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Demonetization and Indian Economy: A Beginning of New Land of Opportunity

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ABSTRACT

It was 8th of November 2016 the Government of India took the whole country by blizzard by announcing that the currency notes of Rs 500 and Rs 1,000 would be no longer legal tender. However, the whole isometrics of moving from cash-driven economy to cashless economy has somehow been assorted with demonetization that was aimed to extract liquidity from the system to unearth black money.

A report by Boston Consulting Group (BCG) and Google India revealed that last year around 75 per cent of transactions in India were cash-based, while in developed nations such as the US, Japan, France, Germany etc. it was around 20-25 per cent. The depletion in cash due to demonetisation has pushed digital and e-transactions to the forefront; e-banking, e-wallets, and other transaction apps becoming prevalent.

Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc.

The Objectives of the paper are to produce:

1. *Demonetization and its Short term and long term impacts on Indian economy.*
2. *Demonetization and its Consumption and investment, impacts on Indian economy.*
3. *Demonetization and Welfare and growth impacts on Indian economy.*
4. *Demonetization and its Impacts on bank deposit and interest rate.*
5. *Demonetization and its Impacts on black money.*

Introduction

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency: The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with new currency.

The opposite of demonetization is remonetization, in which a form of payment is restored as legal tender**.**

There are multiple reasons why nations demonetize their local units of currency:

1- To combat inflation
2- To combat corruption and crime (counterfeiting, tax evasion)
3- To discourage a cash-dependent economy
4- To facilitate trade

India's Demonetization in year 2016

In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denominations in its currency system; these notes accounted for 86% of the country's circulating cash. With little warning, India's Prime Minister Narendra Modi announced to the citizenry on Nov. 8 that those notes were worthless, effective immediately – and they had until the end of the year to deposit or exchange them for newly introduced 2000 rupee and 500 rupee bills.

Chaos ensued in the cash-dependent economy (some 78% of all Indian customer transactions are in cash), as long, snaking lines formed outside ATMs and banks, which had to shut down for a day. The new rupee notes have different specifications, including size and thickness, requiring re-calibration of ATMs: only 60% of the country's 200,000 ATMs were operational. Even those dispensing bills of lower denominations faced shortages. The government's restriction on daily withdrawal amounts added to the misery, though a waiver on transaction fees did help a bit.

Small businesses and households struggled to find cash and reports of daily wage workers not receiving their dues surfaced. The rupee fell sharply against the dollar.

The government's goal (and rationale for the abrupt announcement) was to combat India's thriving underground economy on several fronts: eradicate counterfeit currency, fight tax evasion (only 1% of the population pays taxes), eliminate black money gotten from money laundering and terrorist-financing activities, and to promote a cashless economy. Individuals and entities with huge sums of black money gotten from parallel cash systems were forced to take their large-denomination notes to a bank, which was by law required to acquire tax information on them. If the owner could not provide proof of making any tax payments on the cash, a penalty of 200% of the owed amount was imposed.

Short-term impacts of Demonetization

There will be a disruption in the current liquidity situation as households are likely to get affected by the note exchange terms laid by the government. Though clarity is unfolding on this, commodity transactions and general cash market transactions are likely to feel an immediate impact.

Unorganized sector proceedings, including small trade market activities, will remain volatile in the short-term. Roadside vendors, cab drivers, kirana stores, etc., have already stopped accepting Rs 500 and Rs 1,000 notes. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which is likely to be affected by immediate liquidity issues. Overall, negative impact on disposable income is expected along with likely disruption in the consumption patterns of the general populace.

It is estimated that there will be a negative GDP impact in the current quarter as consumption gets a shock in the immediate term. However, quantum and degree of this impact cannot be ascertained at this time.

Long-term impacts of Demonetization

This essentially represents a change in regime for the real and financial economy. Domestically, there could be some turmoil as the effect will be disproportionately felt by the lower and upper income classes. Internationally, the government is likely to get a thumbs up for the move and more countries could potentially see this as a viable option to curb black money and stem illegal financial activity.

Last, though this move by the government may not be a first, having being tried by earlier governments as a tool to fight corruption. Such an action achieves larger significance for a globally connected India as it shows boldness in tackling an issue which has remained a thorn in the growth success story of this generation.

Demonetization: The impact on agriculture

Reports of stress in agriculture have begun to appear because of demonetization. Cash is the primary mode of transaction in agriculture sector which contributes 15% to India’s total output. Formal financing in many parts, especially Punjab, Uttar Pradesh, Odisha, Maharashtra, Gujarat and Kerala is significantly from cooperative banks, which are barred from exchange-deposit of demonetized currency. Notably, this is a time of kharif harvest and start of rabi sowing, partly explaining why this period is dubbed the ‘busy season’ from a standpoint of credit demand, the other being bunching of festivals and weddings.

Agriculture is affected through the input-output channels as well as price and output feedback effects. Sale, transport, marketing and distribution of ready produce to wholesale centres or mandis, is dominantly cash-dependent. Disruptions, breaks in the supply chains feedback to farmers as sales fall, increased wastage of perishables, lower revenues that show up as trade dues instead of cash in hand and when credited into bank accounts with limited access affect the sector.

