

Impact of Demonetization in India

Jayabrata Ghosh

Assistant Professor of Commerce, Ranaghat College
jghosh644[at]gmail.com

Abstract: *Money is the most important part of every economy. Without money circulation in an economy world could not be developed in such a space. Over a period of time money helps to create a strong economy. Money is guaranteed by the Government of a country. In other words, monetization may be described as a process of giving guarantee to a particular form of the unit of money by the Government of a country. Unless and until a form of unit of money is recognized by a Government as money the same has no value whether it is in the form of paper or metal except the mere material value. On the other hand, demonetization is a process by which the Government of a country withdraws the backing or guarantee of one or more of its currency in circulation. This paper describes the history of demonetization in India. The latest demonetization in this country was announced on 8th November, 2016. In this paper an attempt has been made to discuss the reasons and the consequences of demonetization on some important economic factors.*

Keywords: Demonetization, Economic effect, Tax, Employment, Black Money, Equity Market

1. Introduction

Money is the most important part of every economy. Without money circulation in an economy world could not be developed in such a space. Barter system of the ancient world is replaced by the introduction and circulation of money in transaction. Over a period of time money helps to create a strong economy. Money gets its value when it is backed or guaranteed by the Government of a country. In other words, monetization may be described as a process of giving guarantee to a particular form of the unit of money by the Government of a country. Unless and until a form of unit of money is recognized by a Government as money the same has no value whether it is in the form of paper or metal except the mere material value. In every sphere of economic activity like, production, buying, selling and distribution, transfer, servicing etc. money helps in conducting the transactions and thereby making economy strong. In the reverse, demonetization is a process by which the Government of a country withdraws the backing or guarantee of one or more of its currency in circulation with the objective of getting some economic benefit or to minimize the evils presently facing by the country. Consequently, the currency ceases to be legal tender. In this paper an attempt has been made to understand the effect of demonetization on various significant economic factors of India.

2. Literature Review

Sukanta Sarkar (2010) made a research on the parallel economy in India where he identified the existence of black money and its effects on economy. He pointed out the reason for generation of black money which is the Indian political system. Government plans, makes committees but the implementation is not satisfactory. In his opinion implementation of rules and regulations is essential to control black money. Ghandy (2016) studied the reasons for demonetization and subsequent effect on general people. Though the main reasons were to wipe out black money and pave the way for a cashless society, it fails to achieve its main goals. As less than 50 percent of households have access to banks and more than 60 percent of the economy is

in the informal sector, it is much difficult to jump to a cashless society. The author opined that demonetization drive increased the sufferings of the poor and middle class society. Tax Research Team, NIPFP (2016) examined the both short and medium term impact of demonetization on black money in India. The team argued that demonetization is not an effective means to check black money in a large scale rather it will help in reduction of major economic activities. Kumar and Kumar (2016) studied the effect of demonetization on financial inclusion and concluded positively. In their opinion the effects of demonetization are encouraging in the long run though it was painful for the short run. They mentioned that this is reaping time for banks that made lump sum investment for digitization of banking services which results in increased financial inclusion in India. Veerakumar, K.(2017) put forward the view that demonetization of 500 and 1000 currency notes by the Government upset the people of India. The notes are monetized to arrest tax evasion, to check black money and fake currency and to control illegal activities. He observed that some people deposited massive unaccounted money directly to banks which were beyond the specified limit and subject to higher taxes and penalties. Also online transactions have been increased which will improve better cashless infrastructure. Muthulakshmi, E. Kamatchi (2017) in her paper entitled "Impacts of Demonetisation on Indian Economy-Issues & Challenges" argued that in the short run economy is not benefited from demonetization. But if the money paves its way in the economy it would have a positive impact. She also described that though demonetization was a severe attack on black money, corruption, hawala transaction, counterfeit currency and terror funding it had a negative impact on various sectors like commodities, real estate etc. Abhani Dhara K. (2017) in his paper "A Study On Impact Of Demonetization Over The Banking Sector With Reference To Veraval City" mentioned that from the results of data analysis it is found that the demonetization of the year 2016 is somehow more successful than previous two. People became more alert about online banking. The bank employees are trying to serve better in this matter. He also mentioned that though, huge black money had not been seized by this demonetization, it became successful in creating a fear in the mind of hoarder of black money.

