

DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

**1. Dr.KIRAN KUMAR KOTHA**

MBA DEPT. HOD

MAHAVEER INSTITUTE OF SCIENCE & TECHNOLOGY

EMAIL:dr.kirankumarkotha@gmail.com

PHONE: 9573395919

**2. O.LAKSHMINARAYANA**

MBA DEPT., ASST.PROF.

MAHAVEER INSTITUTE OF SCIENCE & TECHNOLOGY

EMAIL:olakshmi9999@gmail.com

PHONE: 9885439576

**ABSTRACT**

*India is one the nation with highest level of currencies in circulation at 12.1% of GDP. Cash on hand is an estimated at around 3.2% of household assets, higher than investment in equities, or roughly around \$ 220 billion. Of this cash, 87% is in the form of Rs 500 and Rs 1,000 notes or roughly Rs 14 lakh crore (\$190 billion).A significant portion of the household cash on hand is generated by economic transactions that are not reported to tax authorities or generated through corruption. Scrapping the higher denomination money would either result in these being brought into the system or the money just disappearing. The present paper highlights the probable consequences of this decision on various economic variables and entities.*

**I INTRODUCTION**

Under Demonetization process for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as an

official mode of payment. Demonetization is the act of stripping a currency unit of its status as legal tender. On 28 October 2016, the total currency in circulation in India was

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

Rs. 17.77 lakh crore (US\$260 billion). In terms of value, the annual report of Reserve Bank of India of 31 March 2016 stated that total bank notes in circulation valued to Rs.16.42 lakh crore (US\$240 billion) of which nearly 86% (i.e. Rs. 14.18 lakh crore (US\$210 billion)) was 500 and 1000 rupee notes. In terms of volume, the report stated that 24% (i.e. 2,203 crore) of the total 9,026.6 crore banknotes were in circulation

➤ In an important move, the Government of India declared that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI will issue Two thousand rupee notes and new notes of Five hundred rupees which will be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. The reasons of it are as under: To tackle black money in the economy;

➤ To lower the cash circulation in the

country which is directly related to corruption in our country;

➤ To eliminate fake currency and dodgy funds which have been used by terror groups to fund terrorism in India;

➤ The move is estimated to scoop out more than more than Rs 5 lakh crore black money from the economy

Similar measures have been taken in the past. In January 1946, currency notes of 1000 and 10,000 rupees were withdrawn and new notes of 1000, 5000 and 10,000 rupees were introduced in 1954. The Janata Party coalition government had again demonetized notes of 1000, 5000 and 10,000 rupees on 16 January 1978 as a means to curb forgery and black money.

## II OBJECTIVES

□ To workout the probable consequences of the demonetization.

□ To analyze the current the immediate impact of demonetization on Indian economy.

□ To study the experience of impact of demonetization in various countries in past years.

## III RESEARCH METHODOLOGY

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

The paper is based on secondary data. The data has been collected from internet. Graph and percentile method has been used to analyze the data.

### IV EXCHANGE OLD NOTES PROCEDURE

The Reserve Bank of India laid down a detailed procedure for the exchange of the demonetized banknotes with new Rs.500 and Rs.2000 banknotes of the Mahatma Gandhi New Series and Rs.100 banknotes of the preceding Mahatma Gandhi Series. Following are the key points:

- Citizens will have until 30 December 2016 to tender their old banknotes at any office of the RBI or any bank branch and credit the value into their respective bank accounts.
- Cash withdrawals from bank accounts will be restricted to Rs.10,000 per day and Rs.20,000 per week from 9 November 2016 till 24 November 2016.
- For immediate cash needs, the old banknotes of value up to Rs.4000 per person were exchanged for the new Rs.500 and Rs.2000 banknotes as well as Rs.100 banknotes over the counter of bank branches from 10 November 2016 by filling up a

requisition form along with a valid ID proof.

- All ATMs dispensed bank notes of only 50 and 100 rupee denominations.
- Banks provide all cash withdrawal transactions at their ATMs free of cost to their customers till 30 December 2016. Cash withdrawals from ATMs will be restricted to Rs.2000 per day per card up to 18 November 2016 and the limits will be raised to Rs.4000 per day per card from 19 November 2016.

However, exceptions were given to petrol pumps, CNG stations, government hospitals, train and airline booking stations, state-government recognized dairies, ration shops, and crematoriums to accept the 500 and 1000 rupee notes until 14 November. International airports were also instructed to facilitate an exchange of notes amounting to a total value of Rs.5,000 (US\$74) for foreign tourists and out-bound passengers.

