Impact of Demonetization (Cash Shock) on Economy

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***Abstract*: Block money and corruption are the vicious incentive structure in the Indian economy. This effects adversely and led many social, unethical and economic struggles in the country. This block money is the biggest crisis that erosion in human values. Eradication of corruption answers many social and economic evils. Demonetization was the step taken by government of India against corruption posits that the cashless would extinguish the block money. Therefore, the present paper, evaluates the impact of "demonetization or cash shock" on the Indian economy.**

***Keywords*: Block money, demonetization, cashless transactions, corruption, credit, tax evasion**

I. INTRODUCTION

Demonetization (cash shock) is the act of stripping a currency unit of its status as legal tender by central bank. Reserve Bank of India, central bank in our country, had withdrawn the old Rs 500 and Rs 1000 notes as an official mode of payment on November 8, 2016. The government of India had executed a major change in the economic environment by ceasing the high value currency notes – of Rs 500 and Rs 1000 denomination. 86% of country's currency was nullified in a great cash shock effort that aimed to clean out the black market's cash supply and counterfeit notes which completely disrupted the social, political, and economic spheres of the world's second largest emerging market. People had been given up to December 30, 2016 to exchange their old notes held by them. The proposal by the government involves the elimination of these existing high value currency notes from circulation and a gradual replacement with a new set of Rs. 500 and Rs. 2000 notes. In the short term, it was intended that the cash in circulation would be substantially squeezed since there were limits put on the amount that individuals can withdraw.

II. REASONS FOR DEMONETIZATION

The reasons for demonetization of currency notes given by Prime Minister Sri Narendra Modi were:

1. To tackle the black money more than Rs 5 lakh crore in the economy.
2. To lower the cash circulation in the country this is directly related to corruption.
3. To eliminate fake currency and dubious funds which have been used by terrorists groups to fund terrorism in the country?
4. To control escalating price rise and
5. To make a cashless society and create a Digital India.

This recent attack of cash shock was planned in secret by a small, tight-knit group led by Prime Minister, and it overtook the country like a flash flood. There is a great background effort to the current decision of demonetization of 500 and 1000 rupee notes. The government had taken two major steps in this direction much before its cash shock announcement.

- The first and foremost step, the government had advised people to open bank accounts under Jan Dhan Yojana and asked to deposit all the money in their Jan Dhan accounts and do their future cash transactions through banks only.
- The second step that the government initiated was a tax declaration of the income and had given October 30, 2016 deadline for this purpose. Through this method, the government was able to mop up a huge amount of undeclared income.

However, there were many who still hoarded the black money, and in order to tackle them; the government announced the demonetization of 500 and 1000 currency notes.

Government's demonetization decision rooted an unexpected crash in India's commercial ecosystem. Trade across all parts of the economy was disordered, and cash-centric sectors like agriculture, fishing, and the voluminous informal market were virtually shutdown, with many businesses and livelihoods going under completely -- not to mention the economic impact of millions of people standing in line for hours to exchange or deposit cancelled banknotes rather than their routine personal works i.e. working or doing business.

The demonetization policy is being seen as a financial reform in the country but this decision is backed with its own merits and demerits.

Merits

By demonetizing the old currency notes, the government of India is expected the following advantages:

- With the demonetization policy, it is possible to become India corruption-free.
- Officers those indulging in taking bribe will refrain from corrupt practices as it will be tough for them to keep their unaccounted cash.

- This move will help the government to track the black money. Those individuals who have unaccounted cash are now required to disclose income and submit their PAN for any valid financial transaction. The government can get income tax return for the income on which tax has not been paid. Revenue to the government will be enhanced.
- Restraining high-value currency notes will stop funding in criminal activities like terrorism etc.
- This ban on high value currency will also control the peril of money laundering (making illegal into legal). This move helps the government in tracking such people who are engaging money laundering activities.
- Most of the fake currency notes put in circulation in the form of Rs. 500 and Rs.1000 notes. This move eliminates the fake currency circulation in the economy.
- The demonetization policy will force people to file income tax returns. Most of the people who have been hiding their income are now forced to come forward to declare their income, file returns and pay tax on the same.
- Even though deposits up to Rs 2.5 lakh will not come under Income tax scrutiny, individuals are required to submit PAN for any deposit of above Rs 50,000 in cash. This will help the income tax department to track individuals with high denominations of currency.
- The ultimate objective is to make India a cashless society. All the monetary transaction has to be through the banking methods and individuals have to be accountable for each penny they possess. It is a giant step towards the dream of making a digital India. If these are the merits, there are demerits of this policy as well.