Volume 10 Issue 5, May 2021

www.ijsr.net

Licensed Under Creative Commons Attribution CC BY

Objectives of the Study

- 1) To understand the meaning of demonetization.
- 2) To go through the history of demonetization in India.
- 3) To understand the reasons of demonetization.
- 4) To assess the important economic effects of demonetization on Indian economy.

3. Research Methodology

This study is mainly of descriptive nature and makes use of secondary information published in RBI Report, different Research Papers, Journals, Publications, and Websites etc. Also various books have been referred for theoretical aspect.

The meaning of demonetization

Demonetization is a process of restricting a currency note or metal coin to circulate in the economy. In other words withdrawal of backing or support a currency by the Government of a country in order to achieve one or more economic objectives. Wikipedia defines demonetization as the act of stripping a currency unit of its status as legal tender. In India the Reserve Bank of India on behalf of Government of India demonetizes currency. Currency after being demonetized cannot be used as legal tender in dealing transaction but to replace with a new currency.

The history of demonetization in India

India has observed demonetization earlier before independence. For the first time in January 12, 1946 when Rs.1,000, Rs.5,000 and Rs.10,000 notes were demonetized. The measure resulted in the return of 94 percent of the currency demonetized to RBI. The highest currency notes of Rs.10,000 were introduced for the first time in 1938. Though these three notes were reintroduced in 1954. For the second time in January 16, 1978 all the three high value notes of Rs.1,000, Rs.5,000 and Rs.10,000 were again demonetized to curb the generation of black money in India. Though the measure affected around 1.5 percent of the currency in circulation. However, Rs. 500 note was introduced in 1987 and Rs. 1000 note was reintroduced in the year 2000. The latest measure of demonetization took place on November 8, 2016 when the currency denomination of Rs. 500 and Rs. 1000 were declared banned and the notes have been restricted to be used as legal tender money in transactions. The holders of the notes so banned were allowed to deposit it to their banker within a few days. The demonetization of the year 2016 affected about 86 percent of the currency in circulation.

Reasons of demonetization

In spite of having a substantial cost involved in demonetization Government uses the process to overcome some economic problem. It cannot be treated as full proof method to overcome the problems faced by the Government. Benefit achieved must be compared with the cost involved in it to know the net effect of demonetization. However, the following are some of the main reasons of demonetization.

- **To check black money:** Black money is the money which is circulated in the economy of the country and thereby creates a parallel economy. Black money is also legal tender money but it is not coming in the purview of Government accounting as the earner of the money does not pay tax payable by the earner. The tax evader hoards

black money generally in the form of high value currency notes. The developmental activities of the Government are drastically hampered by the volume of black money. Demonetization is a strong measure to check black money.

- **To reduce the counterfeit currency notes:** Forged or counterfeit currency is the other serious problem for the country. Demonetization can remove the fake currency from the economy. When high value notes are withdrawn from circulation terror funding faces problem and terrorism activities are minimized.
- **To increase online transactions:** Another objective of the Government in demonetization is to increase cashless transactions through online mode. It becomes easier to the Government to identify online transactions and thereby ensures increased tax collection which in turn helps reduction of black money in the economy.
- **To prevent tax evasion:** Demonetization of currency can prevent tax evasion as the persons who are evading tax must exchange their existing money with bank or have to hold it as valueless paper. In the exchange process government will be able to track the unreported earnings and the tax evaders.
- **To reduce criminal activities:** Demonetization largely affects criminal activities. As the old currencies are taken out of circulation, the large fund available with criminals become worthless. Due to shortage of finance their power to organize terrorism is reduced to a great extent.
- **To control hyperinflation:** Sometimes demonetization is adopted to control hyperinflation in an economy. Hyperinflation is used to mean situations when the prices of all goods and services rise uncontrollably over a period of time. Alternatively, hyperinflation may be defined as a situation when rapid inflation takes place. It occurs when money supply is increased by Government printing and injecting into the domestic economy or to cover the budget deficit which is not corroborated by the economic growth.
- **To reduce hawala transactions:** Demonetization is an effective tool to control hawala transactions. In hawala racket money is transferred among the racketeers without its actual movement. Black money is used to run hawala. It is used as a way to facilitate money laundering and terror funding. Sudden withdrawal of black money from the economy is a shock to the hawala operators.

