower inflation, tempting the central bank to reduce interest rates. But the bigger impact on interest rates will be the liquidity with which banks will be flushed. CLSA's points out that banks would benefit with higher CASA (current account savings account) growth as a part of the $ 190 billion cash pile gets deposited with them. Higher deposit growth and continuing weak credit growth would create opportunities for lending rate cuts and investment activities to pick-up.

Liquidity: Movement of goods and money will be hit in the short. A Bank of America Merrill Lynch note says that wholesale channel forms over 40% of the sales for the Indian consumer firms. This channel works mainly on cash transactions and will likely witness liquidity constraints in the near term. This could disrupt the supply chain and impact growth in the December quarter. The report further adds that consumer firms typically provide tight credit terms (<7 days) to the distributors, who in turn provide credit to the wholesalers/ outlets on their own accounts. Due to overall tightening of the cash-liquidity in the supply chain, consumer firms may be forced to offer easier credit terms to the distributors in the near term. As a result we expect an increase in their receivables in the December quarter.

GST: Demonetization comes at an important as the country heads to a new tax regime with the implementation of GST. Demonetization would increase the tax net and along with GST result in reduction of black money generation. Along with GST, demonetization will lead to a higher tax/GDP ratio, says CLSA.

Effect on Demand: The overall demand is expected to be affected to an extent. Sectors like Consumer goods, Real estate and property, Gold and luxury goods and Automobiles (only to a certain limit), all these mentioned sectors are expected to face certain moderation in demand from the consumer side because significant amount of cash transactions involved in these sectors.

Effect on Prices: The Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

Consumer goods: Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.

Real Estate and Property: Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheque transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices (probably charging more on cheque payment). The Indian real estate market which is largely fragmented and unorganized has had a reputation of being a safe haven for black money and therefore we expect to see impact on the sector. The impact is likely to be seen in secondary markets thereby making real estate more "illiquid" for a period of time till the market adjusts to a new normal. It will not have any impact on the primary residential segment as the buyers in this sector are driven by mortgage. The impact will be felt in the secondary market and the unorganized developers' community where there were still cash dealing. Prices coming down to more reasonable levels in the housing market cannot be ruled out. In the immediate future, the sector will be under serious pressure with volume and number of transactions in residential and land markets seeing a substantial downward trend.

Effect on Various Economic Entities: With cash transaction lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are: Agriculture and related sector like Small traders, SMEs, Services Sector, Households, Political Parties, Professionals like doctor, carpenter, utility service providers, etc.

Effect on GDP: The GDP formation could be impacted by this measure, with reduction in the consumption demand. However with the recent rise in festival demand is expected to offset this fall in overall impact. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and re-enter the stream once the cash situation becomes normal.

Effect on Banks: As directed by the Government, the 500 and 1000 Rupee notes which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there would be withdrawals at the second stage.

Effect on Online Transactions and alternative modes of payment: With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. 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 increase in demand. This should eventually lead to strengthening of such systems and the infrastructure required.

FINDINGS

Although the effect of demonetization perhaps did not cause the economic hurricane that some analysts expected, we believe the slight puff of headwind that the economy has faced up till now won't be all of it. Ultimately, the negative effects are dependent on the period of time before liquidity in the economy has returned to pre-demonetization levels. The gap between former and current levels is still substantial and we believe the negative effects on the Indian economy might reveal themselves in upcoming revisions of GDP or when more reliable informal sector data is released next year. As for now, we will stick to our forecast and expect the Indian economy to grow by 5.5% in FY2016/2017 and 8.2% in FY2017/2018. The pick-up in growth later this year is due to important reforms that Modi has been able to implement, such as the Goods and Service Tax (GST), which brings uniformity in India's complicated and inefficient tax scheme and reduces the cascading effect in the old system. The implementation is most likely due in July 2017, and will result in lower prices of goods and services, as well higher investment and tax revenues.

CONCLUSION

With this so-called demonetization plan, 86% of the currency in circulation was replaced and this resulted in a huge monetary squeeze. The plan was an attempt by the government to wash the stock of counterfeit money out of the economy, which has allegedl'y been used to fund criminal activities, such as terrorism and drug trafficking. In addition, the scheme aimed to draw a large part of the black economy into the banked and taxable part of the economy (overall tax revenue to GDP is a meagre 11%). The demonetization plan could be beneficial for India in future, as it will lift government revenues due to a broader tax base and less tax evasion. In addition, the operation will foster the use of bank accounts and digital payments, making the Indian economy less cash-dependent and improve efficiency and productivity. Demonetization though it has created some positive and some negative impacts on different sectors but in long run it definitely will have positive impact in controlling black money and fake money.

REFERENCES

1. Braga, F.D., Isabella G and Mazzon J.A., (2013) Digital wallets as a payment method influence consumer in their buying behaviour
2. Internet desk (2016, Nov. 12) Recalibration of ATMs will take up to three weeks, says Jaitley The Hindu Retrieved fromhttp://www.thehindu.com/news/national/demonetisation-arun-jaitley-on-atms-going-dry/article9338238.ece
3. Padmini Sivarajah. (2016, Nov. 11). Demonetization: Madurai Corporation makes record tax collection on a single day. The Times of India Retrieved from http://timesofindia.indiatimes.com/city/chennai/Demonetisation-Madurai-Corporation-makes-record-tax-collection-on-a-single-day/articleshow/55374378.cms
4. PTI (2016, Nov. 9). Demonetization will benefit economy in long run: Jaitley The Hindu Business Line. Retrieved from http://www.thehindubusinessline.com/economy/ demonetisation-to-increase-eco-size-enhance-revenue-base-says-jaitley/article9324312.ece
5. Special correspondent (2016, Nov. 13) As ATMs run out of cash, RBI ‘encourages’ public to go digital. The Hindu Retrieved from http://www.thehindu.com/business/Economy/rbi-urges-public-to-adopt-digital-as-atms-run-dry/article9339020.ece
6. Sukanta Sarkar (2010) “The parallel economy in India: Causes, impacts & government initiatives”. Economic Journal of Development Issues, Volume 11-12 no (1-2) p.124-134
7. Tax Research Team, Demonetization: Impact on the Economy No. 182 14-Nov-2016, National Institute of Public Finance and Policy, New Delhi
8. www.investopedia.com/terms/d/demonetization.asp
9. www.investopedia.com/terms/b/black-money.asp
10. https://economics.rabobank.com/.../2017/march/india-where-is-the-negative-impact-of-demonetization?