

Likely effects of demonetization: A quick preview

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Abstract

Recent implementation of the demonetization of high value currency notes of Rs. 500 and Rs. 1,000 by the Indian Government, comprising 86% of total running currency, caused a major change in the economic environment. It is therefore very essential to analyze the effects of the demonetization on the economy by this sudden step taken by government. This review paper explicate the likely effects of demonetization on different aspects like inflation level, position of fiscal deficit, GDP of the country, agriculture sector, banking sector, education sector, automobile sector, real estate market, gems and jewellery market and trend of online transactions *etc.* Additionally, a brief history of demonetization around the globe and in particular India is also elaborated herein.

Keywords: Demonetization; India; History; Likely Effects;

Introduction

Demonetization is the process to withdraw the particular type of currency from the circulation [1]. The old unit of currency lost its status as legal tender and it is retired and replaced with new currency units. India is not the first country to introduce the concept of demonetization but probably is the first one to observe this event at such a large scale where about 86% of the total running currency was demonetized (Figure 1).

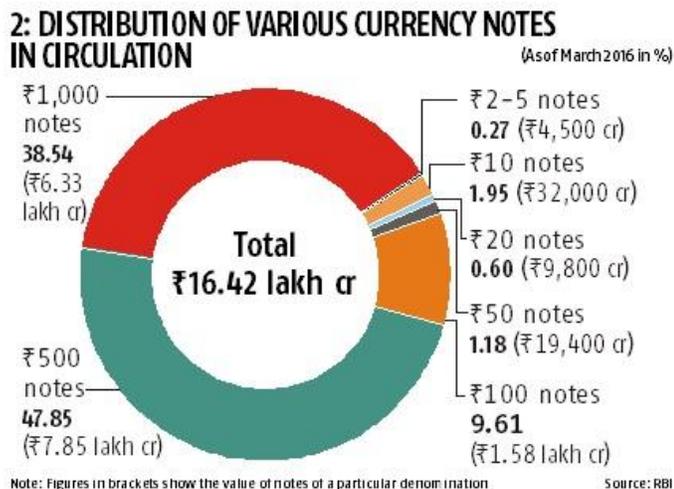


Figure 1. Distribution of various currency notes in circulation in India. Source-RBI

Many other countries had taken this step in the past. In order to monitor money laundering and corruption, Ghana-a West African country had demonetized their 50 cedi currency notes in 1982. For controlling corruption, Nigeria, a country on the coast of West Africa, in 1984 issued new currency notes with new features in order to render old notes unusable. In 1987, Myanmar also demonetized its 80% currency to put a check on black money. In order to remove black money and increase the currency value in 1991, Soviet Union (short for Union of Soviet Socialist Republics or USSR) removed 50 and 100 ruble notes from circulation which was around one third of the total running currency. North Korea, a country in East Asia, also tried demonetization of its currency in 2010. Zimbabwe in 2015 decided to replace its Zimbabwe dollar with American dollar [2].

On 8th November, 2016, Government of India declared the demonetization of high value currency notes of Rs. 500 and Rs. 1,000. The announcement was done by the Prime Minister of India through live telecast on television addressing to the nation. As per these orders, usage of all Rs. 500 and Rs. 1,000 banknotes was ceased from 9 November, 2016. New currency notes of Rs. 500 and Rs. 2,000 have replaced the old currency from 10 November, 2016. The main purpose behind this step was to put a check on unaccounted money or black money, fake currency as well as funding of terrorism.

