

## Demonetization effect on Indian economy

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### Abstract

Demonetization is the act of strip a currency unit of its status as legal tender. The PM announced on 8th of November, 2016 about the withdrawal of legal tender of 500 and 1000 currency note in the late evening. The Indian government claimed that this demonetization is required reasons for stopping the funding of terrorism, facing the problem of fake Currency, for making the black money worthless, for reducing the corruption, etc. In terms of value, the annual report of Reserve Bank of India of 31 March 2016 stated that total bank notes in circulation valued to 16.42 lakh crore of ` 500 and ` 1000 banknotes. Banks started accepting deposits from 10th of November but within a period of 18 days around half money has been received by the banks. The show is still on. But, between this the Government again provided the scheme of pay tax and converts your black money into white money scheme launched. Prime Minister Modi decision effected totally the whole country was stunned. This decision caused sensation in the whole country. Social Media was flooded with messages and information. People started counting the trash they had accumulated for years legally or illegally. The main objective of this move was to curb the black money, corruption and fake money menace. All the people but those who were indulged in malpractices welcomed the move. The entire restriction shook hand against this move under one falsification or the other. They called this decision a draconian law and required the govt to move back it. Tirades were settled on to concentrate on the decision. Govt also did counter strikes.

**Keywords:** demonetization, currency, reserve bank of India, black money, corruption

### 1. Introduction

Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit. The new currency which replaced the old one is of denomination of 500/- and 2000/-. Though the people faced a lot of inconvenience owing to shortage of funds, they did not criticize the govt for the move. Even they lauded the Modi govt for this big move. Prime Minister also addressed the people many times telling the people that it was a *mahayajna* they must offer their own *ahuti* in it. At the stroke of the hour on midnight of 9<sup>th</sup> November 2016, India lost 86% of its monetary base. The print, electronic and social media has been praising Prime Minister's masterstroke by which he has reportedly destroyed the base of corruption in India. In this single move, the Government has attempted to tackle all the three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing. There is no doubt that Prime Minister has pulled out a major coop and substantially enhanced his reputation as a strong leader.

### 2. View

The idea of demonetization is good but it has to be taken into consideration that most of the black money is kept in the form of land, buildings or gold or kept abroad. What is in cash constitutes only 4% of the total amount of black money on which taxes are not being paid. Out of this, a lot of money is in circulation in everyday transaction like if someone is building a house; the bill is not paid through banks for sand, bricks etc. This money goes into the other systems though it has been

drawn from bank. These things will come under control with this step.

Small farmers, sellers, merchants, daily wage labourers and traders are suffering because of lack of proper planning, intelligence and foresight such as recalibration of ATM machines. There was need to pile up enough 100 Rupee notes and other smaller denomination notes in the market before taking this step. It is being said by critics that this step was taken only to bolster the image of the Prime Minister as he has been unable to deliver on GDP growth, inflation and bringing the black money from abroad.

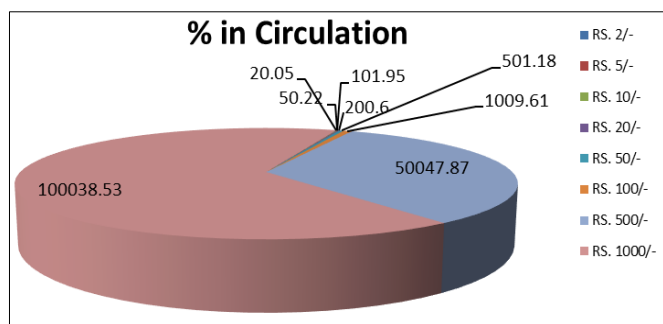
Demonetization is an established practice in monetary policy to tackle black money. The Prime Minister has explained why this is a financial surgical strike. It was meant to be suddenly implemented. In the past, demonetization has taken place twice but it fails because the idea is to tackle the black money existing in circulation. This is not tackle corruption per se or the Government is not saying that 100% corruption will be tackled. If announcement and time would have been given, this step might not have been successful in controlling black money and counterfeit currency in circulation coming from Pakistan, Nepal or other countries.

People are facing problems because the limit of withdrawal has not been kept at a higher level. If this would have been kept at a higher level, there were chances that the recycling of black money might begin. The ideal money in distribution has to come to the banking channels.

