

# Impact of Demonetization on Indian Economy

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**Abstract:** *Currency Demonetization has taken the world by surprise. It expressed the commitment of the Indian Government in cracking a whip on the black money and flushing out the fake money. The present Government has demonetized Rs.500 and Rs.1,000 denomination notes in circulation and ushered in a sleuth of reforms that directly addresses the common man, economy, business and global relations. Interestingly, there are views that both supports and argues on the currency demonetization in India. This debate will provide a forum for students to talk for and against the demonetization of higher denomination currencies in India*

**Keywords:** Prime Minister Modi, Mahayajna, Economic Liberty, Currency Notes, Demonetization, Black Money, Electronic Payment Systems, Fake Currency, GDP Growth, Inflation, Undocumented Transactions, Tax Evasion, Loan Burden, Monetary Transmission, Share Indices

## I. INTRODUCTION

In a 40 minute long speech Prime Minister Narendra Modi announced the demonetization of existing notes of Rs 500 and Rs 1000 during a televised address on Tuesday evening. Modi announced that the notes of Rs 500 and Rs 1000 "will not be legal tender from midnight tonight" and these will be "just worthless pieces of paper. PM also urged people to join this mahayajna against the ills of corruption. In an effort to combat corruption, tax evasion and counterfeiting, all 500 and 1,000 rupee banknotes are no longer recognized as legal tender. Electronic payment systems are convenient, fast and easy, but when a government imposes this decision on you, your economic liberty is debased. In a purely electronic system, every financial transaction is not only charged a fee but can also be tracked and monitored. Taxes can't be levied on emergency cash that's buried in the backyard. Central banks could drop rates below zero, essentially forcing you to spend your money or else watch it rapidly lose value. Inevitably, low-income and rural households have been hardest hit by Modi's currency reform. Barter economies have reportedly sprung up in many towns and villages. Banks have limited the amount that can be withdrawn. Scores of weddings have been called off. Indian stocks plunged below their 200-day moving average.

### What Is Demonetization?

Demonetization is the process of devaluing a piece of currency to zero. In other words, changing the value of a particular denomination of currency to nil, making it a piece of paper with absolutely no value greater than a regular piece of paper. Demonetization for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as a official mode of payment. According to Investopedia, demonetization is the act of stripping a currency unit of its status as legal tender. What was the reason? The reasoning given by Modi was: 1. To tackle black money in the economy. 2. To lower the cash circulation in the country which "is directly related to corruption in our country, " according to PM Modi. 3. To eliminate fake currency and dodgy funds which have been used by terror groups to fund terrorism in India. 4. The move is estimated to scoop out more than more than Rs. 5 lakh crore black money from the economy, according to Baba Ramdev, a staunch Modi supporter.

### Positive & Negative Impact of Demonetization

Impact on Black Money and Corruption: 'Black Money' or 'Dirty Money' is the money on which not tax is paid to the Government and it goes unaccounted in the duration of country tax assessment period which causes revenue loss to the government. It is argued that steps taken by the government of demonetization can help curbing black money in the country. Corruption will also be automatically reduced by removing black money from economy.

Source: SBI Research, RBI The Table depicts the public holding of high denomination notes worth Rs. 9926 billion as on march 2016. There are 3 scenarios in table. In scenario 1 and 2 it is assumed that 50% of the notes of higher the denomination do not return to the system. It is also reasonable to expect that 60% of Rs. 500 notes and 40% of Rs. 1000 notes would be exchanged at banks/ post offices and RBI before March 31, 2017. Based on such estimates, roughly round Rs. 4.5 lakh crore of money could disappear from the system.

**Impact on Counterfeit Currency:** The Biggest positive impact of the demonetization will be on the counterfeit/fake currency as it currently thrown out of the system fully.

**Impact on GDP:** GDP become down because circulation of currency is less because of cash crunch in the country. The GDP formation could be impacted by this measure, with reduction in the consumption demand. 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.