History of Demonetizations in India

On 12 January 1946, demonetization occurred first time in India when currency notes of Rs. 500, Rs. 1,000 and Rs. 10,000 were ceased to be legal tender on the expiry of 12 January 1946 primarily to curb unaccounted or black money. At that time, the government collected Rs. 134 crores from the public out of total currency of Rs. 143 crores available in the economy which means that only Rs. 9 crores was not exchanged through demonetization [3]. So it was not considered much successful measure. The higher denominations were reintroduced in the year 1954 with banknotes of Rs. 1,000, Rs. 5,000 and Rs. 10,000. These banknotes of Rs. 1,000, Rs. 5,000 and Rs. 10,000 were again demonetized on 16 January 1978 primarily to control illegal transactions in the economy [4]. At that time these high denomination currency notes were worth Rs. 145 crores which was only 1.8% of the total currency value in the circulation [5]. So this move also did not create much impact. In January 2014, the Reserve Bank of India announced that all the bank notes which are printed before 2005 will be withdrawn from the economy. Customers could exchange their old currency notes with new from the banks for full value. Most recently on 8 November, 2016 Government of India has demonetized the banknotes of higher denomination *i.e.* Rs. 500 and Rs. 1,000. These two denominations account for approximately 86% of total currency in circulation, as per the RBI's Annual Report for the financial year 2015-16 [6]. The big difference is the size this time. Previous demonetizations have very less impact on common people but this time it is huge in size so definitely going to affect everyone.

Likely effects of demonetization

1. On Gross Domestic Product (GDP)

In India, around 95% transactions are carried out through cash [7]. Main reasons behind it are that it is easily accessible and it is certainly accepted everywhere. Main problem of cash transaction is its ambiguity which gives rise to unaccounted transactions. Due to demonetization many type of financial transactions which earlier were not covered for calculating GDP now would become a part of it. Just because now people have very less cash in their hands to spend, it is expected that GDP will fall in the next one or two quarters because of fall in the overall spending of people. Even people having cash in their hands will spend less money on different products because

of the fear of facing cash shortage ahead. But after some time when cash position will be restored in the circulation then demand will again rise to the same level to offset the negative short term effect of demonetization on GDP. One major aspect affecting the economy's GDP is the foreign investment. Such type of sudden moves of demonetization can create a fear in the minds of foreign investors also regarding reliability of Indian currency. They will hesitate to invest further in future in such type of economy where currency can be banned at any time. Because such type of act will slow down the GDP of the economy which will ultimately decrease their return on their investment.

2. Effect on Inflation

Inflation is the increase in the price level of goods and services over a given period of time. It is increase in the prices of the goods and services as compared to last year's prices rather than their quantity of production. Consumer Price Index (CPI) is considered as the best measure of inflation as per RBI which is the overall cost of basket of essential, semi-essentials and white goods. Food item inflation, measured by changes in the Consumer Food Price Index accounts for 47.3% of the overall CPI. Demonetization is expected to have a negative effect on inflation. Consumption expenditure has fallen. Now consumers are spending their money on consumer staples and healthcare products only. Slow process of re-monetization has decreased the demand and supply of food items in the market. This squeeze in demand by consumers because of less cash holdings, price level will fall leading to situation of deflation in the economy. But when the economy will be settled down in the long run then effect of demonetization will be neutralized.

3. Effect on fiscal deficit

Fiscal deficit represents the excess of total government expenditures over government revenues that it generates excluding the borrowings. As per an estimate by Global agencies, there is 23% black money in the economy which is a huge loss to economy [8]. Now due to Demonetization, hoarders will have to disclose their unaccounted cash holdings and have to pay tax and heavy penalty and these tax collections by government will help to reduce the fiscal deficit of the country. Beside this, few people will not disclose this black money with the fear of heavy penalty and legal consequences so they are left with the option of burning that money only. Because of this action, RBI would not be liable to return the same amount of currency which was earlier issued. This surplus amount will be transferred to Central Government. Implementation of GST (Goods and Service Tax) would increase the scope of organized sector. Single comprehensive indirect taxation system which will cover majority of goods and services will also increase the revenues of the Government. Thus, increase in receipts of Government from various sources will bring down the liability of fiscal deficit.

4. Effect on Banking sector

The biggest beneficiary will be the bank due to demonetization because they are the backbone of this entire process. With the old Rs.500 and Rs.1,000 notes becoming invalid, people are to deposit or exchange their old currency through banks. With increased amount of deposits in Current account as well as saving account liquidity of banks will increase. Banks usually do not pay any interest on Current account deposits and pay very less interest on Saving account deposits. In this way, Banks will be able to lend more money to the borrowers at low rate of interest. Further due to sufficient liquidity, banks will not have to be dependent on anyone for funds like loan from RBI or other commercial banks *etc.* In spite of so many private e-wallet players, banks are



considered more reliable for retail payments which means that banks will become the ultimate beneficiary of cashless position of the country.