Economic effects of demonetization on Indian economy**Effect of demonetization on Tax Collection and GDP Growth**

Table 1 represents the collection of direct taxes and GDP at current market price for ten years i.e. from 2009-2010 to 2018-2019. It is seen that the GDP growth rate lowered slowly over the years up to 2015-2016 and reached at 8.25 % except the year 2010-2011 in which service sector and agriculture sector contributed much. After demonetization in the year 2016-2017 the growth rate of GDP increased by 4.98% over the previous year and reached at 13.23%. Thereafter, decreased slightly. So, it is obvious that the positive effect of demonetization contributed on GDP growth rate. On the other hand, we observe slight fluctuation in Tax Growth up to 2013-14. The year 2014-15 showed a fall of 5.28% over the previous year. The sluggish growth

especially in service sectors and Tax Deducted at Source (TDS) category took a toll on the direct tax collection. Demonetization in the year 2016 contributed to positive movement of Tax growth rate and showed an increase of

7.90 % in the year 2016-17 over the previous year. The year 2017-18 also witnessed a 3.4 % rise of Tax growth rate over the earlier year. The year 2018-19 recorded a slight fall in the growth rate of Tax.

Table 1: Collection of Direct Taxes and GDP Growth Rate from 2009-2010 to 2018-2019.

Financial Year	Net Collection of Direct Taxes (Rs.Crore)	GDP at Current Market Price (Rs. Crore)	Direct Tax to GDP Ratio	GDP Growth Rate	Tax Growth Rate
2009-10	378063	6457352	5.85%	14.69%	13.25%
2010-11	445995	7674148	5.81%	18.84%	17.97%
2011-12	493987	9009722	5.48%	17.40%	10.76%
2012-13	558989	10113281	5.53%	12.25%	13.16%
2013-14	638596	11355073	5.62%	12.28%	14.24%
2014-15	695792	12541208	5.55%	10.45%	8.96%
2015-16	741945	13567192	5.47%	8.25%	6.63%
2016-17	849713	15362386	5.53%	13.23%	14.53%
2017-18	1002037	17095005	5.86%	11.28%	17.93%
2018-19	1137685	19010164	5.98%	11.20%	13.54%

Source: RBI, Database on Indian Economy.

Demonetization and Digitization

Digitization was one of the important motives of demonetization. Though cash transaction in the country cannot be measured accurately, payments made electronically can be measured precisely. Digital payments include credit transfers through NEFT (National Electronic Funds Transfer), fast payment through IMPS (Immediate Payment Service) and UPI (Unified Payment Interface) and direct debits through ECS (Electronic Clearing System) and NACH (National Automated Clearing House).

According to RBI (Reserve Bank of India), the last five years i.e. from 2014-2015 to 2018-2019 evidenced substantial increase in the volume and value of digital payments. The overall digital payments in the country have recorded a Compounded Annual Growth Rate (CAGR) of 61% in terms of volume and 19 % in terms of value during this period. Among these digital payments credit transfer through NEFT, fast payment through IMPS and UPI and direct debit through ECS and NACH have displayed a fast growth at a CAGR of 65% and 42% in terms of volume and value respectively. Value of wallets and prepaid cards showed an increase at a CAGR of 96% and 78% in respect of volume and value respectively. Payments made through Debit and Credit card increased at a CAGR of 44% and 40% in terms of volume and value respectively. The use of cards for payments and withdrawal of cash is increasing day to day.

Demonetization and equity Market

The last demonetization was announced on 8th Nov, 2016. On the same day the result of US presidential election was declared. The victory of Donald Trump amplified concerns more protectionist trade policies in America. In response to these developments the Indian equity market dropped with BSE Sensex declining by 3.5 percent up to 30th December, 2016 from its level on 8th November, 2016.

The Indian equity market was affected by both the domestic and international factors. However, we can make an idea of the effect of demonetization on the movement of indices of cash sensitive sectors like, FMCG, consumer durables, auto and realty vis-à-vis the overall index. As against the decline of 3.5 percent in the BSE Sensex from 9th November 2016 to 30th December, 2016, the realty sector index declined 14.4

percent, consumer durables declined 9.9 percent and also FMCG the index declined by 5.3 percent which indicate the sharp fall in demand for these products as they were driven by cash transactions. The impact on sectoral indices was temporary and they recovered their lost ground thereafter. In response to overall increase of 8.9 percent in BSE Sensex between 7th March, 2017 to 30th December, 2016 consumer durables index increased by 23 percent followed by realty (18.8 percent), FMCG sector (8.7 percent) and also auto (7.2 percent) during this period.