Demerits

- The announcement of the demonization of the currency has caused huge inconvenience to the people. The sudden announcement has made the situation become hectic. Tempers are running high among the masses as there is a delay in the circulation of new currency.
- This cash shock has highly affected normal business. The entire economic activities have declined.
- Many daily wage workers lost their jobs and their daily income because inability of employers to pay their daily wages.
- This became very hard to implement the policy to the government. The circulation of Rs. 2000 new currency notes became difficult to transact.
- There was a criticism that the policy helping people to use black money more easily in future.
- Some people have silently rejected the policy.

It was interesting that people were chosen different techniques for exchanging and transforming their black money in to white. Some of these methods are as follows –

- Deposited old currency notes (block money) in their poor relatives and friends' accounts.
- Enticing the people with some percentage of money for exchange.
- Asked or ordered their workers to stand in the long queues in front of Banks and ATMs for exchange of money.
- Hired people and paid money ranging from Rs 500/- to 700/- per day for becoming the part of long queues in front of banks/ ATMs.
- Purchased gold and tried to convert the black money in to white.
- Institutions Paid advance salaries to their employees.
- Paid back loans forcibly.
- Used their influence / links with bank employees by paying commission and exchanged old notes in with new notes illegally.

III. EXPERTS' OPINION ON THE POLICY

Almost all the stalwarts of the banking sector including Deepak Parekh, Chanda Kocchar think that the move will help curb black money in the economy.

According to MD & CEO, ICICI Bank Chanda Kochhar who told ET Now, "this move will definitely bring about a whole amount of transition to no cash or low cash kind of transactions".

Narayana Murthy, founder of the Infosys welcomed the government's move in its fight against corruption. Murthy also added that "the dishonest will have to suffer; absolutely that is the right thing."

HDFC Chairman Deepak Parekh anticipated that the Land will become cheaper and "one expects that real estate price will come down in medium term."

Former Prime Minister Manmohan Singh who is a noted economist, former RBI governor and former Finance Minister of the country, names the demonetization move as an 'organized loot and legalized plunder'.

IV. OBJECTIVES OF STUDY

The following are the main objectives of the present study.

- To examine the past experience of demonetization in India and in abroad.
- To review the impact of demonetization on nation's economy.

V. METHODOLOGY

The present paper is based on only secondary data. The data so required has been collected from various websites, news papers. Tables and graphs are used to present the information, where necessary.

VI. PAST EXPERIENCE OF DEMONETIZATION IN INDIA

In the month of January 1946, the government of India banned Rs. 1000 notes and gave time for exchange them. Availability of high denomination notes in the market accounted to 3 per cent of the total circulation representing Rs. 143 crores, it didn't affect the normal life of the people. With this decision government collected Rs. 134 crore out of the total and the remaining Rs. 9 crores were not exchanged. This move turned out like a currency conversion drive as the government didn't achieve much of profit in the cash-strapped economy at that time.

In 1954 the government had reintroduced Rs. 500, Rs. 1000 and Rs. 10000 notes. The Wanchho Committee (1969) strongly recommended the government to withdraw all high denomination currency. But then prime minister Smt. India Gandhi refused this recommendation.

In 1978 when Janata Party government led by Morarji Desai announced withdrawal of high denomination notes based on the recommendations of Wanchoo Committee (1969). This demonetization was failed because there were spread of rumours about the demonetization (decision was leaked).

VII. PAST EXPERIENCE OF DEMONETIZATION IN OTHER COUNTRIES

United States of America (1969)

US President Richard Nixon announced all bills above $100 null and void due to existence of black money in the nation which led the country losing its reputation on Silicon Valley. This move was success; even today $100 bill is the maximum available for circulation in USA.