### V COMPARATIVE ANALYSIS OF IMPACT ON INDIAN STOCK MARKET AND ASIAN

#### STOCK MARKET IN PRESENT SCENARIO

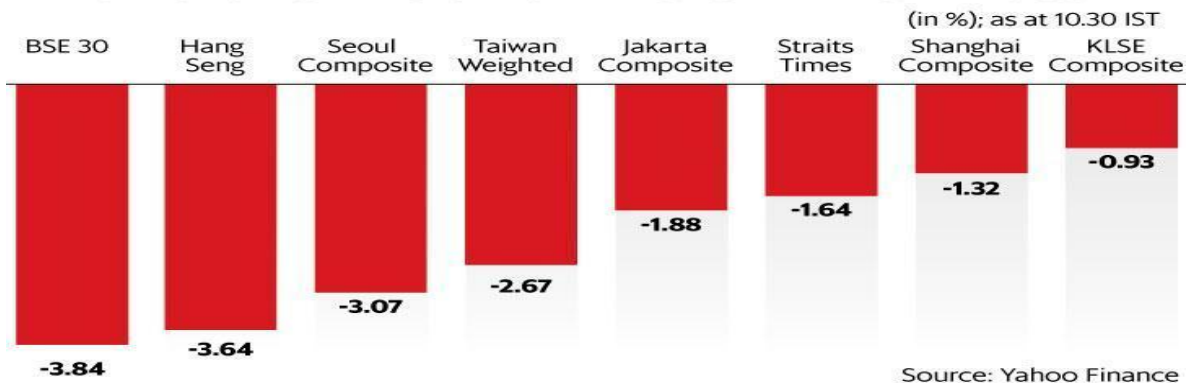
At the time of writing, the Indian markets have fallen a bit more than other emerging

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

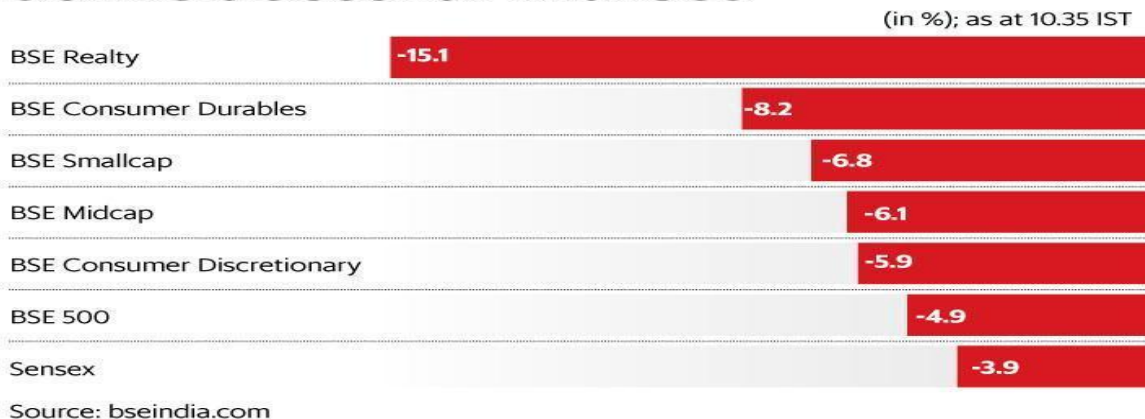
markets in Asia. The S&P BSE Sensex is down 3.8%, which is more than more or less all other Asian emerging markets. The possibility of a Donald Trump win is keeping markets on the edge worldwide. The extra fall in the Indian markets compared to others could be due to many factors, including high valuations, but it's very likely that the demonetization effect is mainly responsible for the fall.

That is clearly seen if we dig a little deeper. The Sensex is made up of very large companies which may not be impacted as much by the demonetization process. BSE's mid-cap and small-cap indices have fallen by over 6% each at the time of writing. And in truth, the largest impact of the government's move will be in the unorganized sector, which isn't represented in the markets.

### Indian shares have fallen slightly more than other Asian markets



### The real impact of the demonetisation process is seen in mid-and small sized stocks and some sectoral indices



## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

The true picture is reflected in sectoral indices such as the BSE Realty index, which is down as much as 15% at the time of writing. Some stocks such as DLF Ltd are down nearly 20%. This industry is known to entertain cash transactions of large magnitude. Similarly, stocks of jewellery companies such as Titan Industries Ltd have fallen by around 11% as well, perhaps because a lot of gold purchases are through cash. Besides, stocks of mid- and small-sized finance companies which collect payments in cash have fallen by 8-10%.

Information technology stocks, for now, are down around 3%, which is more or less in line with the broad markets. While these companies will be unaffected by the demonetization process, this reflects a concern about a Trump presidency and a possibility of anti-outsourcing measures.

