A STUDY ON IMPACT OF DEMONETISATION OF CURRENCY NOTES ON THE FUNCTIONING OF INDIAN ECONOMY

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ABSTRACT

BACKGROUND

Demonetisation is the process of stripping a currency from general usage or circulation. Demonetisation is one of the boldest movements taken by Government of India under the leadership of our Hon. Prime minister, Sri Narendra Modi in the history of Indian economy which came into effect from November 8, 2016 midnight. This initiative will have huge impact on Indian economy, GDP of India and the functioning of various industries. Thus, in this paper, an attempt has been made to understand the impact of demonetisation of higher denomination currency notes on the functioning of Indian economy. In addition to this, the study also examines the impact of demonetisation on GDP of India.

KEYWORDS

Demonetisation, Impact on Indian Economy, GDP.


BACKGROUND

Demonetisation is the process of stripping a currency from general usage or circulation. This is usually done whenever there is a change of national currency or replacing the old unit with the new one. A similar step was taken when the European Monetary Union nations decided to adopt Euro as their currency. The old currencies were allowed to convert into Euros for a period of time allocated, in order to ensure a smooth transition through demonetisation. Zimbabwe, Fiji, Singapore and Philippines are the other countries who have opted for demonetisation.

Demonetisation is one of the boldest movements taken by Government of India under the leadership of our Hon. Prime minister, Sri Narendra Modi in the history of Indian economy which came into effect from November 8, 2016 midnight. The idea behind this move of demonetisation was to declare that Rs 500 and Rs 1,000 notes will be no longer legal tender. The aim is to curb the corruption and get into lawful, banked and taxable part of economy.

According to the RBI's database on the Indian economy, currently there are Rs 17,54,000 crore worth of notes in circulation, of which Rs 500 notes constituted almost 45% of the currency in circulation while 39% of the notes were of the Rs 1,000 denomination in value terms, which means demonetisation of high denomination currency notes will definitely affect the economy through the liquidity side. This impact would immediately press a pause button on transactions that were planned in black money.

It is also fascinating to note that this was not the first time the Government of India has gone for the demonetisation of high-value currency. It was first implemented in 1946 when the Reserve Bank of India demonetised the then circulated Rs. 1,000 and Rs. 10,000 notes. The government then introduced higher denomination bank notes in Rs. 1,000, Rs. 5,000 and Rs. 10,000 in a fresh avatar eight years later in 1954 before the Morarji Desai government demonetised these notes in 1978.

Objectives of the Study

To study the impact of demonetisation of higher denomination currency notes on the functioning of Indian economy.

Impact of Demonetisation on Indian Economy

Demonetisation had a very important impact on the functioning of Indian economy. This move helped in eradication of black money. With this move black money holders either have to show their income source from which they earned their black money to the department or burn the stacked income. RBI data shows that in 2015-16; almost 6.5 lakhs counterfeit notes were detected in commercial banks of which almost 4 lakhs were in the Rs 500 and Rs 1,000 category. Apart from that it also helped in curbing of counterfeit currencies. This initiative will help to fight against counterfeit currencies that are being used for financing terrorism activities.

It should be noted that only a small portion of black money is actually stored in the form of cash. Most of the black income is kept in the form of physical assets like gold, land, buildings, etc. Hence, demonetisation can help in curbing only the amount held in hand in form of cash.

