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Demonetization

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***Abstract*: Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change in 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. This paper deals with the Impact of Demonetization on Economy. It outlines the effects of demonetization on GDP growth and the impact of demonetization on business. This paper makes a special note on the merits of demonetization. This paper concludes with some interesting findings along with policy suggestions.**

***Keywords*: Demonetization**

1. Introduction

The government has implemented a major change in the economic environment by demonetizing the high value currency notes – of Rs. 500 and Rs. 1000 denomination. These ceased to be legal tender from the midnight of 8th of November 2016. People have been given up to December 30, 2016 to exchange the notes held by them.1 The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat. The reasons offered for demonetization are two-fold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the "black economy". There are potentially two ways in which the pre-demonetization money supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange. The empirical extent of these two components will be untraveled only over the next six months. These two would have different effects on the economy in the short term and in the medium term, as will be explored below. To understand the effects of these dimensions, it is important to first understand what is it that cash does in the economy? There are broadly four kinds of transactions in the economy: accounted transactions, unaccounted transactions, those that belong to the informal sector and illegal transactions. The first two categories relate to whether transactions and the corresponding incomes are reported for tax purposes or not. The third category would consist largely of agents who earn incomes below the exemption threshold and therefore do not have any tax liabilities.

A. Objectives of Demonetization

1) Removing Black Money from Country

Modiji has done a really good work, as people who are having black money will now be left with nothing particularly. All the cash which resides below the pillow, will now be useless (although small amount of black money can be converted into white, but amount in hundreds of crore of rupees is almost next to impossible to make it white).

2) Stopping of corruption

By removing the currency notes from circulation, it will have a direct impact on corruption. People who have this notes will now be left with nothing.

3) Stopping terror funds

Because of demonetization, the people or organizations who used to fund terror groups will be now sitting without any works, they will naturally die and that too with starvation.

4) Curbing fake notes

Demonetization will also stop the circulation of fake notes in the economy (although the amount of fake notes revolving in the economy was around 400 crores).

5) Stopping illegal dabba trading

Due to demonetization, the illegal share trading and dabba trading will cease to exist. This will ensure stability in share markets, especially at these 'times of turbulence.

6) The Uttar-Pradesh elections

It is generally seen that, there is ample liquidity in the states, where elections are to happen, this thing is considered as vote bank and politicians buy votes of people by offering them money, if they vote for them. Now because of demonetization, vote bank system will not be in existence (the proof here is currency notes, which were found from river ganga). As an ultimate result, we would see transparent elections.

7) The Betting on U.S. presidential election results

It seems that Modiji is well aware of the fact that Indians are a master in betting at anything like pro!!!! Because of his address to nation at 8:00 pm, there will be no betting done on the us presidential election results, or atleast its quantum would be less than, what it should be have earlier.

8) To send a clear message that this government is well inclined towards working for the development of nation

Because of his bold step, it will send a clear message that this government is well inclined towards development of nation. It will also send a message to the international community, that the government is doing constant efforts to make India a better place to invest and a better place to do business.

B. Advantages of Demonetization

1. A major advantage is that demonetization helped the government track black money. Large sums of black money were kept hidden by tax evaders. Demonetization helped government uncover huge amount of unaccounted cash. According to estimates made by RBI, people have deposited more than rupees 3 lakh crores worth of black money in the bank accounts. This has helped the government in slowing down the plague of parallel economy.
2. A major reason behind demonetization was that a big part of black money was being used for funding terrorism, gambling, in inflating the price of major assets classes like real estate, gold and other social evils. demonetization is acting as an effective countermeasure against such activities. Now all such activities will get reduced for some time and also it will take years for people to generate that amount of black money again and hence in a way it helps in putting an end this circle of people doing illegal activities to earn black money and using that black money to do more illegal activities.
3. Another benefit is that due to people disclosing their income by depositing money in their bank accounts government gets a good amount of tax revenue which can be used by the government towards the betterment of society by providing good infrastructure, hospitals, educational institutions, roads and many facilities for poor and needy sections of society.

C. Disadvantages of Demonetization

1. The biggest disadvantage of demonetization has been the chaos and frenzy it created among common people initially. Everyone was rushing to get rid of demonetized notes while inadequate supply of new notes affected the day to day budgets of citizens. Banks and ATMs witnessed long queues while small businesses suffered temporary financial losses. The situation was even worse in rural India where people struggled to exchange and withdraw cash due to lack of enough number of banks and ATMs in their vicinity.
2. Another disadvantage is that destruction of old currency units and printing of new currency units involve costs which has to be borne by the government and if the costs are higher than benefits then there is no use of demonetization.
3. Another problem is that this move was targeted towards black money but many people who had not kept cash as their black money and rotated or used that money in other asset classes like real estate, gold and so on were not affected by demonetization.