### IV. THE EXPERIENCES FROM SOME COUNTRIES

#### **Russia:**

On its last legs, the country under Mikhail Gorbachev in January 1991 withdrew large-ruble bills from circulation in a move to take on the black economy. The reform failed to halt inflation, and instead served mainly to accelerate a slide in public confidence in the government. As political infighting combined with economic collapse, Gorbachev faced a coup attempt that August which destroyed his authority and led to the Soviet break-up the following year. Learning lessons, Russia's 1998 redenomination of the ruble, when it removed three zeroes, went altogether more smoothly.

#### **North Korea:**

In 2010, the regime of then-dictator Kim Jong-Il mounted a reform that knocked off two zeros from the face value of the old currency in an effort to tighten control of the economy and close black markets.

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

Combined with a poor harvest, the measure left the country with severe food shortages, according to reports at the time. Surging rice prices stoked unrest that prompted an unusual apology from Kim, and -- reports suggested -- the execution of the ruling party's head of finance.

### **Zaire:**

Dictator Mobutu Sese Seko faced increasing economic disruptions in the early 1990s, when his administration mounted successive banknote reforms. A plan to withdraw obsolescent currency from the system in 1993 saw a surge in inflation and a collapse in the exchange rate against the dollar. After a civil war, Mobutu was ousted in 1997

### **Myanmar:**

In 1987, the country's military junta invalidated as much as 80 per cent of the value of money in circulation, according to reports at the time -- as in other such initiatives, it was directed at curbing the black market. One result was the first student demonstrations in years. Deepening economic unease helped trigger mass protests across the nation the following year that led to a government crackdown that killed thousands of people.

### **Ghana:**

The country in 1982 got rid of its 50 cedi note to crack down on tax evasion, address corruption and mop up excess liquidity. The move eroded confidence in the banking system as people turned to foreign currency or physical assets instead. The black market for currency flourished.

As rural dwellers had to walk miles to the nearest banks to exchange their money, and after the deadline passed, there were accounts of bundles of notes abandoned as worthless.

### **Nigeria:**

In 1984, the military government led by Muhammadu Buhari instituted an anti-corruption crackdown that involved issuing new banknotes with a different color, forcing the replacement of old ones within a limited period. The move was one of a series that failed to fix a debt-burdened and inflation-ridden economy. Buhari, who is now in power again, was eventually ousted in a coup the following year.

## V. THE PROBABLE CONSEQUENCES OF THE DEMONETISATION

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

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 AND ITS IMPACT ON INDIAN ECONOMY

demonetization will lead to a higher tax/GDP ratio, says CLSA.

**Financial Assets:** As money lying idle comes in the main economy it would move to higher yielding and liquid assets. Money is likely to move to financial assets from gold, precious metals, real estate and plain cash. Equities might reflect the panic in the economy in the short term, but the move is will be beneficial in the long run say most of the broker's report and expert comments.

**Effect on parallel economy:** The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee Notes is expected to - remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks, - Temporarily stall the circulation of large volume of counterfeit currency and - curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

**Effect on Money Supply:** With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to reduce in the short run. To the extent that black money (which is not

counterfeit) does not re-enter the system, reserve money and hence money supply will decrease permanently. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.

**Effect on Demand:** The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly: November 09, 2016 I Economics: Policy View Economic consequences of demonetization of 500 and 1000 Rupee Notes Contact: Madan Sabnavis Chief Economist madan.sabnavis@careratings.com 91-022 - 6754 3489 Anushka Sawarkar Associate Economist anushka.sawarkar@careratings.com 91-022-6754 3609 Mradul Mishra (Media Contact) mradul.mishra@careratings.com 91-022-6754 3515 Disclaimer: This report is prepared by the Economics Division of Credit Analysis & Research Limited [CARE Ratings]. CARE Ratings has taken utmost care to ensure accuracy and objectivity while developing this report based on information available in public domain. However, neither the accuracy nor completeness of information contained in this report is guaranteed. CARE Ratings is

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

not responsible for any errors or omissions in analysis/inferences/views or for results obtained from the use of information contained in this report and especially states that CARE Ratings has no financial liability whatsoever to the user of this report

Economics I Economic consequences of demonetization of 500 and 1000 Rupee Notes 2 Consumer goods □ Real Estate and Property □ Gold and luxury goods □ Automobiles (only to a certain limit) □ All these mentioned sectors are expected to face certain moderation in demand from the consumer side, owing to the 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, this decision along with real estate regulatory law, GST and Real Estate Investment Trusts would further improve transparency and

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

increase investor confidence in the real estate market.