Demonetisation has indisputably aided banks high accretion of deposits. According to the data, between October 28, 2016 and December 23, 2016, bank deposits have shot up from around Rs. 107 lakh crore to Rs. 112.6 lakh crore, which is an increase of about Rs. 5.5 lakh crore in two months. This is nearly twice the amount of deposits that flowed into banks between April and October 2016. But what is much important to know is how much of this increased liquidity will stay in the banking system, once currency flow normalises and various caps on withdrawal are lifted. This scenario of banks flushed with funds and low interest rate is a perfect recipe for boosting lending.
But a moderate borrowing appetite on the part of highly-leveraged Corporates and banks’ reluctance to lend have failed to spur loan growth, even after a substantial fall in lending rates over the past year. According to the RBI’s latest figures (as on December 23), credit growth has fallen to a meagre 5.1 percent, down from 10-odd percent levels last year. The growth had already fallen to 5 percent levels in the end of November, as credit to Corporates shrunk by 3 percent. Even within the modest 10-11 percent credit growth in 2017-18, the growth will be concentrated in pockets. In the last three years, PSBs have grown at a far slower pace, because of their huge exposure to the corporate segment. Credit growth of PSBs plummeted to 4 percent in 2015-16 from 7 percent in 2014-15. In contrast, private sector banks were able to clock a robust 26 percent year-on-year rise in lending in 2015-16. This disparity is likely to continue and the growth in 2017-18 too will be driven by private banks. The biggest setback in terms of costs for banks due to demonetisation has been on account of recalibration of ATMs and logistics costs involved in transporting currency, in a short-period of time. Also, post demonetisation, between November 9 and December 30, banks had to waive ATM charges for all transactions (irrespective of the number) and merchant discount rate for debit card transactions, etc. These will have short-term impact on costs. However, over the long run, the sector as a whole will benefit from increased use of digital modes of transactions, which will improve operational efficiency.

No doubt, there was rise in short term deposits, but in the long run, its effect will come down. The deposit made by the people with the banks was actually liquid cash which they had in hand to meet their emergency needs. One can’t assume that the cash once stored in their hands will be put into savings for a longterm with bank. People were compelled to save this money into banks as they had to replace their old notes with new notes. These are definitely not voluntary savings done with the aim of investment.

Reserve Bank of India has made few amendments like ATM withdrawal limits which were earlier restricted to Rs 2000 per day have been increased to Rs 10000 per day per card. The restrictions on current account is also shifted to Rs. 1,00,000 per week from Rs. 24000, whereas the restrictions on withdrawals from savings bank account is at present unchanged to Rs 24000 a week which is signalling that the post-demonetisation cash crunch is easing as currency supplies have raised over the past few weeks.

The aim to make Digital India can be seen and felt as most of the transactions started to happen through e-commerce. Online shopping portals like Paytm, PayPal, etc. have seen a surge in adoption of their digital wallets and many big organised retail stores which have card payment options have started experiencing an upsurge in their usage patterns. Demonetisation has resulted in people adopting virtual wallets such as Paytm, Ola Money, future Pay Wallet and so on. This change of e-wallet transactions have seen a surge in production of point-of-sale machines as their platform has increased to 2000%. This behavioural change could be a game changer for India. Digital transactions in banking sector have also seen an uptrend as the point-of-sale transactions in State Bank of India surged 300 percent in numbers and 200 percent by value. But on the other side of the coin, most active segments of the population who constitute the ‘base of the pyramid’ use currency to meet their transactions may feel the pinch of demonetisation. The daily wage earners, other labourers, small traders, etc. who reside out of the formal economy use cash frequently. These sections will lose income in the absence of liquid cash as they get income based on their daily work and those who doesn’t have the digital transaction culture. Liquidity crunch will compel firms to reduce labour cost, which will surely lead to reduced income for poor working class. This will also bring liquidity chaos even to the higher income people with time.

Demonetisation has brought the real estate market to a complete stand-still. As these developments take their toll, the housing market will experience stillness in the coming months. The housing market is a hot-bed for the indiscriminate use of black money. The real estate sector is estimated to have suffered notional revenue loss of Rs. 22,600 crores in the fourth quarter of 2016 due to demonetisation as home sales plunged 44% as compared with the same period last year and new projects fell by a massive 61% year-on-year during the same period (according to the real estate consultancy Knight Frank India). Demonetisation will also bring down interest rates and force cuts in real estate prices. Buying a dream house would be no longer be a dream as it is expected that property prices would come down in near future.

Apart from real estate, demonetisation also put brakes on automobile sales. Automobile demand was hit hard by withdrawal of high-value currency, with total sales of cars, two-wheelers and commercial vehicles shrinking to 18.7% which is the steepest drop since December 2000. Light commercial vehicles emerged as the only segment that managed to grow in December, rising 1.15 percent. Vehicle sales across categories declined to 12,21,929 units from 15,02,314 units in December 2015. Sales of scooters, which are more popular in urban markets, saw the biggest decline in more than 15 years, falling 26.4 percent to 2,84,384 units in December (According to data released by the Society of Indian Automobile Manufacturers, SIAM).