It is also being said that what is being attempted is replacement of currency and not demonetization itself which was unnecessary. This is a terrible setback for the international standing of the Indian economy. At this time, the economy is

struggling with slowdown. There is demand sluggishness in the economy leading to practically no private sector investment and stagnant industrial growth. If we look at the farm sector, this is the harvest time. Farmers generally deal in cash and India is also largely a cash economy. The cash transactions in this economy are far more than the total number of electronic transactions done on a daily basis. In the tribal heartland of the country, the poor people through middlemen are getting their currencies exchanged for Rs.300 or Rs.400 because of lack of proper information which is hitting them.

The stock of the black economy constitutes a major part of the GDP is significant. Even if 50% of this amount is withdrawn, the kind of relief that RBI will get on its liabilities and the sort of deposits commercial banks will get will lead to a rise in the deposit and later on there will be decrease in lending rates plus fiscal deficit. The black money in circulation is like a steroid in the economy which keeps the demand going gives a feeling that everything is working well. The problem is that investment is not taking place in the economy and the rate of growth of capital formation is down. The only way to bring this up is to divert more funds into investments which will happen when the cost of capital comes down.



**Fig 1:** The bar chart indicates the distribution of different denominations of Indian currency in month of March 2016.

### 3. Impact of Demonetization

The demonetization that has been in effect since November 9, 2016 is expected to have a negative impact on inflation. Consumer spending activity fell to a near halt. Consumers are refraining from making any purchases except essential items from the consumer staples, healthcare, and energy segments. Activity in the real estate sector, which includes a lot of cash and undocumented transactions, slowed down significantly, Metropolitan and Tier 1 cities reported up to a 30% fall in house prices. Food item inflation, measured by changes in the Consumer Food Price Index, accounts for 47.3% of the overall CPI. Due to 86.4% of the value of the currency notes in circulation going out of the financial system and re-monetization being slow, the supply and demand of food items fell. It will exert more downward pressure on inflation.

Investors in India-focused funds EPI, WAINX should continue to monitor CPI inflation. It will determine future rate cuts by the RBI. A change in the repo rate will impact interest rate-sensitive sectors and industries like financials (HDB) (IBN) and automobiles (TTM), among other sectors like the tech WIT, INFY sector.

We shall see a great impact of this move of the Central Govt on Indian Society and Economy. The first impact shall be that people will have lower expenditure power. With that they will not be able to purchase luxurious things.

There shall be no ostentatious expenditures on marriages and other ceremonies. So the society will grow lesser materialistic and people more prudent. With the fake money destroyed, Indian economy will see a big boom and the so far booming real estate sector shall fall on the ground.

The things shall be cheaper. Indian Currency shall get respect at the international market. There shall be a great check on the terror-related funding and therefore on terrorist activities. Corruption shall be down to a great extent as people will stop the tendency of accumulating money using wrong means.

It will abridge the gap between the haves and the have nots. However, there may be some difficulties for a couple of months. But this inconvenience shall be temporary and for short-term.

### 3.1 Following are the main impacts

i) Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.

#### ii) Liquidity crisis

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 mn Rs 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.

#### iii) Welfare loss for the currency use people

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.

#### iv) 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 ↓

#### v) Loss of Growth momentum

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.

#### vi) 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.

#### vii) 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.

#### viii) Impact on fake currency

The real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise. 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 clearness and reduced quantity of black money activities can be pointed as enduring benefits.

### 3.2 Impact on the Poor

Two ideas have been offered in the claim that the adverse impact upon the poor will be small:

- i) **Cash savings as predictors of impact on the poor:** Estimates based on national surveys show that cash earnings of the poor are small, and they usually lack cash savings. So, it is argued, they are likely to seldom visit a bank branch or post office, and they are not particularly inconvenienced.
- ii) **Credit as a mitigant of the impact on the poor:** It has been argued that since the rural economy is significantly credit-driven, the impact on rural poor will be small. If transacting parties know each other, they would be willing to extend credit, which would make short-term non-availability of cash less costly. Given the practices in rural markets, many commercial relationships are indeed credit-driven, and cash calls are only made periodically.