### **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

- Small traders
- Households
- Political Parties
- Professionals like doctor, carpenter, utility service providers, etc
- Retail outlets

Economics I Economic consequences of demonetization of 500 and 1000 Rupee Notes 3 The nature, frequency and amounts of the commercial transactions involved with these sections of the economy necessitate cash transactions on more frequent basis. Thus, these segments are expected to have the most significant impact post this demonetization process and the introduction of new notes in circulation.

**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

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

Credit Cards), etc. will definitely see substantial increase in demand. This should eventually lead to strengthening of such systems and the infrastructure required.

CARE's View In spite of the initial hiccups and disruptions in the system, eventually this change will be well assimilated and will prove positive for the economy in the long run

- Black money hoarders will definitely lose out, eventually boosting the formal economy in the long run.
- Short term fall in real estate prices might benefit middle class citizens.
- This move by the Government along with the implementation of the GST will eventually make the system more accountable and efficient.

### THE SHORT-TERM Vs. THE LONGER-TERM IMPLICATIONS

**The Short-term Impacts:** There will be a disruption in the current liquidity situation as households are likely to get affected by the note exchange terms laid by the government. Though clarity is unfolding on this, commodity transactions and general cash market transactions are likely to feel an immediate impact. Unorganized sector

proceedings, including small trade market activities, will remain volatile in the short-term. Roadside vendors, cab drivers, *kirana* stores, etc., have already stopped accepting Rs 500 and Rs 1,000 notes. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which is likely to be affected by immediate liquidity issues. Overall, negative impact on disposable income is expected along with likely disruption in the consumption patterns of the general populace. It is estimated that there will be a negative GDP impact in the current quarter as consumption gets a shock in the immediate term. However, quantum and degree of this impact cannot be ascertained at this time.

### The Longer-term Implications:

This essentially represents a change in regime for the real and financial economy. 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,

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

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 are likely to be 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 is expected to feel the heat. In the short to medium-term, large denomination purchases will likely be made via electronic purchases rather than through brick and mortar outlets. This will impact the retail sector adversely.

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

reevaluation of current real estate transactions across the board representing possible losses to players in the sector. The luxury goods market is also likely to get affected as this move represents an erosion of real wealth to a large Areas of sub-sectoral impact will be felt in luxury cars, SUVs, 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 reevaluation of current real estate transactions across the board representing possible losses to players in the sector. The luxury goods market is also likely to get 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.

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

Positives	Impacts    Negatives Impacts
E-commerce and Fintech	Agriculture
Payment gateways	Luxury goods
Cards	Real Estate
Mobile wallets	Commodities
Online retail	Traditional Retail
Net and payment banks	Consumer durables
e-marketplace	Consumer non-durables

### VI. CONCLUSION

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.

### REFERENCES

- [1] Partap Singh. 2013. Depreciation of Rupee in Indian Economy: An Analysis, “International Journal of Innovations in Engineering and Technology (IJET)”, Vol. 2 Issue 4 August 2013 332, (ISSN: 2319 – 1058)
- [2] Partap Singh. 2013. Gold Prices in India: Study of Trends and Patterns,

“International Journal of Innovations in Engineering and Technology (IJET)”, Vol. 2 Issue 4 August 2013 332, ( ISSN: 2319 – 1058)

[3] Partap Singh. 2010. Impact of Financial crisis on Indian Economy “Southern Economist” Vol. 49, no. 2. May. 15, 2010; (ISSN: 0038-4046

[4] [http://www.business-standard.com/article/economy-policy/five-likely-effects-of-demonetisation-on-economy-116110901411\\_1.html](http://www.business-standard.com/article/economy-policy/five-likely-effects-of-demonetisation-on-economy-116110901411_1.html)

[5] [http://www.business-standard.com/article/economy-policy/five-likely-effects-of-demonetisation-on-economy-116110901411\\_1.html](http://www.business-standard.com/article/economy-policy/five-likely-effects-of-demonetisation-on-economy-116110901411_1.html)

[6] [http://economictimes.indiatimes.com/articleshow/55348597.cms?utm\\_source=contentofinterest&utm\\_medium=text&utm\\_campaign=cppst](http://economictimes.indiatimes.com/articleshow/55348597.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

[7]

## DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY

[http://www.financialexpress.com/economy/history-of-demonetisation-when-morarji-desai-government-ceased-rs-500-rs-1000-and-rs-](http://www.financialexpress.com/economy/history-of-demonetisation-when-morarji-desai-government-ceased-rs-500-rs-1000-and-rs-2000/)

### **Newspapers:**

The Economics Time, August –September, 2012

The Business Line, July- September, 2012