Currently, many of these networks are operating sub-optimally or altogether at a standstill, depending upon location, market links and other item-specific factors. The input side is equally affected as many payments/purchases, such as seeds, fertilizers, implements and tools, are outright in cash. Borrowing-financing operations of larger farmers and organized producers are also cut off or severely clipped.

The impact is visible in different sub-segments. Winter crops such as wheat, mustard, chickpeas are due for sowing in a fortnight. Wheat prices were already up due to low stocks and anticipated shortfall in 2015-16 output and have firmed up further as demonetization fallout pushes traders to build more inventories. Production in 2016-17 could drop if sowed acreage (rabi) reduces for want of enough seeds on time to exploit the adequate soil moisture. Yields could fall from late sowing and subsequent exposure to rough spring weather, the lack of sufficient or timely application of fertilizers, pesticides, etc. Farm labour, vital for this period, is reported to be unpaid as farmers have no cash. Many of them are reported to be returning from some northern parts to homes in UP and Bihar. Labour shortages and wage-spikes may follow with a lag.

Plantation crops such as rubber, tea, jute, cardamom are seeing no wages paid to workers. Small-medium tea growers have few buyers now (a third of the tea was unsold in recent auction in the south). Raw jute trade is halted as paucity of funds affects procurement-delivery by traders. Projections of scarcity have appeared with appeals for official procurement support. Cotton is witnessing havoc: daily arrivals have plunged to 30,000-40,000 bales against the usual 1.5-2 lakh bales at this time (harvest) as per reports and prices have soared 9% in a week, pushing up global prices in turn.

Vegetables and fruits that along with crops added 61% of agriculture’s gross value added in 2015-16, depends critically upon a cash-strapped transport sector for daily supply network. Sales have dropped sharply (25-50%) across markets with occurrences of dumping. At present, demand is repressed for want of currency, so prices are subdued, but eventually, supply shortages could cause prices to rise.

How long can the demonetization drag upon agriculture persist?

And how soon could the segment rebound?

The answer is up in the air at this point. Production patterns and cycles vary and there is little guidance as to when the demonetization dust finally settles. However, gestation periods extend from 2-3 months for vegetables and 4-6 months for oilseeds, pulses and cereals. Production losses in vegetables cannot be recouped and is a permanent loss. Lower cereals, oilseeds outputs would persist until the next harvest, or about nine months and it is certain that incomes and profit margins will be hurt.

Price and output effects will reflect all the above listed factors. This means considerable fluctuations, increased uncertainty and risk.

Demonetization: The impact on Banks

Banks have gained deposits substantially after demonetisation, which they can invest for improving their profitability. There non-performing advances have also come down.

Besides as banks will reduce their cash holdings due to more digital interface it will add to their long term profitability and cash loss for various reasons like theft, dacoit and misappropriation will be avoided.

Cash is an idle asset and it does not yield any income unless kept in a bank. Therefore, people will keep their surplus cash in banks instead of at home.

However, during November and December bank work was largely centered on accepting and exchanging specified bank notes. As a result other activities like lending during busy season is affected which will reduce their earning for the next quarter and profitability.

Further as all ATMs are to be recalibrated for issue of new denomination notes like □2000 and □500 it will add substantially to their operational expenses. It will reduce their income during the next quarter.

As people are not very much versatile with digital operations, they may face various operational risks like cyber fraud.

Thus, demonetization is not an unmixed blessing but merits are more than demerits and the economy will move forward with less cash holdings by banks.
The negative impacts are because of regulation, costs of demonetization, loss of opportunity and short-term damage to economy.

1. The 100% cash reserve requirement (CRR) on incremental deposits meant that banks did not earn any interest on Rs 3 lakh crore of deposits for nearly a fortnight.

2. The waiver of ATM charges would result in banks losing Rs 20 in every transaction.

3. The waiver of merchant discount rate on cards would result in banks losing 1% in every card transaction.

4. Banks use third parties like cash logistics companies for cash transportation. Moving out Rs 15 lakh crore of currency notes and moving in Rs 7 lakh crore plus from currency chests would have cost several thousand crore.

5. As banks have been focused on exchanging currency notes, they have not been able to sell any loan products.

6. Some SME businesses have seen their sales drop 50–80% and could default in their installments. They won't immediately be classified as NPAs because of some relaxations, but if the delay persists bank NPAs might worsen.

7. Uncertainty has resulted in drop in spending on high value items from credit cards. These are the transactions which are converted into EMIs and banks earn from them.

Demonetization: The impact on Black Money

The biggest mission of demonetization is described as fighting black money. India's economy historically holds a big parallel economy where unreported income is the norm.

Demonetization is a currency side step. That itself will not fight black income. The most important policy should be tax administration where the tax authorities can monitor expenditure and matching it with income of the respective individuals.

The effectiveness of demonetization against black money depends upon the follow-up and supportive measures were made by the government. For example, the enactment of the modified Benami Transactions Act from November 1, 2016 will be a big associated tool in the hand of the government to tackle black income. Thus, to assess the effectiveness of demonetization, we should examine how these steps are complementing each other to fights black money.

