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# Impact of Demonetization in India

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***Abstract*--** On 8 November 2016 midnight, the Government of India announced the demonetisation of all 500 and 1,000 banknotes of the Mahatma Gandhi Series. The government claimed that the action would curtail the shadow economy and crack down on the use of illicit and counterfeit cash to fund illegal activity and terrorism. This scheme has a great impact on the businesses, common people, and financial institutions along with multi-diverse industrial background of India. Demonetization represents much more than destabilization; it has struck a body blow on the economic activity in India. While the proponents of demonetization may have had good intentions, the suffering it has caused to millions of Indians is unwarranted. Since Rs500 and Rs1000 notes make up some 86% of the total currency in circulation in India, especially in the vast rural areas, the pain to what individuals might experience if 86% of their blood was removed from their bodies. The poor were taken totally off guard and the banking infrastructure in the hinterland is rather limited. The tech class has poor exposure to critical social theory in order to understand the impact on the ground. There is an empathy deficit.

***Keywords*--** *Demonetization, Cash Crisis, Cashless Society, Liquidity, Cash on delivery*

## I. INTRODUCTION

After the announcement that 500 and 1,000 rupee notes were no longer legal tender; people were given 50 days to deposit them in bank accounts or exchange them for new notes at banks and post offices, when only half of Indian adults have bank accounts. By withdrawing 86 percent of circulating currency when 70 to 80 percent of transactions are cash-based, the Indian government has burned down its economic house in order to eradicate the pest of corruption

The announcement immediately triggered a mad scramble to unload the expiring banknotes. Though people had time until the end of the year to deposit the notes in bank accounts, doing so in large quantities could expose them to high taxes and fines. So they rushed to gas pumps, banks, foreign-exchange counters, ATMs, to jewelry shops, and to creditors to repay loans and several deaths were linked to the inconveniences caused due to the rush to exchange cash. There was a spike in donations in the form of the demonetized notes in temples in the form of defunct notes. People started making multiple transactions at different bank branches and also sending hired people, employees and followers in groups to exchange large amounts of banned currency at banks. The Indian Railways authorities found that a large number of people started booking tickets particularly in classes 1A and 2A for the longest distance possible, to get rid of unaccounted cash. People used the demonetised 500 and 1,000 notes to pay large amounts of outstanding and advance taxes. As a result, revenue collections of the local civic bodies jumped.

Only 5 percent of Indian workers pay income tax, just 15 percent of the economy is inside the tax net and India's tax to GDP ratio at 17 percent is 5 points lower than comparable countries. Because of high property taxes, buyers collude with sellers to understate the sale value and split the tax difference. India's wealthy, who are less reliant on cash and are more likely to hold credit cards, park illicit wealth in Indian and overseas real estate, shell companies, shares, gold and overseas bank accounts, are relatively unaffected. The poor and the lower middle classes, however, rely on cash for their daily activities, and thus are the main victims. Only 5 to 6 percent of India's illicit wealth is estimated to be held in cash components. The rich have engaged "mules" to line up and exchange their currency for them while the "common man" faces hardships in the daily purchases of food, medicine, bus and rail tickets, and so forth.

## II. IMPACT OF DEMONETISATION ON INDIAN ECONOMY

India's previously booming economy has now ground to a halt. All indicators sales, traders' incomes, production, and employment are down. Small producers, lacking capital to stay afloat, are already shutting down. India's huge number of daily wage workers can't find employers with the cash to pay them. Local industries have suspended work for lack of money. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class. The informal financial sector which conducts 40% of India's total lending, largely in rural areas has all but collapsed.

The BSE SENSEX and NIFTY 50 stock indices fell over 6 percent on the very next day. In the days following the demonetisation, the country faced severe cash shortages with severe detrimental effects across the economy. It reduced the country's GDP and industrial production. Some sectors of the economy continue struggling with the lack of readily available cash, grassroots businesses are still being revolutionized with electronic payment capabilities, and masses of people continue transitioning towards new ways of paying for basic goods and services. The banks didn't have enough of the newly designed banknotes on-hand to distribute in exchange for the canceled notes. It caused a sudden breakdown in India's commercial ecosystem. Trade across all facets of the economy was disrupted. Consumer goods sales are reported to have dropped by one-third. Trucks are at a standstill.