Ghana (1982)

In 1982, Ghana abandoned their 50 Cedis note to attempt the tax evasion and address corruption and wash out the excess liquidity in the economy. The country's economy became unhealthy as the move gradually destroyed the confidence among people in the banking system and they started investing in physical assets instead.

Nigeria (1984)

During the government of Muhammadu Buhari in 1984, Nigeria introduced new currency and banned the old notes to control corruption in the country. The government issued different colour banknotes and forced people to replace their old notes with new ones within a limited period. However, this move was one of a series that failed to fix a debt-burdened and inflation-ridden economy

Myanmar (1987)

In 1987, army government quashed nearly 80 per cent of the value of money in circulation to restrain the black market. This action deepened the country's economy and encouraged mass protests lead to killed many people and caused fall down of the government.

Soviet Union (1991)

The government led by Mikhail Gorbachev, in January 1991, extracted large-Ruble bills from circulation in a move to tackle the black economy. The reform failed to arrest the inflation in the country and condensed the confidence in the government among the public and led to economic fall down. With the revolution raised in the month of August, Gorbachev lost his authority and this movement led to the break-up Soviet Union in the following year

Australia (1996)

To restrain the black money crisis and improve security features on the notes, the government withdrew all paper-based notes and replaced them with long life polymer-based notes of the same denomination. This move improved the life of the bills and helped in making Australia a business friendly country, despite the initial costs incurred to manufacture polymer-based notes.

North Korea (2010)

The then dictator of North Korea Kim Jong-IL removed two zeroes from the currency denominations to control black money menace and tightly control the economy. This decision was miserably failed due to high inflation. This move was highly criticized by the International Media, making the dictator to apologize in the public.

VIII. IMPACT OF CASH SHOCK ON ECONOMY

A sudden cash shock washed out nearly 86 per cent of cash circulation in the economy at once affected adversely. The economic activities in the country were clogged-up. The following impacts on the economy are observed and presented in the following lines.

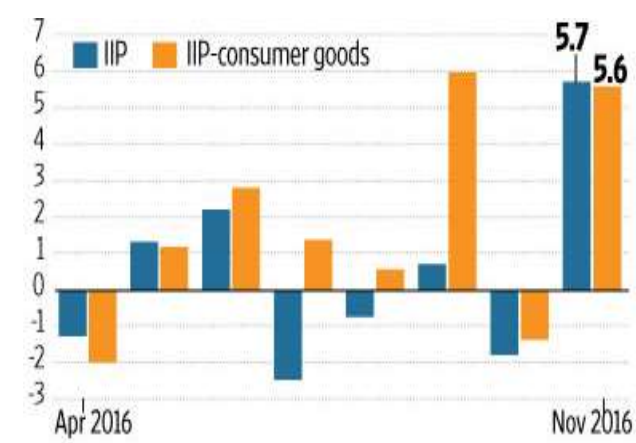
Effect on GDP: This move affects the GDP formation with reduction in the consumption demand. Annual Growth Rate of nation's GDP is expected to be 6.50 percent by the end 31 March, according to Trading Economics global macro models and analysts expectations. This organization estimated the GDP Annual Growth Rate in India to stand at 7.10 in 12 months time. In the long-term, the India GDP Annual Growth Rate is projected to trend around 5.70 percent in 2020.

Forecast	Actual	Q1/17	Q2/17	Q3/17	Q4/17	2020
GDP Annual Growth Rate (%)	7.3	6.5	6.5	7	7.1	5.7
Source: www.tradingeconomics.com and Ministry of Statistics and Programme Implementation (MOSPI)						

Effect on Index of Industrial Product (IIP):

It was expecting the index of industrial production (IIP) to partially arrest the impact of demonetisation on industrial production as the move was announced. IIP rose 5.7 per cent in the month of November, the month demonetisation was announced, driven by a positive base effect, from a contraction of 1.9 per cent the previous month October, shrugging off the initial impact of demonetisation.

