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Demonetization And Its Impact On The Indian Economy

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Abstract:

Demonetisation was favoured keeping in mind the cash that would be extinguished would be “black money” and hence, should be rightfully excised to set right the incentive structure in the economy. While the facts are not available to anybody, it would be difficult to argue that this is the only possibility.

INTRODUCTION

The major purpose for demonetisation are two-fold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the “black economy”.

There are potentially two ways in which the pre-demonetisation money supply will stand altered in the new scheme: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system.

Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money.

There are broadly four kinds of transactions in the economy: accounted transactions, unaccounted transactions, those that belong to the informal sector and illegal transactions. The first two categories relate

to whether transactions and the corresponding incomes are reported for tax purposes or not. The third category would consist largely of agents who earn incomes below the exemption threshold and therefore do not have any tax liabilities.

OBJECTIVES OF THE STUDY:

- 1.To eliminate black money or unaccounted money.
- 2.To control counterfeit currency.

METHODOLOGY

THE DATA WAS COLLECTED BY SECONDAR SOURCE through magazines and newspapers

SHORT-TERM IMPACT

The demonetisation, by removing 86 percent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will

eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available.

In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing. This in turn can have two effects: while it is expected that supply exceeds demand, there would be a fall in prices. Thus, while generally people seem to expect prices to fall, it is quite possible that prices would instead rise.

The second sector which could be adversely affected would be the construction sector. The sector, it is often argued, works with a significant amount of cash. Payments to workers as well as a variety of purchases might be carried out in cash.

There are a number of transition issues that need to be managed for this transition to be effective. The projections are done using the ratio for 2011-12 since in subsequent years the ratio declined due to low off-take of credit in the economy.

Alternatives to currency: would they evolve in the face of demonetisation?

Effects on government finances: the impact through RBI's finances, the impact through taxes and the impact through credit available to finance deficits.

Impact through taxes:

Indirect taxes would be negative because of the compression in demand increase in revenue collections in property tax. 16 reduction in the tax collection if the tax

department through investigation, finds that some of the deposits are not explained income tax collections would increase.

While this is the third time in the Indian history that Indian high value currency has been stripped of its status as a legal tender, the first two instances of demonetization did not have an impact like the recent one. This is primarily because, this time, the demonetized currency represents 86% of the total currency in circulation.

In a country where 68% of the transaction are cash based (as per CLSA data), a move like this is definitely going to have several long- as well as short-term impacts.

Impact on Banks Deposit and Interest Rates - Positive

The growth in Bank deposits, which was at a 53 year low at the end of March 2016, has seen a spike ever since the demonetization was announced in India. The total deposits collected by banks amounted to Rs 6 trillion (~USD 92bn) by 23rd of November 2016. With this rate of money deposited, entire INR 15 trillion (~USD230 bn) of currency demonetized is expected to be deposited by end of December 2016. If most of these deposits being made in the banks are emergency savings of households, most of these deposits will be withdrawn after government uplifts the withdrawal limit.

Given the huge surge in liquidity post demonetization, major banks in India like the ICICI (NYSE:IBN), HDFC (NYSE:HDB) and SBI have lowered their interest rates. For fixed deposit between 390 days to 2 years, ICICI bank has lowered interest rate to 7.10% from 7.25% while HDFC has made a reduction of interest rates up to deposits of 1 year to 6.75% from 7% and to 6.5% from 6.75% on maturities ranging from one year to years. Similarly, SBI has also announced reduction of interest rates on deposits for select tenors. With the reduction in fixed deposit rates, a reduction in lending rate was on the cards. However, on Saturday, 26th November Reserve Bank of India (the Central Bank of the country) released a circular that banks will have to deposit a 100% CRR with the RBI on any incremental deposits due to demonetization. Although banks are seeking further clarification from the central government, if applied this move will shatter expectations of a sharp decline in interest rates

Surge in use of digital money - Positive

The limitation on cash withdrawal has forced many Indians to move to alternative forms of payment like digital transactions, e-wallets, internet banking and plastic money. As per data collected by Economic Times, in FY 2015 cashless transactions through credit card, debit card, NEFT, and online wallets

stood at around INR 92 lakh crore (~USD1.42 Trillion). Retail electronic clearing comprised of more than 71% of this number. In the current scenario, E-wallet firms and other e-commerce platforms have noticed a surge in their business. For example, Paytm has witnessed a five fold increase in overall traffic while downloads of applications have tripled with a 250% surge in transaction number and value. Ola money also saw a 1500% increase in recharge immediately after the announcement of demonetization. Similarly, Razorpay's numbers also shot 150% in the morning post the decision was announced which further surged to 200% by afternoon.

To promote digitalization further, the government has announced certain incentives on electronic payments using debit card, Internet and mobile phones till December end. While moving to a non cash economy largely will be difficult for a country like India, demonetization has and will further result in strengthening of the digital transactions.

The Central Government is expecting to make a one-time gain - Less Likely

The government is expecting that a significant percentage (~20%) of the demonetized currency will never be exchanged. If this happens (although in my view it is less likely as people have various

options to convert their currency (refer table 1 in appendix)), the central bank will see a reduction in liability which becomes a one-time profit and can be distributed as one-time dividend to the government.

Impact on GDP and economy - Negative

The GDP growth of India is expected to slow down due to the impact demonetization has on various sectors. The decline in demand due to unavailability of cash is expected to bring down the GDP growth by 0.5% as per a forecast by CARE. A significant proportion of business in India is transacted in cash which employs a huge proportion of workforce. Demonetization can result in disruptions in these businesses posing a threat to the employment of the weaker section of the society.

Impact on Tax Revenue - Positive

Any abnormally high deposits will be scrutinized and will be subject to a 200% penalty. At least a part of the money being deposited will be subject to tax and penalty. This will result in an increase in the government revenue and hence reduced budget deficit.

Conclusion

While this move by the Indian Government, will definitely eliminate the counterfeit currency, its impact on the black economy

and corruption is highly debated. While in isolation demonetization might not be effective in shrinking the black economy in the long run, it will definitely bring in most of the money back into the system from where tracing and tracking can be done with much ease. Further moves by the government like not allowing high amount of cash expenses as a tax deductible expense is expected to increase the tax revenue of the government.