

## **Impacts of Demonetization on Indian Economy: An Overview**

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**ABSTRACT:** The fact is that India has a thriving cash economy. A majority of businesses in India run on cash with no transparency or accountability. This money never enters the tax system of the country. It is a leakage from the economic cycle adversely impacting the working of the Indian economy. According to reports, two thirds of India's GDP is cash economy—around Rs 90 lakh crores. It is the honest tax-paying citizen of the country who suffers. Ever since demonetization initiative was announced by Prime Minister Narendra Modi on November 8, several developments have taken place related to the move. While some have been encouraging, others highlight the flip side of the historic step taken by the Centre. The demonetization programme has been evaluated in the context of its short-term costs and long term gains. Short term losses include loss of welfare for the low-income people and decline in GDP growth. On the long-term gain side, a large number of benefits are identified which will appear with time. The present research paper is an overview of impacts of demonetization on Indian economy.

**KEYWORDS:** Demonetization, Economy, Economic Growth, GDP, Positive Impacts.

**INTRODUCTION:** Actually, demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes, there occurred huge gap in the currency composition as after Rs 100; Rs 2000 was the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 have reduced the utility of Rs 2000. Effectively from introduction of Rs 500 denomination, the problem has been overcome.

Prime Minister of India, Mr. Narendra Modi, took the entire country by surprise when he declared demonetization of INR 500/- and INR 1,000/- currency on 8th November, 2016. As per Modi Government, the agenda of this move was three fold:

- To shrink the size of the parallel economy and black money in India;
- To eliminate counterfeit currency;
- To reduce corruption.

It is not the first time in the history of India or globally that demonetization has happened. In India, it occurred one-and-a-half years before Independence in 1946, and again in 1978. The drive could not be successful earlier as people anticipated the move. Thus, they had ample time to park their black money in safe zones. Also, the circulation of higher denomination notes was not as high then as the current 86 per cent. While this is the third time in the Indian history that Indian high value currency has been stripped of its status as a legal tender, the first two instances of demonetization did not have an impact like the recent one. This is primarily because, this time, the demonetized currency represents 86% of the total currency in circulation. In a country where 68% of the transaction are cash based (as per CLSA data), a move like this is definitely going to have several long- as well as short-term impacts.

**IMPACTS ON INDIAN ECONOMY:** 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. In this context, the exercise may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks. Following are the main impacts.

- **Liquidity Crunch (short term effect):** Liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes,

higher will be the duration of the liquidity crunch. Current reports indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 MNRs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

- **Welfare loss for the currency using population:** Most active segments of the population who constitute the 'base of the pyramid' uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class. There will be a trickle up effect of the liquidity chaos to the higher income people with time.
- **Consumption will be hit:** When liquidity shortage strikes, it is consumption that is going to be adversely affected first.  
Consumption ↓ → Production ↓ → Employment ↓ → Growth ↓ → Tax revenue ↓
- **Loss of Growth momentum-** India risks its position of being the fastest growing largest economy: reduced consumption, income, investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.
- **Impact on bank deposits and interest rate:** Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply take place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the

SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

- **Impact on black money:** Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depend upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. such a nationwide awareness and urge will encourage government to come out with even strong measures.
- **Impact on counterfeit currency:** the real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

Thus, the demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the unmeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

**SHORT TERM NEGATIVE IMPACTS:** The process of demonetization will have also some short term negative impacts as under:

- **Impact on Working class:** The largest adversely affected group, numerically, is the working class. Casual workers are at the bottom of the working-class hierarchy. Their incomes are the lowest and least secure. They spend the money as they earn it. Those paid in old Rs500 or Rs1,000 notes would have had to lose a day's wage to queue up at banks to convert their money. If the cash ran out, they would have had to lose another day's wage. Meanwhile, they would have had no money to buy food, medicines or other essentials, and God help them if they had a medical emergency. In the towns and cities,

these workers are queueing up at banks. What about unbanked villages? The banks have reportedly despatched armies of mobile-banking correspondents to service such villages. How that is working out on the ground I have no idea.

- **Impact on Small-medium enterprises:** The next major group adversely affected are the small-medium enterprises in services and industry, especially wholesale and retail traders. Cash transactions are an integral part of their daily operations, especially for traders. Their range of goods includes everything from raw materials to intermediate inputs to food items and other consumer goods. Numerically, this class is not as large as the working class, but their impact on economic activity is very large. Demonetization is a bit like a car running out of fuel in their case. Their businesses have been severely disrupted. Those with substantial stocks of black money are also probably taking large haircuts. We are likely to see a significant dip in economic activity till January or even till the end of the financial year because of this disruption.
- **Impact on self-employed professionals:** The third group adversely affected are the self-employed professionals, for example, doctors, lawyers, accountants. It has been suggested that the incidence of tax-evaded income is high among this group, many of whom are high net-worth individuals. Their wealth portfolios would be similar in structure to those of the “big fish” even if not quite as large. For both groups, the large non-monetary component of their wealth would be unaffected, but the monetary component will be extinguished to the extent that demonetization forces the unloading of hoarded black money.
- **Impact on real-estate industry:** For all the three groups above, the impact would probably be quite short-lived. But for a fourth category, the real-estate industry, the disruption is likely to be quite severe and long lasting. This sector is the destination where large proportions of black-money flows are converted into real assets, and black-money transactions are all-pervasive. The sector has already been in the doldrums for the past couple of years and transactions are likely to remain frozen for quite a while, with corresponding downstream effects in cement, steel and other construction materials.

**CONCLUSION:** Thus, we can point out that demonetization is a highly disruptive way to fight black money and it is only a one-time effort to flush out hoarded money. We can't do it always. Similarly, only a fraction of black money is stored in liquid cash. All these indicate that fight against black money will be successful in the long term only if the other measures suggested here are adopted. Above all, the legal system should be prudent to prevent people to invent new ways of hoarding and dealing with black income. A step like this can result in the cleaning up of a system for which many believed it could not be done, as earlier attempts did not have significant impact. However, the decision by Prime Minister Modi is one the most historic steps in Independent India. A decision like this can help curb inflation, recapitalize banks, reducing the interest rates and making the economy vibrant, with capital inflows. The taxes will be spread to a much larger population. At present only 2.6 per cent of the Indian population pays taxes. Some just don't make enough and the others who do, siphon off the money. If this plan works, the ramifications of the currency demonetization can touch all parts of the Indian economy.

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