### 4. India's Financial Markets Fall down In case of Demonetization

Indian equity markets have been on a near secular falling trend since the government demonetized the 500 rupee and 1,000 rupee currency notes after midnight on November 8, 2016. The two benchmark equity indices—the Nifty 50 and the S&P BSE Sensex—fell on each trading day since the demonetization except for November 10 and November 22. While the Nifty 50 fell 6.3% from November 8 until November 22, the S&P BSE Sensex fell 5.9% during the same period. Due to the rise in the US dollar, the dollar equivalents of the Sensex and the Nifty fell more than 8% each.

The S&P BSE 100 Index, which is comprised of 100 stocks compared to the Sensex's 30, fell 6.6% during this period. Mid and small-cap indices have been hit much harder than broader market indices. Even after a rise on November 22, the S&P BSE MidCap and the S&P BSE SmallCap indices fell 8.2% and 10.9%, respectively, in the previously mentioned period.

Apart from concerns about demonetization, Donald Trump's victory and concerns about his restrictive trade philosophy led to foreign investors pulling out of Indian equities. According to Bloomberg, foreign investors have net sold Indian equities (PIN) (INDA) worth \$1.4 billion from November 9–17.

However, once the short-term impact of demonetization is over, Indian equities will likely bounce back sharply. A rate cut from the Reserve Bank of India would be helpful and easy monetary conditions are generally beneficial for equities. Consumption-driven sectors and stocks (TTM) (VEDL) will continue to be hit in the short term.

#### 4.1 Indian Rupee Fall Down

The Indian rupee fell against the US dollar. It mainly fell due to Donald Trump's victory in the US presidential election. Given the pressure on the local unit and its relative stability, it seems like the Reserve Bank of India has been working hard to keep the currency stable.

India's tech companies (INFY) (WIT) saw a sharp correction since the demonetization was announced. However, the rupee's weakness can benefit these stocks. For now, Donald Trump's trade philosophy will be the main driver of the Indian unit.

#### 4.2 Mutual Funds Perform Better

In the long term, the mutual fund industry, will benefit from scrapping of 500 and 1,000 rupee notes. Banks will soon reduce the fixed deposit rates. Some banks have already reduced fixed deposit rates. With fixed deposits offering less interest, citizens will shift money to mutual funds, to get returns more than inflation. Investments in mutual fund schemes, will increase. When interest rates are falling in the economy, debt mutual funds do well. Many debt mutual fund schemes, have given more than 2% returns in a week. This could continue for some time. Good equity mutual funds, invest in fundamentally strong stocks. Stocks with good fundamentals, do well in the long term. With stock markets falling due to demonetization uncertainty, you can invest in good equity mutual funds, at a low price. Expect to get good returns, from your equity mutual funds, in the long term.

The most interesting thing regarding the demonetisation is that people are devising various unique methods for changing their black money in to white one. Some of these methods are as follows –

- Depositing currency in the accounts of their poor relatives and friends.
- Enticing the people with some percentage of money for exchange.
- Asking their employees to stand in the long queues in front of Banks and ATMs for getting currency exchanged.
- Hiring labors for some Rupees ranging from Rs 500/- to 800/- for becoming the part of long queues in front of banks/ ATMs.
- Changing black money in to gold.
- Paying a few months salaries in advance.
- Paying back loans forcibly.
- Using their influence / links with bank employees and so on.

**4.3 What Will Be the Effect of the Ban of the 1000rs and 500rs Notes On The Stock Market?**

The Impact is huge, with a population of 125 crore people in India, total demat account holders in India is less than 1.5 crores. Which is comparatively very very less in India. As per National Securities Depository Limited, total investor accounts in India is 1.45 crores. Out of these active account

will be very less. Aware of after demonetization, currency is heavy into banks with huge deposits from public. A heavy cash inflow in the bank account will cause the following impacts.

1. Reduction in Interest rate for Fixed Deposits.
2. Savings Account
3. Public Provident Fund and savings scheme in Post offices interest rate will be reduced.
4. Real Estate Investments would be reduced drastically and people will be looking for better investment options.