Table 2: BSE Sectoral Performance (% Change)

Sector	Dec 30 / Nov 8, 2016	Mar 7, 2017/ Dec 30, 2016	March 7, 2017/ Nov 8, 2016
Consumer Durables	-9.9	23.0	10.8
Realty	-14.4	18.8	1.7
Metal	-3.7	18.1	13.7
Telecom	-2.5	15.0	12.1
Bankex	-7.1	13.4	5.4
Capital Goods	-4.7	13.0	7.6
Oil % Gas	2.1	12.0	14.3
Power	-0.1	10.0	10.0
PSU	-0.3	9.4	9.1
Sensex	-3.5	8.9	5.1
FMCG	-5.3	8.7	2.9
Auto	-9.0	7.2	-2.4
Healthcare	-3.4	3.8	0.3
IT	3.3	2.9	6.3

Source: RBI Report

Effect of demonetization on employment

The recent demonetization in India announced on 8th November, 2016 of Rs.1000 and Rs.500 notes trembled the citizens across the country. Political parties were divided on this issue. Some viewed the demonetization positively and they highlighted only the possible positive impact of it like, minimizing black money, fake currency, cross border terrorism etc. While others argued that the decision of demonetization of high value currencies amounting to over 86 percent of total currency in circulation was unplanned and far from ground level reality. It only caused miseries to millions of people making them wait in queue for day long.

The Centre for Monitoring Indian Economy has shown that around 1.5 million jobs were lost as a result of

demonetization of 2016. With this loss of employment the labour force participation rate were also declined which contribute to the economic slowdown. The All India Manufacturers' Organization's (AIMO) survey report shows a drop in employment of 60 percent and loss in revenue of 55 percent after demonetization. Medium and large-scale industries engaged in infrastructure projects reported a 35 percent drop in employment and 45 percent revenue loss. Foreign companies engaged in export-oriented activities reported 30 percent job loss and 40 percent revenue loss. Medium and large scale manufacturing industries reported the least job loss of 5 percent and 20 percent revenue drop. Labour intensive units like, food and beverage, tobacco, textile, leather, jewellery, wood etc. where half of the workers of organized manufacturing sector of the economy are employed, were affected by the effect of demonetization of 2016.

4. Conclusion

The latest decision of the Central Government to demonetize high value currency consisting of 86 percent of the total currency in circulation was a sudden monetary shock on the Indian economy particularly for the sectors heavily dependent on cash transactions. During the period of two months after the demonetization severe disturbances occurred in the normal cash dependent economic activities in the country. The aim of demonetization targeting arrest of black money and counterfeit currency was not successfully achieved as most the demonetized currencies were somehow returned by public to the Central Bank in exchange of other currencies. Huge shortage of cash in banks and ATMs caused misery to the people and small cash dependent sectors. The labour market was affected largely by the sudden decision of demonetization. The demonetization decision showed a very short-term effect on tax base. However, the objective of digitization of transactions got an impetus and showed a positive movement in the post demonetization period. The vital economic decisions may reap greater benefit if it is taken on long-term thinking and substantial information relating to the subject matter under consideration.

References

- [1] Abhani, D.K. (2017). A Study On Impact Of Demonetization Over The Banking Sector With Reference To Veraval City. *International Journal of Marketing & Financial Management*. 5(3). 21-26.
- [2] Bharadwaj, A. (2016). Demonetization and the Economy: Signs of Distress Everywhere. *Business Standard*, 1, p.1-10.
- [3] Ghandy, K. (2016). Demonetization : One Step Forward, Two Steps Back. *Economic and Political Weekly*, 51(50), p.28-31.
- [4] Kumar, S.V., & Kumar, T.S. (2016). "Demonetization and Complete Financial Inclusion". *International Journal of Management Research and Reviews*, 6(12), p.1703-1707.
- [5] Lahiri, A (2020). "The Great Indian Demonetization." *Journal of Economic Perspectives*. Volume-34, Number-1 p. 55-74
- [6] Muthulakshmi, E.K. (2017). Impacts of Demonetisation on Indian Economy- Issues & Challenges. *Journal of Humanities and Social Science*. p. 34-38.
- [7] 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*.
- [8] Tax Research Team. (2016). Demonetization : Impact on the Economy. Retrieved from <https://ideas.repec.org/p/npr/wpaper/16-182.html>.
- [9] Veerakumar, K. (2017). A Study on People Impact on Demonetization. *International Journal of Interdisciplinary Research in Arts and Humanities*. 2(1). 9-12.
- [10] <https://www.rbi.org.in>