

Demonetisation in India : A Critical Study

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Introduction

On the 8th of November, 2016 when the sun had descended below the horizon and the light of day had completely faded, when people were returning back home from a long day at work, a misty light of a new economy was brewing over the country. All ₹500 and ₹1000 banknotes of the Mahatma Gandhi Series ceased to be legal tender in India from 9 November 2016.

The government claimed that the demonetisation was an effort to stop counterfeiting of the current banknotes allegedly used for funding terrorism, as well as a crack down on black money in the country. The move was described as an effort to reduce corruption, the use of drugs, and smuggling.

However, in the days following the demonetisation, banks and ATMs across the country faced severe cash shortages. Also, following Modi's announcement, the BSE SENSEX and NIFTY 50 stock indices crashed for the next two days.

INDIA'S PAST EXPERIENCE WITH DEMONETISATION :

India has carried out demonetization exercises twice before, in 1946 and 1978. In Jan 1978 episode, currency worth INR 1.46 bn (1.7% of total notes in circulation) was demonetized. Of this INR 1.0 bn (or 68%) was tendered back.

In 1978 the value of demonetisation was very small (only 0.1% of GDP). However, the 2016 demonetisation was 11.2% of GDP.

RBI DATA REGARDING DEMONETISATION;

1. On November 8, 2016 there were 1,716.5 crore pieces of Rs 500 and 685.8 crore pieces of Rs 1,000 in circulation, totalling Rs 15.44 lakh crore.
2. Post-demonetisation RBI spent Rs 7,965 crore in 2016-17 on printing new Rs 500 and Rs 2,000 and other denomination notes, more than double the Rs 3,421 crore spent in the previous year.
3. RBI said just 7.1 pieces of Rs 500 note per million in circulation and 19.1 pieces of Rs 1,000 notes per million in circulation were found to be fake.
4. RBI said 8.9 crore pieces of Rs 1,000 notes or 1.3 per cent of the scrapped ones have not returned. The actual number of old 500 rupee notes that were returned has not been specified.
5. RBI said its income for 2016-17 decreased by 23.56 per cent while expenditure jumped 107.84 per cent. The year ended with an overall surplus of Rs 306.59 billion as against Rs 658.76 billion in the previous year, representing a decline of 53.46 per cent.

6. RBI said there are as many 588.2 crore of Rs 500 notes, both old and new in circulation as of March 31, 2017. As of March 31, 2016, there were 1,570.7 crore Rs 500 notes in circulation.
7. As many as 328.5 crore pieces of new Rs 2,000 notes were in circulation as on March 31, 2017.
8. Besides, new Rs 500 and Rs 2,000 notes, the RBI has also circulated new Rs 200 notes last week.
9. While stating that Rs 15.28 lakh crore have come already come back, the RBI said the government has allowed District Central Cooperative Banks (DCCBs) to deposit the scrapped notes accepted by them from their customers during November 10 to 14.
10. Banks, financial institutions and intermediaries reported as many as 4.73 lakh suspicious transactions in 2016-17 compared to about 1.06 lakh in the previous year.

Impact of Demonetisation on the Economy:

On GDP Growth :

India's GDP which grew at 7.6% in FY 2015-16 is likely to **slow down by 0.5% to 1.5%** as per reports of various agencies. This is due to less availability of cash in **cash-intensive sectors like manufacturing and real estate**. Even the automobile industry which was growing rapidly earlier has seen a contraction in the October-December quarter of 2016. Purchasing power of consumers has been negatively affected due to cash not being readily available.

We need to remember that Indian economy is largely cash driven with **more than 90% transactions taking place in cash** and digital transactions accounting for just the remaining 10 percent.

Banks have also been focusing on the single task of deposit and withdrawals with the result that their **core function of issuing loans has been adversely affected**. Also current account customers, who are largely business owners, need large amounts of cash at short notice have not been able to access cash and credit owing to restrictions on withdrawals and inability of banks to focus on the task of issuing loans.

On Tax Compliance :

India's **tax-to-GDP ratio is quite low at 16.6%** compared to other emerging economies. It is estimated that since more money, including black money, gets accounted for this will lead to **better tax compliance** owing to better targeting of income. The positive impact could be **lower tax rates as the tax base widens** and more people start paying taxes. The digital push of the government will also result in **higher indirect tax revenue** for the govt. in the form of service tax. Moreover businesses that under-reported their revenue earlier, will have to make proper disclosure, especially, of revenue received through digital or cashless means.

On Small and Medium-sized Enterprises (SMEs):

The labour wages in this sector are largely paid in cash and **wages have been adversely affected** by the demonetisation move. Unemployment has also been reported owing to decline in demand of SME goods as the purchasing power of the consumers has contracted in the short term. Other sectors within the SME space like **restaurants and transport operators have also been negatively impacted** since economic activity has declined and also due to the fact that there is high tendency in this segment to accept payments through cash only.