Demonetization will act as a liquidity shock that disturbs economic activities. Liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Liquidity crunch is a short term effect. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. When liquidity shortage strikes, consumption gets adversely affected.

Consumption ↓→ Production ↓→ Employment ↓→ Growth ↓→ Tax revenue ↓

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.

The combined effect of above would lead to a wider impact on the economy namely deflation. Sectors like real estate, construction material and unorganized trade will see significant pain in the near term

## III. IMPACT OF DEMONETIZATION ON WORLD ECONOMY

Demonetization will certainly have effects on world economics. But the ripples will be felt only for the countries that directly trade with India. Due to demonetization, the first thing that happened in India was it curbed the purchasing power of most of the people. So this in turn decreased the overall trade in the country.

## IV. MAJOR IMPACTS

### *A. Domestic/Household Sector*

The logic behind this demonetization is to curb the use of these high value notes in the black money market. Now almost everyone has Rs1000/500 notes so now it would become difficult for the common people to do their business/ household works easily.

### *B. Reduce Government Liability*

It will reduce the risk and cost of cash handling as soft money is safer than hard money. It will also reduce government liability. Since every note is a liability for the government, the old currency will become worthless for those people, who choose not to disclose their income. Thus, this will extinguish government's liability to that extent. It is expected approximately Rs 5 lakh crore may come to the government in the form of extinguished RBI liability, taxes and penalties. It will reduce tax avoidance. Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this period.

Importantly, in the longer run, tax and interest rates on loans are expected to come down as higher income tax collections arising from better compliance would offer scope to reduce rates over the long term. This, in turn, will drive up disposable income. This can give a positive impact on consumption demand in long term.

### *C. Farming and fishing industry*

Farmers generally deal in cash . The poor people through middlemen are getting their currencies exchanged for Rs.300 or Rs.400. Farmers have difficulty buying seeds and fertilizer and selling crops and perishable products. The demonetisation led to unavailability of cash to pay for food products. The reduction in demand that arose in turn led to a crash in the prices of crops. Farmers were unable to recover even the costs of transportation from their fields to the market from the low prices offered. This forced the farmers across the country to dump their products in desperation. Some farmers resorted to burying unsold vegetables. Agricultural products such as vegetables, foodgrains, sugarcane, milk and eggs were dumped on roads. The fishing industry which depends on cash sales of freshly caught fish is close to collapse.

### *D. Business*

E-commerce companies saw up to a 30% decline in cash on delivery (COD) orders. Several e-commerce companies hailed the demonetization decision as an impetus to an increase in digital payments. They believe that it would lead to a decline in COD returns which is expected to cut down their costs. The demand for point of sales (POS) or card swipe machines has increased. The goods and services tax (GST), whose objective is to replace all taxes levied by the federal government and the states with one central tax

### *E. Drop in industrial output*

There was a reduction in industrial output as industries were hit by the cash crisis. The growth in eight core sectors such as cement, steel and refinery products, which constitute 38% of the Index of Industrial Production (IIP), decreased. The construction industry has been badly hit with significant wage implications for its casual workforce. Traders are losing perishable stocks

### *F. Black Money Hoarders*

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. On the other hand, black money holders either have to show their income source from which they earned their black money to the department or to burn the stashed income. However people declaring their income in excess of threshold limit will be subjected to scrutiny.

### *G. Impact on counterfeit currency*

The real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise. It was previously estimated that 250 out of every million Indian bank notes were fakes. The new 500 and 2,000 rupee notes are less vulnerable to counterfeiting, having advanced security features with one report claiming that it will be “impossible” for Pakistan to fake them. The Demonetization has badly hit Maoist and Naxalites as well. The surrender rate has reached its highest since the demonetization is announced. The move also reportedly crippled Communist guerrilla groups (Naxalites) financing through money laundering. The smuggling of arms and dealing with the terrorist will not sustain further as all of the money will be on record now.

