International Journal of Business and Management Invention (IJBMI)
ISSN (Online): 2319 – 8028, ISSN (Print): 2319 – 801X
www.ijbmi.org || Volume 8 Issue 04 Series. V || April 2019 || PP 18-22

Impact of Demonetisation in Indian Economy

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ABTRACT: *The main objectives of the financial sector reforms are to allocate the resources efficiently, increasing the return on investment and accelerated growth of the real sectors in the economy. 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. This paper analyses the current the immediate impact of demonetization on Indian economy; and it also workout the probable consequences of the demonetization. Demonetisation announced with the objective to fight black money, corruption and terror funding.. But after demonetisation the poor and people working in the informal sector have not only been inconvenienced, they have been dislocated and their livelihoods irreparably damaged. If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact.*
KEYWORDS*: Demonetisation , Economic reforms*

Date of Submission: 20-04-2019 Date of acceptance: 05-05-2019

I. INTRODUCTION

Financial sector is the backbone of any economy and it plays a crucial role in the mobilisation and allocation of resources. The constituents of the financial sector are Banks, Financial Institutions, Instruments and markets which mobilise the resources from the surplus sector and channelize the same to the different needy sectors in the economy. The process of increasing capital accumulation through institutionalisation of savings and investment fosters economic growth. The main objectives of the financial sector reforms are to allocate the resources efficiently, increasing the return on investment and accelerated growth of the real sectors in the economy. The measures initiated by the Government of India under the reform process are meant to increase the operational efficiency of each of the constituent of the financial sector and economy.

Objectives of paper:

- To analyze the current the immediate impact of demonetization on Indian economy;
- To workout the probable consequences of the demonetization.

Research Methodology

The study is based on secondary data. The data has been collected and compiled from various books, journals, and websites.

Demonetisation

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.

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.

Financial sector reforms refer to the reforms in the banking system and capital market

Demonetisation in India

India has a long-standing relationship with demonetisation. 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 demonetisation of high-value currency in January, 1946.

The government of India recently took a decision to demonetize Rs 500 and Rs 1000 currency, which means that the legal tender of currency units is declared invalid from the specified date. The demonetisation of currency notes was supposed to be an attack on black money, on counterfeit notes, and projected as part of a broader push to promote digitization and non-cash payments. A year later, progress on all these counts appears to be very modest, and should make us question whether this exercise was needed at all to fulfil its stated aims. The costs imposed by the currency-scrapping exercise were, however, quite severe, at least in the short term, disrupting ordinary life across the country for several weeks. The hardest-hit were those in rural areas, where access to banking and the internet are quite low. A 2016 Reserve Bank of India (RBI) report on branch authorization policy classified 93% of rural centres in the country as unbanked, with the population dependent on roving banking correspondents and on distant urban or semi-urban branches. Access to the internet is equally patchy, with only 3% of households in underdeveloped rural areas reporting access to internet in a 2016 consumer economy survey.

Impact of demonetisation

The Indian Economy which was billed as the "fastest growing major economy" in the world and the "only bright spot" among Emerging Markets seems to have slowed down even before the latest "shock therapy" of "demonetization". Indeed, the growth figures from the CSO or the Central Statistical Office considered to be the official department that releases projected, and actual growth figures (apart from the RBI or the Reserve Bank of India and the Finance Ministry) hints at a slowdown in the Indian economy even during the quarter before demonetization happened.

While this is indeed cause for concern with projected growth figures revised downwards from 7.6 % to 7.1% for the financial year ending March 2017, what is cause for greater worry and even alarm is the view among some economists including the former Prime Minister Dr. Manmohan Singh that the current and ongoing attempt to flush out black money would shave a good 2% of the GDP or the Gross Domestic Product. the consensus view among many economists is that while there would be indeed a noticeable slowdown in the economy for a "quarter or two", most of them seem to agree that growth would indeed bounce back and the Indian economy would regain its momentum as well as turnaround with a renewed sense of vigour due to higher tax revenues.

Having said that, one must keep in mind the fact that as per the recent estimates by some economists, nearly 90% of the total cash in circulation has come back into the banking system and hence, the stated purpose of the Demonetization exercise which was to "extinguish" black money and enable the RBI to lower its liabilities thereby providing the government with a huge dividend seems to have been belied. there are some who now argue that the Indian Banking System is now "flush with cash" and this has enabled the government to "nudge" the RBI to cut rates as well as to allow banks to pass on the benefit of ample liquidity to consumers by lowering lending rates.

However, the flip side of this has been that banks have cut their deposit rates as well which is natural considering that any cuts to lending rates have to be accompanied by cuts to deposit rates. This has resulted in a situation where banks with enough deposits seem to be encouraging spending more than saving and this can indeed create demand in the system since more money with consumers means more spending thereby leading to an uptick in sales of goods and services and which has the "multiplier effect" of resulting in more growth.