**Lower Inflation:** Inflation arises due to higher liquidity in the market. Because of demonetization there is less liquidity and less cash flow in the market that's why inflation becomes down. As the black money goes out of the system the money supply will shrink to some degree. This will reduce inflation rate in the Lower absence of any open market interventions by the Reserve Bank of India. Inflation is of four types.

Creeping Inflation (2% – 4%)

Walking Inflation (5% – 10%)

Galloping Inflation (10% – 20%) Hyper Inflation (more than 20%)

**Impact on Purchasing Power:** The move of demonetization has affected the purchasing power. This is mainly affect those assets that are used as long term investments like Real Estate, Vehicles and core sectors of cement and steel. The stock prices of the companies of these sectors will have a negative impact. Purchasing power of consumer is also affected due to the shortage of cash because 90% transactions taking place in cash in the Indian economy.

**Impact on Real Estate Sector:**

Demonetization smashed the real estate market and it will result in more than 50% drop down and it will remain for further 5 to 6 months. While the short-term impact is negative, Experts hoping that rate cuts in the coming months would boost home sales.

**Impact on Banks and Financial Institutions:**

The demonetization effects on banks will be both on the positive side and the negative side. However, In the long run it will be more on the positive side. As per directions of Government people have to deposit their money with the banks which will increase the liquidity of the banks for short term. This liquidity can be used by banks for lending purpose for long run.

As the liquidity of banks increases, they are expected to enhance the borrowing cycle by the lending money at lower rate of interest. However, the negative impact also as the earning of the banks will also take a hit for the next 2-3 quarters. We may not see loan bookgrowing as the banks will be busy in facilitating the demonetization process.

**Impact on Lending Rate:** Lending rate become down because of Banks getting money at Repo rate and banks lending money at Base Rate. In this situation Repo Rate become less and automatically Base Rate will become down and banks having sufficient money to lend so lending rate become down.

**Impact on Ecommerce:** Impact of demonetization on Ecommerce mostly bad, some good. For the online retail market, gross merchandise value (GMV) of players fell by 40-50% in first few weeks after demonetization, in the middle of their biggest quarter for sales. Things may remain bleak till March. Even high-value items like expensive smart phones are selling less. Products returned are up by 50%. And experts feel consumer sentiment wont improve quickly. But the boost to digital payments (100% jump in transactions) has led industry to hope for a bright medium term. Also, grocery and food delivery set-ups are doing better since they sell essential items. Some saw new customer orders jump to 25%, from the usual 15-16%

**Impact on Tourism:**

Cash Crunch badly hits the tourism sector. It is very difficult for people for getting the money from the banks and ATMs. The travel and hospitality industries are facing a tough time.

Peak tourism period of November-December badly hit. For tourist destinations beyond metros, business may be down by as much as 40%. Tourism business in metros may go down by 10%. Cash shortage at airports and hotels are a big

problem. And many national monuments entry points dont have card payments facilities. Western countries have issued advisories on cash Liquidity in India.

Online Transactions and others modes of payment: The Government wants to go cashless, Demonetization will have positive impact on digital transactions and other mode of payment.

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), UPI, EFTPOS, Net Banking Aadhar card, etc. will definitely see substantial increases in demand. This should eventually lead to strengthening of such systems and the infrastructures required

## II. CONCLUSION

In long run, there are some positive and some negative impact of demonetization but negative impact does not outweigh the positive impact of it. After the demonetization some sectors not affected like Pharma, FMCG, Education, Agriculture, Hospitals, Energy and Telecommunication From an equity market perspective, this move would be positive for Banking and Infrastructure sector in the medium to long term. This would be negative for Real Estates, Customer durables, Luxury items in the near to medium term.

Demonetization can lead to elimination of fake currency and corruption, it can be said that this is a historical step by the Modi Government and should be supported by all. This decision of Government will definitely fetch results in the long term this is the stepping stone towards/ for sustained economic growth in long run.

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