### *H. Hawala*

The brightest spot is the end of Hawala racket and rising property prices. Hawala is the way of transferring money from a different country to India in Indian denominations. Although illegal, the people in this racket make their money white through this process in different countries . To attract more people to remit through this form, they pay a premium over the existing exchange rates mostly for remitters from African-based nations. Come 8th November, 2016, the government scrapped all high denominations making the notes lying with the Hawala traders null and void.

### *I. Impact on bank deposits*

Bank deposits will increase by a huge margin and this will increase their lending activities. The banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial inclusion. The existing white money of people will be known to the government and it will remain with banks so that it can be put on loan, and interest can be generated from it with a corresponding fall in Inflation. However, it needs to be seen how much money actually remains in the system, once the cash withdrawal limits are eased. 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. The 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

### *J. Jewelry and Real Estate Business*

The liquidity squeeze caused by demonetisation will be negative across sectors with high level of cash transactions. Real estate, jewellery, retailing, restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space will be facing short term instability. Those companies with high level of debt will face more pressure and can face loan defaults.

### *K. Impact on IT Industry*

This step can bring grey market commodities / illegal money lending / money laundering etc., under control which is otherwise unmanageable. The IT industries prefer purchase and sales through banking system only. It won't curb grey channel market but will surely have an adverse effect on the products which are promoted by grey channel. This move will help brands to grow and helps in curbing the fake, grey market, and Chinese import cash sales. New-age payments like PayTM, Instamojo Payment Gateway, PayUMoney and Mobikwik, online banking and e-commerce platforms will see an increased demand in the near future as people will show willingness to move away from cash. This particularly will benefit IT startups and Fintech domains that work on online payments that enable technology processes for such companies. This also could create key requirements for technology processes for tracing financial information, eKYC form Income Tax departments. Government initiatives such as Aadhar, Jandhan will nudge a lot of Fintech companies to enable financial institutions and banks to adopt these facilities.

On the other hand sales at all major electronic and computer hardware retailers have hit rock bottom. Unable to compete with the massive discounts and low taxation offered by online giants, like Flipkart, Snapdeal and Amazon, computer retailers are forced to decrease their margins and offer freebies to walk-in customers. Currently, retailers profit from a 3%-5% margin on laptops, desktop computers and accessories. The adoption of cashless transactions through debit cards or credit cards eats into this margin as the retailer has to pay 1.8%-2% bank commission on each transaction. This has already resulted in significant slowdown of demand across PC, tablet PC and Mobile devices.

## V. FACTS ABOUT DEMONETIZATION 1946, 1978 AND 2016

The term demonetization is not new to the Indian economy. 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. The goal was to combat tax evasion by "black money" held outside the formal economic system.

In 1946, the pre-independence government hoped demonetisation would penalize Indian businesses that were concealing the fortunes amassed supplying the Allies in World War II. It turned out to become more like a currency conversion drive as the government couldn't achieve much of profit in the cash-strapped economy at that time.

In 1978, the government demonetised banknotes of 1000, 5000 and 10,000 rupees, again in the hopes of curbing counterfeit money and black money. The Wanchoo Committee had recommended the government to withdraw the currency because the country was going through a difficult period

In 2012, the Central Board of Direct Taxes had recommended against demonetisation, saying in a report that "demonetisation may not be a solution for tackling black money or economy, which is largely held in the form of benami properties, bullion and jewellery."