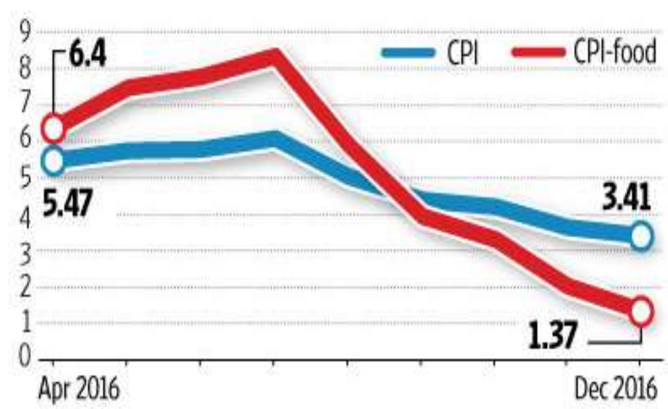
November was the first month of demonetisation, though not fully since the decision was announced by prime minister Narendra Modi on 8th November. When the IIP data is put side by side with that for the previous month, it is obvious that there has been a decline. The IIP general index read 175.8 for November, down from 178 in October. Based on this it is expected that the IIP may decline in the month of December 2016.



Source: Central Statistics Office

Inflation:

Inflation fall in December 2016 to 3.41 per cent against 3.63 per cent in the month of November, the lowest since November 2014, it is now convincingly within the RBI's comfort zone of 4 per cent, leaving room for the Reserve Bank of India to cut rates next month. However, a look at the underlying causes would reveal that the fall was triggered mainly due to a slowdown in purchases caused by the cash shock than anything else. For instance, food price inflation stood at 1.37 percent, as purchases of many items were hit due to the inability of people to buy. Seasonal factors due to soft winter prices coupled with weak purchasing power due to the cash shock. Vegetables, being perishable in nature, aided the fall in overall inflation rate. "Inflation in vegetables, which accounts for 6 per cent in the consumer price index (CPI) basket, declined 14.6% YoY (11.7% MoM) in December 2016. Consequently, CPI inflation excluding vegetables was unchanged at 4.8% in the last two months.



Source: Central Statistics Office

Banks Deposits

Cease of Rs. 500 and Rs. 1000 notes from legal tender, people deposited or exchanged their old currency in banks (subject to certain limits). This move led to Rs.13.78 crore 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.

Interest rates:

With demonetization, people were deposited money into banks. This means banks had more liquid funds and more money to lend. With this many banks also reduced their interest rates including SBI, ICICI Bank, HDFC Bank up to 1 per cent.

Effect on Money Supply and Liquidity:

Move initiated to cease Rs. 500 and Rs. 1000 notes hit the supply of money, to the extent of black money, and movement of goods and services for the short period, until the new Rs. 500 and Rs. 2000 notes get widely circulated in the market. This situation continues for short period and money supply and liquidity will pick up gradually as the new notes get circulated in the market and bridged the gap between the demand and supply of money.

Method of Payment:

The move cash shock reduces the money circulation in the economy in coming days; demand for alternative forms of payment will be increased. The government of India created awareness on Digital Payment System (DPS) among the public with help of non-governmental organizations (NGOs). Many business units installed point of sale (POS) machines. In coming days there is a significant increase in demand for e-transactions like e-banking, e-wallets and mobile applications (apps). This change in economy will strengthen the transactions through digital system.

IX. CONCLUSION

With the cash shock, transactions of other sections of the economy affected adversely. Agriculture and related sector, Small traders, Micro, Small and Medium Enterprises (MSMEs) Services Sector Households Political Parties Professionals like doctor, carpenter, utility service providers, retail shops etc., were highly disturbed in facilitation of their transactions. The government is expected that there are only advantages of demonetization policy and this will be seen in the long term. The RBI government is taking all required steps to overcome the cash shock. Once the sufficient quantity of currency flows in the economy it could have a meaningful impact on various sectors of the economy.

From the past experiences in the country and different countries, however, shows that this move will lead to increase the debt burden and inflation in the country. By comparing the merits and demerits, it will be expected and concluded that the former offsets the latter.

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