5. Effect on Property and real estate

Demonetization will bring huge cash in banking sector through saving account system which will reduce the dependence of banking sector. Ultimately lending rates of banks are likely to come down. Thus, people who wish to buy their own house by taking loan from bank will be able to do so more economically. However demonetization will adversely affect unorganized builders which include local brokers *etc.* who sell plots, kothis and agricultural land *etc.* because they do most of their dealings through cash. Organized builders however will not be affected by this decision because proper rules are followed, fair prices are charged and clear declarations are made by them. In general, prices of real estate will show slow down because less cash holdings with people will decrease its demand as well.

6. Effects on Agriculture

Agriculture sector contributes India's 15% of total output where cash is the primary mode of dealing [9]. Different activities under agriculture like purchase of seeds, fertilizers and farm equipments as well as payment to workers, transport, marketing and sale of produce are all cash dependent activities. Due to Demonetization the farmers are not able to perform all these activities properly. Perishable farm products like fruits and vegetables which is a major share of farm output, can't be stored for long time so farmers have to sell them out at even low prices due to cash crunch. Financial help was provided to farmers by the government through cooperative banks, where exchange-deposit of demonetized currency is not permitted. Although in order to help farmers, government raised the limit of cash withdrawal for farmers up to Rs. 25,000 which was only Rs. 2,000 for others, but that was not sufficient for the farmers because of much crowd in the banks as well as shortage of cash in banks also.

7. Effects on Auto Industry

Temporary disruption will be felt by auto industry due to the ban of currency notes. Two-wheelers sale could be slow down mainly in rural areas since most of these transactions are done through cash. Even there is no need to show Permanent Account Number at the time of buying a Two-wheeler while it is mandatory to disclose when buying large vehicles. The unorganized market where used cars are sold is also going to feel the heat of demonetization because major payments of such transactions are also done in cash from uncounted money and because it will be difficult for the people to sell out their old vehicles, it will bring down the demand of new vehicles also. Dealers must be very upset due to fall in demand because delay in buying decisions will left a huge stock of unsold cars which will be carried forward to next year and obviously reduces its value being an old model.

8. Effect on Education sector

No area or sector is unaffected by demonetization so its heat is also felt by education sector. The decision of Demonetization would have positive impact on the students while it would have adversely affected those educational institutions who accept donations or capitated payments from students. So called “management quota seats” will be available to meritorious students who deserve those seats instead of those who can buy those seats, without any caliber, with their unaccounted money by giving huge amount of cash as donation . However, this situation is going to linger on for a year or two. After that some other way will be founded by these institutions to collect money. It is also doubtful that admission without donation may negatively affect the quality of education. Those students who are aspirant to study in abroad may also face trouble because most of their expenses are met by this accounted money only.

9. Effect on Gems and Jewellery

With the announcement of demonetization, the purchase of gold and jewellery items was substantially increased just to get rid of old currency notes. Around 15 tones of the gold was sold in the informal market between 6 to 7 hours from the announcement of demonetization. A price hike up to Rs. 55,000 per 10 grams of the gold was reported against the normal price of about Rs. 31,000 [10, 11]. This momentary spike in the gold price soon dropped down as people were unable to purchase yellow metal with cash crunch in the domestic market, uncompromised and inflexible PAN card requirements and tax evasion fear (Figure II).