On Agriculture :

This is one sector where all transactions are in cash and, given the values involved, involve the higher denomination notes. The withdrawal of the old currency notes has put **pressure on the mandis**; farmers are having problems in selling their produce as both the parties have to agree on the mode of payment. Also since there is acute shortage of Rs 500 denomination notes presently, **change for the high denomination Rs 2000 notes is not readily** available with the vegetable and fruit vendors. This is also taking the buyers away from these vendors to big retail markets thus impacting the livelihood of the unorganised sector.

On Employment Generation :

Since consumer demand has slowed and consequently industrial production has declined, **employment generation has been adversely impacted** by the currency demonetisation drive. Since the manufacturing sector which accounts for the highest employment of skilled and semi-skilled labourers, is witnessing slowdown in production; not only less jobs are being created but lay-offs are also taking place at a higher rate.

As many as 4 lakh people, mostly daily wagers, may have either lost their jobs or shunned work temporarily due to the lack of payment so far, and the number is only going to grow if the cash crunch persists.

Impact of Demonetisation on Black Money :

As outlined in the first post on What is Demonetization of Currency, fighting black money rampant in the economy was one of the foremost objectives of this entire exercise and we will discuss in detail whether this objective was realised or not.

If you read the above post, you will know that **cash component forms just 6% of the black money** in the Indian economy and currency demonetization will target just this 6% black income. If various reports are anything to go by, **most of this black income has been converted into white** by depositing it in Jan Dhan accounts, depositing in individuals own accounts by breaking into smaller chunks, by exchanging for new currency notes through hawala dealers, by buying last-minute luxury items like jewellery and high priced mobiles, by paying advance wages to employees etc.

This is supported by the fact that almost the entire amount of Rs 14.18 lac crores in Rs 500 and Rs 1000 currency denominations lying with the public has returned to the banks at the time of writing this post. This implies that the dividend which the govt. has been hoping for by way of 2-3 lac crores not returning to the banking system (since it is black money and/or counterfeit currency) has turned out to be a mirage.

Also as per various announcements by the govt. from time to time that deposits by housewives and those exempt from tax will not be scrutinized has provided a way out for black money hoarders to convert their money into white.

However there have also been some positive impacts like one time **removal of counterfeit or fake currency from the economic system**. Some people argue that since black money has reduced, prices of black money intensive sectors like real estate and gold jewellery will go down. This remains to be seen.

But demonetisation cannot and will not prevent future generation of black money since black money problem is more of a cultural mindset in India than a legal problem.

It will also be easier for the corrupt and black money hoarders to deal in Rs 2000 currency notes as compared to Rs 500 and Rs 1000 notes since higher currency value can now be carried with greater ease.

A total of **Rs 3185 crores in black money of which Rs 86 crores in new notes** has been seized by the Income Tax authorities since the launch of the demonetisation drive on 8th November. This implies that on the one hand black money is getting unearthed and on the other **leakage of new currency notes is taking place**; most probably through the banking system itself.

Impact of Demonetisation on Cashless Transactions :

As already explained above that cashless transactions account for only 10% of all transactions on daily basis. The government in order to divert some of the blame for the poor implementation of this demonetization exercise announced mid-way that making India a cashless or less cash economy was one of the important objectives of this demonetization drive. Towards this end, the Finance ministry, RBI and NITI Aayog announced a **host of incentives to boost cashless transactions**. This was also done to ease some of the problems that have resulted due to acute shortage of cash in the economy.

Conclusion :

Demonetisation of old currency notes surely has had **some positive impact** like reducing the cash flow to terror organisations, dismantling of counterfeit currency infrastructure, better income tax and indirect taxation, boost to digital economy. However, it has come at a huge social and economic cost. Sandeep Dongre writes that demonetization costs are estimated at Rs 1.28 lakh crore to the economy for the 50-day time period till the end of depositing period of old currency. This includes a cost of Rs 17,000 crore towards the government and the RBI for implementing the demonetisation process in India.

Demonetisation is a **one-time event and will not have much long term effect.** It alone is not sufficient to counter black money and corruption in the country; rather other measures are more crucial like bringing the offshore tax evaders to book whose names figure in the Panama papers, raid on benami properties, making donations to political parties open to public scrutiny and making it mandatory for all donations above Rs 2000 to political parties and religious places to be through digital means only.

This entire exercise seemed more like a **carpet bombing than a surgical strike** where the vast majority of honest and law abiding citizens had to undergo terrible hardships in order to catch the few black sheep who have hoarded black money and who also managed to convert their black income into white.

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