Demonetisation has wiped out the gains made by the mutual fund industry in the equity market in the last one year. The sharp fall in stock prices post-demonetisation resulted a 3.3% decline in equity market assets for the first time in nine months in November. The assets under management of mutual funds in equity schemes were down from 16000 crores to 4.68 crores in November. Apart from these, the huge volatilities were seen in the performance of our stock market as the market valuation took a beating due to a spate of events such as global commodity meltdown, Brexit and demonetisation in India which resulted in drop in economic activity.

Demonetisation made Indians to go through liquidity shock, as people were not able to get sufficient volume of popular denomination especially Rs 500. 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. As per the reports only 2000 million units of Rs. 500 notes could be printed by the end of December 2016 whereas around 16000 million Rs 500 notes were in circulation as on end March 2016. Some portion of this has been filled by the new Rs 2000 notes. Towards end of March 2017 approximately 10000 million units will be printed and replaced which indicates that currency crunch will be there in our economy for the next few months.

The Centre’s fiscal deficit remained high in the first eight months of the financial year with gross tax revenues somewhat muted in November. This is the first set of official data on government finances since the decision to demonetise
high value currency on November 8. The Centre’s fiscal deficit amounted to Rs. 4,57,996 crore or 85.8 percent of the budget estimate, between April and November 2016. It was slightly lower at 79.3 percent, the full fiscal deficit was at 87 percent of the budget estimate in November 2015. The revenue deficit shot up to Rs. 3,48,211 crore or 98.4 percent of the full-year target by November 30. It stood at 87.5 percent of the budget estimate a year ago but was 92.6 percent of the target in October 2016.

Impact on GDP
The assumption is that immediate impact of demonetisation towards economy will be a heavy deflation as people who have earned money through illegal means such as smuggling, corruption would be fearful to declare the money as they might be prosecuted by Government/Income Tax Department on the legitimacy of their income. This will reduce the total currency circulation in the economy leading to deflation. Deflation increases the value of money because the total money supply goes down but the commodities and things available in the market would not decrease.

The Gross Domestic Product (GDP) is one of the primary indicators used to gauge the health of a country’s economy as it represents the total dollar value of all goods and services produced over a specific time period. It is expected that demonetisation will see a decline in the GDP of India but this is going to be a temporary phenomenon. Consumer spending activity chopped down to a near halt as consumers are refraining from making any purchases except essential items. Food item inflation which is 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-monetisation being slow, the supply and demand of food items will fall and wield more downward pressure on inflation. Ambit Capital, a respected Mumbai-based equity research firm, has officially estimated that the demonetisation-driven cash crunch will result in GDP growth crashing to 0.5% in the second half of financial year 2016-17. This means the GDP growth for six months, from October 2016 to March 2017, could decelerate to 0.5%, down from 6.4% in the previous six months.

MSMEs play a very important role in its contribution to the total GDP, but post demonetisation it has also come down. The cash-dependent micro, small and medium enterprises (MSMEs) across the country have also borne the brunt of the ongoing demonetisation exercises as most of the transactions in unorganised SMEs will be cash based.

Growth in the Indian economy remained firm in the quarter from April to June 2016 which is the first quarter of fiscal 2016-2017. During this period, the GDP (gross domestic product) rose 7.1%, while the GVA (gross value added) rose 7.3%.

The fall in economic activity due to demonetisation could last from two to three quarters. As a result, GDP and GVA growth in the quarters from September to December 2016 and January to March 2017 could be significantly lower than previous years. There could be some recovery in the first quarter of fiscal 2017–2018. In the medium term, the Indian economy can grow considerably after curbing the debilitation caused by counterfeit money and an increase in economic activity.

A fall in discretionary consumption will hurt companies operating in this space (TTM) (VEDL). However, a rise in tax flow and lower interest rates, are expected to help the Indian economy (PIN) (EPI) (INDA) grow stronger.

CONCLUSION
Demonetisation of currency in India will have an important role to play in Indian economy as the repercussions caused by the demonetisation-driven cash crunch that is playing out in India will paralyse economic activity only in the short term and has a dynamic and important role towards the upliftment of the economy. It will definitely bring structural changes in the longer run and lead to a greater formalisation of the modern economy. So, one should always look at the bigger picture which will definitely fetch results in the long term. This is what the people of India have been asking for a long time which has finally happened.

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