## VI FACTS ABOUT DEMONETIZATION IN DIFFERENT NATIONS ACROSS THE GLOBE

| Country | Year | Step Taken | Status |
|---|---|---|---|
| United States of America | 1969 | Due to black money existence in the nation, the country was losing its sheen built on Silicon Valley and the so-called even today existent American Dream. In 1969, US President Richard Nixon announced all bills above $100 null and void. | Success. Even today $100 bill is the maximum available for circulation. |
| Nigeria | 1984 | The government run by Muhammadu Buhari has announced demonetization of all existing currencies to improve the high-inflation-debt economy. | Failed. He was thrown out of power in 1985-86. |
| Zaire | 1990 | The Dictator Mobutu ran the demonetization drive which led to economic instability in the country which won freedom in 1970 making it more vulnerable to foreign funding at that time. The country recovered in 2000. | Failed |
| Soviet Union | January 1991 | Mikhail Gorbachev, withdrew 50 and 100 ruble notes, in order to eliminate black money and increase the currency value. The notes accounted for a third of the total money in circulation. | Gorbachev faced a coup within eight months in August as the move was not a success. The 1991 attempt led to a successful re-denomination of the ruble in 1998 where three zeros were removed. This was followed by another currency switch in 2010 when two more zeros were removed from the old currency. The 2010 |

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|---|---|---|---|
| | | | attempt was not as successful as the timing coincided with a poor harvest. |
| Australia | 1996 | The government to the curb black money crisis and improve security features on the notes, they withdrew all paper-based notes and replaced them with long life polymer-based notes of the same denomination. | Success. This improved the life of the bills and helped in making Australia a business friendly country, despite the initial costs incurred to manufacture polymer-based notes. |
| Zimbabwe | 2010 | Due to chronic inflation in Zimbabwe, the government started printing notes with a face value of 1 hundred trillion Zimbabwean Dollars' worth just 40 cents. | Failed. The country replaced their currency with US Dollars later |
| North Korea | 2010 | The then dictator of North Korea Kim Jong-IL has decided to remove two zeroes from the currency denominations to curb black money menace and tightly control the economy. | Miserably Failed. Due to bad harvest and high inflation, this move was highly criticized by the International Media, making the dictator to apologize in the public. |
| Pakistan | June 2015 | The Government of Pakistan has announced the demonetization of Rs.5 and Rs.500 in June 2015 with immediate effect and phase out of all other denominations. The people of Pakistan had one-and-half year time to exchange these notes, after which (December 1, 2016) the notes will be declared null and void. | Messed Up. One and Half Years for demonetization. To exchange notes. Can't curb black money neither counterfeit notes |
| Venezuela | Dec 11,2016 | The president of the country Nicolas Maduro signed an emergency decree ordering the country's largest banknote, 100 Bolivar bill, to be illegal tender within 72 hours. This was a step to curb the hoarding of cash by international "mafia". | Forced to take it back after chaos & death of a person |

From the table above we find the demonitization done by developed nations have been successful and African nations have suffered a lot because these countries are still a victim of neo-colonialism.

## CONCLUSION

Demonetization is an established practice in monetary policy to tackle black money. The idea of demonetization is good but it has to be taken into consideration that most of the black money is kept in the form of land, buildings or gold or kept abroad. What is in cash constitutes only 4% of the total amount of black money on which taxes are not being paid. Not all black money is in cash, and not all cash is black money. Those who held large quantities of black money seem to have found creative ways to launder it, rather than destroying it to avoid attracting the taxman's attention, as the government expected. Small farmers, sellers, merchants, daily wage labourers and traders are suffering because of lack of proper planning, intelligence and foresight such as recalibration of ATM machines. There was need to pile up enough 100 Rupee notes and other smaller denomination notes in the market before taking this step. People are facing problems because the limit of withdrawal has not been kept at a higher level. It is also being said that what is being attempted is replacement of currency and not demonetization itself which was unnecessary. This is a terrible setback for the international standing of the Indian economy. At this time, the economy is struggling with slowdown. The truth is that its design was fundamentally flawed. There was no "policy skeleton," no cost-benefit analysis, and no evidence that alternative policy options were considered. Judging by the blizzard of policy tweaks since the announcement, it seems clear that no impact study was carried out. A better solution would have been to shift the balance of economic decision-making away from the state to firms and consumers; simplify, rationalize and reduce taxes; cut regulations and curtail officials' discretionary powers; eliminate loopholes; and widen the tax net.

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