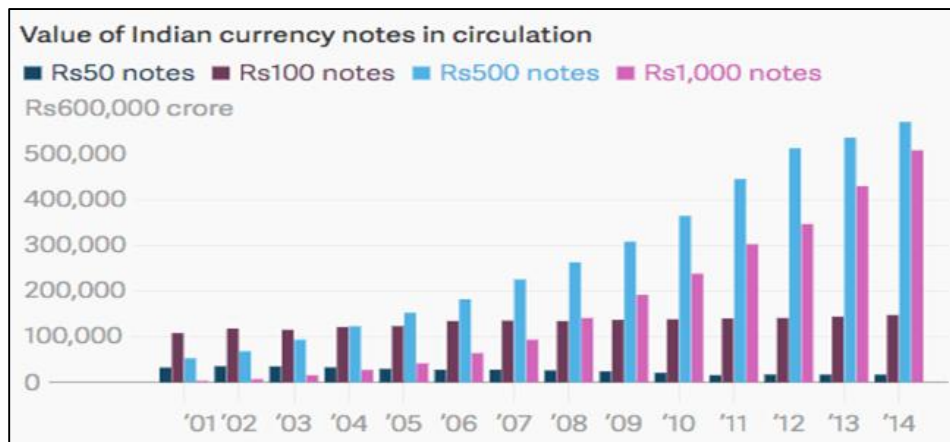
All fixed return investment options are likely to give less return in future. What to do now? Where to invest money after Demonetization?

Apart from this, US election is also over the head pressurising the Indian economy if Trump wins the game.

IT stocks are suffering due to US election. However, black money curbing event might not affect these stock much as most of the transaction are from overseas in digital modes. No interaction of notes.

Real estate stock was suffering from this 500 & 1000 black money curbing. And real estate also need a good amount of operational ready cash to operate the daily operational expense limit.

Banking stock was also suffered a lot. Bank Nifty faced a severe fall but that doesn't justify the case. The banks are the one which are benefited the most from this event.



**5. Advantages and Disadvantages of Demonetization**

**5.1 Advantages of Demonetization**

1. The greatest favorable position of demonetization is that it helps the legislature to track individuals who are having expansive totals of unaccounted money or money on which no pay charge has been paid in light of the fact that many individuals who acquire dark cash keep that cash as trade out their homes or in some mystery put which is extremely hard to discover and when demonetization happens all that money is of no esteem and such individuals have two choices one is to store the cash in financial balances and pay assesses on such sum and second choice is to let the estimation of that money diminished to zero.
2. Since dark cash is utilized for illicit exercises like psychological warfare subsidizing, betting, IRS evasion furthermore blowing up the cost of significant resources classes like land, gold and because of demonetization all such exercises will get lessened for quite a while furthermore it will take years for individuals to produce that

measure of dark cash again and consequently in a way it helps in putting an end this hover of individuals doing unlawful exercises to gain dark cash and utilizing that dark cash to accomplish more illicit exercises.

3. Another advantage is that because of individuals revealing their pay by storing cash in their financial balances government gets a decent measure of duty income which can be utilized by the administration towards the improvement of society by giving great foundation, doctor's facilities, instructive organizations, streets and numerous offices for poor and destitute segments of society.

**5.2 Disadvantages of Demonetization**

1. The greatest weakness of demonetization is that once individuals in the nation becomes more acquainted with about it than at first for few days there is disorder and free for all among open as everyone needs to dispose of demonetized notes which thusly infrequently can prompt to

lawfulness issue and clamorous circumstance particularly in banks and ATMs which are the main medium to change the old cash units to new money units.

Another hindrance is that annihilation of old coin units and printing of new cash new units include costs which must be borne by the legislature and if the expenses are higher than advantages then there is no utilization of demonetization.

2. Another issue is that dominant part of times this move is focused on towards dark cash however in the event that individuals have not kept money as their dark cash and pivoted or utilized that cash as a part of other resource classes like land, gold thus on then there is no certification that demonetization will help in getting degenerate individuals.

As should be obvious from the over that demonetization has both points of interest and disservices and it is up to the administration to see and dissect every one of the upsides and downsides and after that choose whether it is helpful to proceed with demonetization or not.

## 6. Conclusion

Demonetization is a generations' excellent 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 is the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination.

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.

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