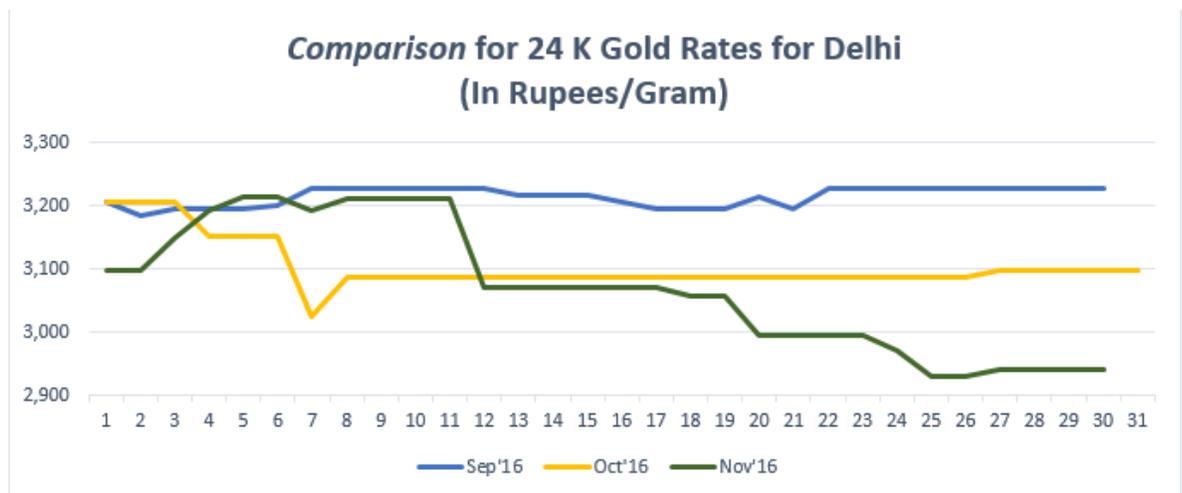


Figure II. Comparison of Gold rates in the months of September, October and November, 2016. Source-<https://www.bankbazaar.com/gold-rate-delhi.html>

But the demand for gems and jewellery is likely to fall in future because majority of the people invest their unaccounted or black money in such type of things. Unorganized segment of these articles will definitely face a hard time, at the cost of which organized segment will get benefit where people invest their white money. Demonetization will have very less impact on jewellery exporters because it is done through organized market and sales are done only against bills and invoices. Future of gold industry will have bright prospects because people will consider gold as



more trust worthy than currency notes. 70 % market of jewellery and gems are unorganized, only 20 % of the organized market contributes to 80 % of the business. For long run, demonetization will be a very beneficial decision for organized jewelers [12].

10. Effect on online transactions

Central government's decision of demonetization will give a major push to e-wallets. Trend of online transactions and e-wallets has grown up already and cash transactions are facing a decline. People have started following digital transaction systems, e-wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. Recently launched UPI (United Payment Interface) an interoperable system launched by the Reserve Bank of India (RBI) and the National Payments Corporation of India (NPCI) and other e-wallets like paytm, freecharge and Mobikwik etc. are likely to get major boost because of demonetization. Various e-wallet companies are trying to attract the people through their aggressive advertisements and taglines like "ATM Nahi, Paytm karo" so that usage of digital wallets can be increased as a way of moving towards a cashless economy. Apart from this, various other companies are also trying to get benefit of this move taken by government by using different strategies like Ola passing message to its passengers "Recharge Ola Money now and you don't have to worry about carrying any notes, whether 500 or 1000. Ride cashless".

Conclusion

In conclusion, demonetization is a very bold, farsighted and appreciable step taken in national interest by the Indian Government which can help to curb black money, corruption and funding of terrorism but it is just a possibility, no facts and figures are available to support this hypothesis at this early stage. Here it seems not to be properly planned step because most of the Indians live in villages. Banks and ATMs are too far away for them to access. Majority of them follow cash as the only medium of exchange. Even maximum of the labor or lower middle class people living in urban area also do not have debit or credit cards. Beside these, another major problem was the bigger denomination of new currency notes i.e. Rs. 2,000 because no one was ready to change it for smaller denomination. Brilliance of this great move has been reduced due to its bad implementation. However success of this move could be reckoned from the actual number of Rs. 500 and Rs. 1,000 notes received back by the banks. Despite of all this, it is expected that demonetization will be proved as a historic step and will definitely contribute towards the development of the country.



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