On the other hand, with more taxes being collected due to higher deposits in banks that can be taxable as well as increased compliance due to greater scrutiny and oversight by the IT (Income Tax) Department, the government too might be tempted to announce lower rates for taxes and other aspects of what are known as fiscal measures. In this context, it is worth remembering that fiscal stimulus which is by lowering taxes and providing more incentives to consumers as well as producers by boosting supply can be complemented and supplemented by the monetary stimulus which is by boosting demand for goods and services by lowering lending rates thereby putting more money in the hands of consumers.

As economic theory states, both fiscal and monetary stimulus can be implemented in isolation or taken together and hence, the Demonetization or the DeMo as it is being called might indeed act as a catalyst for growth. Having said that, one must remember that India is primarily a cash transaction based economy and hence, removing 86% of the money in circulation is indeed a "brave" move since there are reports that large sections of the informal economy have come to a grinding halt.

Moreover, there are also reports of farming sector taking a hit due to lack of cash as well as sales of automobiles and other capital goods falling even though inventories are building up. Thus, it remains to be seen as to how the growth figures for the next quarter and the overall financial year turn out to be. Given that mainstream economists tend to debate and argue both sides with equal passion and vigour, it is the case that as the cliché goes, the "proof of the pudding is in the eating" and hence, the actual growth figures have to be watched.

Of course, there are other indicators to keep track of as well in the form of various Indices such as the PMI or the Purchasing Managers Index which tracks industrial activity as well as the rates of investment and the credit pickup as well as the Inflation figures. Having said that, one must also note that given the lack of communication about some of the economic indicators from the government is indeed worrying given that Demonetization has been billed as the "Biggest Monetary Experiment" in recent times in the entire world.

Positive Effects Of Demonetization?

In what could be termed as the mother of all reforms, Prime Minister Modi's demonetisation move will have far reaching implications. This is not to dispute that the transformative step has brought some hardship for the citizens, but those are temporary and will blow over soon. For the larger benefit of the nation, we the citizens can bear such hiccups with a smile. After all, this is how we as citizens can contribute in policy making and nation building. While bank employees are working overtime to make Modi's ambitious demonetisation drive a success, let's discuss its many-fold impacts.

1. Black money: At one stroke the Prime Minister has choked the supply of black money stacked inside the country. Of the Rs 17 lakh crore of total currency in circulation in the country, black money is estimated at mind-boggling Rs 3 lakh crore. Black money is nothing but a plunder of the nation. Black money operators run a parallel economy which shakes the very foundation of the Indian economy. With Modi's demonetisation move, all domestic black money will either be deposited into the banks with heavy penalty or be simply destroyed.

2. Economy: Demonetisation will have a huge resultant effect on the Indian economy. The clean-up of illegal cash will help turn around the economy. First, it will bring more borrowings to the exchequer, improve inflation outlook and increase India's gross domestic product (GDP). Second, it will revive investment opportunities and give a fillip to infrastructure and the manufacturing sector. Third, it will help reduce interest rates and lower income tax rate

3. Note bank politics: In the run up to the crucial assembly elections in Uttar Pradesh, Punjab, Goa and Uttarakhand, Prime Minister Modi's demonetisation announcement has come as a shock and awe for the political parties and politicians for whom black money is a lifeline. The pulling out of the old Rs 500 and Rs 1,000 currency notes will help make the election process clean and transparent. But it has brought tough times for the political parties and politicians who believe in the idea of purchasing votes in exchange for notes. That is precisely the reason a rainbow coalition of a galaxy of regional parties and the Congress is building up against Modi, because their political interests are badly hurt.

4. Real estate cleansing: It is said that real estate is an industry built on black money. The extent of black money floating around in the sector is huge. According to an estimate at least 40 per cent of real estate transactions in Delhi-NCR are in black. Modi's demonetization move will curtail the flow of black money into the real estate sector. This will help in making the much needed correction in the sector. The impact: An unexpected dip in land and property prices.

5. Hawala transactions: Demonetisation has crippled the hawala rackets. Hawala is a method of transferring money without any actual money movement. Hawala route is used as a means to facilitate money laundering and terror financing. Hawala rackets run again on black money. With black money suddenly being wiped out of the market, thanks to demonetisation, hawala operations have come to a grinding halt. According to an India Today report, one of the hawala operators in Mumbai has destroyed currency notes worth about Rs 500 crores.