Already, several analysis projects that demonetization will bring several long-term besides netting black money deposited in the form of banned notes. Hence, it is logical to classify the black money fighting effect of demonetization as (a) direct or immediate and (b) long term

(A) Direct or immediate effects

Immediate effect of demonetization comes through the netting of black money deposited in the banking system in the form of banned Rs 500 and Rs 1000 notes from November 10 onwards.

Around Rs 12 lakh crore of the Rs 15.44 lakh crore demonetized currency is with banks now and the extent of black money identified out of this will be the direct effect. Here, it is believed that an estimated Rs 1.5 to 2 lakh crore may be identified as black income. Out of this, around Rs 1.2 lakh crores may be collected as taxes at 50% to 85% tax rate.

If Rs 2 lakh crore is revealed as black money out of demonetization, it will amount to around 1.75% of India’s GDP. According to National Institute of Public Finance and Policy (NIPFP), black income amounts to nearly 40% of the coutnry’s GDP

Direct effect depends upon two steps: the Benami Act and the Pradhan Mantri Garib Kalyan Cess

A recent case study on black money front is the non-acceptance of tax from a Gujarati trader -Mahesh Sha and Mumbai family by the Tax Department. In both these cases, the Tax Department refused disclosure under Income Declaration Scheme (which was closed on September 30, 2016) to accept 45% taxes. Instead, the Department invoked provisions of the newly enacted Benami Prohibition Act by waiting till November. The Act prescribes imprisonment up to seven years for having Benami property besides confiscation of the propery.

The same procedure will be repeated in the case of big accounts parked with banks under demonetization. This shows how effective will be demonetization when combined with a built-in Income Disclosure Scheme in the name of Pradhan Mantri Garib Kalyan Yojana and the sharpened Benami Prohibition Act.

(B) **Long term effects of demonetization on black money**

The long-term effect will be much impactful and depends considerably upon how government deploys more measures to depress the shadow or black economy .

The process of formalization

Formalization means under the monitoring of the government. Here, two formalization options are needed: recording (a) high value transactions and (b) low value transactions.

Formalizing high value transactions:

Post demonetization legal steps should be made to ensure mandatory PAN quoting for high value physical assets - gold/land etc. Though this measure is still prevailing, fragmentizing transactions into small helps black money. To avoid this, every small physical asset transaction should be made with Aadhaar ID proof. When each money is to be reported and recorded; land deals will become automatically white.

Formalizing small value transactions: Here, digitalizing transactions in the form of prepaid payment instruments, debit and credit cards and online payments will reduce black money. Several post-demonetization steps were made by the government to promote digital payments.

A social shake up against black money

An awareness against black money and consciousness about legal and punitive measures is an intangible positive effect of this demonetization. It will change the mindset of the people to keep away from black income. This shakeup of Indian society will be a big outcome though it may not be measurable**.**

Demonetization: The impact on Tourism

Demonetization has shed its gloomy shadow on the booming tourism and hospitality industry in India. The onset of the winter travel season has been stymied by the unexpected storm of demonetization. People have curtailed overseas travel and instead are exploring various local tourist destinations. Getting money from banks and ATMs continue to be a hassle with no respite in sight.

The travel and hospitality industries are facing a tough time. Many foreign trips sponsored by big brands largely done through cash transactions is negatively affecting tourism industry and revenues due to the ongoing cash crunch. India's hospitality industry has been severely affected as the hotels have lost a large number of pay-in-cash-only clientele due to demonetization. Around 60 percent drop in hotel bookings have been reported.

At present, the scenario of the Indian citizens are worse, even if they are rich in terms of money. The wealthy and luxury-driven travelers are shifting their plans and in some cases cancelling holidays completely. When the rich and exclusive clientele from Delhi and Mumbai shift their birthday / anniversary extravaganzas to Goa instead of Prague or London, it is clear that demonetization has trimmed their budgets simply because of unavailability of money. It has resulted in a drastic transformation that has veered 'from International tourism to Domestic tourism'.

Not just travel and hospitality industry, but almost all sectors are feeling the impact of demonetization. Not a single sector is immune to it. The industry's corporate clientele though is hit, the leisure segment is hit the hardest. Among the latter, the international leisure segment has been hit severely.

Impulse travelling too has come to a sudden halt. Visiting places like Dubai and Singapore as weekend trips have been suspended as of now. Business or work-related trips are something that cannot be overlooked or avoided are being delayed and only the most unavoidable trip are being taken up.

The accommodation section of hotels is much affected, but leisure segments like hotel banquets and high-end restaurants are feeling the pinch as weddings are being called off and many pre-bookings for different wedding ceremonies are also being cancelled. In addition to this, high-end restaurants are too facing drastic change as people are replacing fine-dining with pocket-friendly eateries.

It seems as if this is just the calm before the storm. We hope that the storm of demonetization will calm and settle down soon and the travel happy citizens can get over this shock and get on to digital payments.

The hospitality industry is the most dynamic industry, especially when it comes to pricing and demand. Hopefully, there will be differently priced packages that will cater to all people so that they can still travel during these changing times.

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