6. Counterfeit currency: Demonetisation has dealt a death blow to the counterfeit Indian currency syndicate operating both inside and outside the country. Counterfeit currency seriously devalues the real worth of Indian currency. A study conducted by Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency (NIA) suggests that fake Indian currency notes (FICN) amounting to Rs 400 crore are in circulation in the country at any given point of time and around Rs 70 crore fake notes are pumped into Indian economy every year. The estimation is based on recovery and seizure made by various agencies. But the actual figure could be much larger. A One India report, quoting an Intelligence Bureau dossier, says fake Indian currency worth Rs 12 lakh crore has pumped into Indian financial system over the years. Needless to say that most of the fake currencies circulated in India are of Rs 500 and Rs 1000 denominations. It is also pertinent to mention that the fake currency floating inside the Indian financial system is not counted within the Rs 17 lakh crore of total currency in circulation in the country. This is an open secret that Pakistan has been printing fake Indian currency at its government printing press in Quetta and its security press in Karachi. The enemy nation funnels the counterfeit currency through the frontier at Jammu & Kashmir and via India's porous border with Bangladesh and Nepal. With Prime Minister Modi's decision to pull out the old Rs 500 and Rs 1,000 notes and replace them with new Rs 500 and Rs 2,000 series has completely stalled the circulation of counterfeit Indian currency. Experts say the new currency notes have come with advanced security features which are almost impossible to replicate. So Pakistan has no option but to shut shops of its fake Indian currency.

7. Terror financing: Terror financing is sourced through counterfeit currency and hawala transactions. This is how terror financing works. Fake currency circulation is routed through a multi-layered network of hawala

operators which are closely linked to gambling and smuggling of drugs, opium and arms. Indirectly, they all end up financing terrorism. In addition, the terrorists collect huge donations and then route the money through hawala transactions. With the circulation of counterfeit Indian currency completely stalled and hawala transactions stopped, all windows for terror financing are closed.

The Short-Term Vs. The Longer-Term Implications

The Short-term Impacts:

There was a disruption in the liquidity situation as households got affected by the note exchange terms laid by the government. commodity transactions and general cash market transactions were showed immediate impact. Unorganized sector proceedings, including small trade market activities, remained volatile in the short-term. Roadside vendors, cab drivers, kirana stores, etc., stopped accepting Rs 500 and Rs 1,000 notes during that time. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which was affected by immediate liquidity issues. Overall, negative impact on disposable income made disruption in the consumption patterns of the general populace. It made a negative impact in the GDP of country.

The Longer-term Implications: This essentially represents a change in regime for the real and financial economy. But GDP growth has decelerated over the last four quarters, from 7.9% growth in Q2 2016 to 5.7% in Q2 2017. By comparison, most of the rest of the world began to see a pick-up in Q3 2016.

The Centre for Monitoring Indian Economy (CMIE), a private forecaster, estimates that 1.5 million jobs were lost between January and April 2017, as the employment level fell to 405 million people.

Domestically, there could be some turmoil as the effect will be disproportionately felt by the lower and upper income classes. Internationally, the government is likely to get thumbs up for the move and more countries could potentially see this as a viable option to curb black money and stem illegal financial activity.

Last, though this move by the government may not be a first, having being tried by earlier governments as a tool to fight corruption. Such an action achieves larger significance for a globally connected India as it shows boldness in tackling an issue which has remained a thorn in the growth success story of this generation. The Sectoral Impacts While sectors with linkages to the unorganized economy were affected, technology and financial services are expected to gain in the medium to long term. On a sectoral basis, the commodities and agricultural sector, including the market for consumer durables and non-durables were affected.. In the short to medium-term, large denomination purchases will likely be made via electronic purchases rather than through brick and mortar outlets. This made impact in the retail sector adversely. The real estate sector showed a significant negative impact in the medium- to long-term, particularly in the repurchase market. The luxury goods market was also affected as this move represents an erosion of real wealth to a large Areas of sub-sectoral impact felt in luxury cars, SUVs, gems, jewellery, gems, jewellery, gold and high-end branded products. The real estate sector is likely to see a significant negative impact in the medium- to long-term, particularly in the repurchase market. There are expectations of a revaluation of current real estate transactions across the board representing possible losses to players in the sector. The luxury goods market was got affected as this move represents an erosion of real wealth to a large number of people. On the positive side, there is likely to a reset of spending patterns as this move represents indirectly a significant push towards a cashless economy. Businesses in the fin-tech sector, including payment banks, mobile wallets, electronic transfer providers, etc., are expected to see gains.

II. CONCLUSION

After demonetisation the poor and people working in the informal sector have not only been inconvenienced, they have been dislocated and their livelihoods irreparably damaged. If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries shows that the move was one of the series that failed to fix a debt burdened and inflation-ridden economy.

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Mathews John" Impact of Demonetisation in Indian Economy" International Journal of Business and Management Invention (IJBMI), vol. 08, no. 04, 2019, pp 18-22