2. Positive effect of demonetization

1) Black money

At one stroke the Prime Minister has choked the supply of black money stacked inside the country. Of the Rs. 17 lakh crore of total currency in circulation in the country, black money is estimated at mind-boggling Rs. 3 lakh crore. Black money is nothing but a plunder of the nation. Black money operators run a parallel economy which shakes the very foundation of the Indian economy. With Modi's demonetization move, all domestic black money will either be deposited into the banks with heavy penalty or be simply destroyed.

2) Economy

Demonetisation will have a huge resultant effect on the Indian economy. The clean-up of illegal cash will help turn around the economy. First, it will bring more borrowings to the exchequer, improve inflation outlook and increase India's gross domestic product (GDP). Second, it will revive investment opportunities and give a fillip to infrastructure and the manufacturing sector. Third, it will help reduce interest rates and lower income tax rate.

3) Note bank politics

In the run up to the crucial assembly elections in Uttar Pradesh, Punjab, Goa and Uttarakhand, Prime Minister Modi's demonetisation announcement has come as a shock and awe for the political parties and politicians for whom black money is a lifeline. The pulling out of the old Rs. 500 and Rs. 1,000 currency notes will help make the election process clean and transparent. But it has brought tough times for the political parties and politicians who believe in the idea of purchasing votes in exchange for notes. That is precisely the reason a rainbow coalition of a galaxy of regional parties and the Congress is building up against Modi, because their political interests are badly hurt.

4) Real estate cleansing

It is said that real estate is an industry built on black money. The extent of black money floating around in the sector is huge. According to an estimate at least 40 per cent of real estate transactions in Delhi-NCR are in black. Modi's demonetization move will curtail the flow of black money into the real estate sector. This will help in making the much needed correction in the sector. The impact: An unexpected dip in land and property prices.

5) Hawala transactions

Demonetisation has crippled the hawala rackets. Hawala is a method of transferring money without any actual money movement. Hawala route is used as a means to facilitate money laundering and terror financing. Hawala rackets run again on black money. With black money suddenly being wiped out of the market, thanks to demonetisation, hawala operations have come to a grinding halt. According to an India Today report, one of the hawala operators in Mumbai has destroyed currency notes worth about Rs 500 crores.

6) *Counterfeit currency*

Demonetisation has dealt a death blow to the counterfeit Indian currency syndicate operating both inside and outside the country. Counterfeit currency seriously devalues the real worth of Indian currency. A study conducted by Indian Statistical Institute, Kolkata on behalf of the National Investigation Agency (NIA) suggests that fake Indian currency notes (FICN) amounting to Rs. 400 crore are in circulation in the country at any given point of time and around Rs. 70 crore fake notes are pumped into Indian economy every year. The estimation is based on recovery and seizure made by various agencies. But the actual figure could be much larger. A One India report, quoting an Intelligence Bureau dossier, says fake Indian currency worth Rs. 12 lakh crore has pumped into Indian financial system over the years. Needless to say that most of the fake currencies circulated

in India are of Rs. 500 and Rs. 1000 denominations. It is also pertinent to mention that the fake currency in circulation in the country.

This is an open secret that Pakistan has been printing fake Indian currency at its government printing press in Quetta and its security press in Karachi. The enemy nation funnels the counterfeit currency through the frontier at Jammu & Kashmir and via India's porous border with Bangladesh and Nepal. With Prime Minister Modi's decision to pull out the old Rs. 500 and Rs. 1,000 notes and replace them with new Rs. 500 and Rs. 2,000 series has completely stalled the circulation of counterfeit Indian currency. Experts say the new currency notes have come with advanced security features which are almost impossible to replicate. So Pakistan has no option but to shut shops of its fake Indian currency.

7) *Terror financing*

Terror financing is sourced through counterfeit currency and hawala transactions. This is how terror financing works. Fake currency circulation is routed through a multi-layered network of hawala operators which are closely linked to satta (gambling) and smuggling of drugs, opium and arms. Indirectly, they all end up financing terrorism.

In addition, the terrorists collect huge donations and then route the money through hawala transactions.

With the circulation of counterfeit Indian currency completely stalled and hawala transactions stopped, all windows for terror financing are closed.

8) *Maoism*

Maoist sympathizers call Modi's demonetization move an "undeclared financial emergency". There are reasons to it. Demonetisation has hit the Maoists and their movement hard. Black money is the oxygen for Maoists. According to an estimate, Maoists manage to raise Rs. 300 to Rs. 400 crore annually through donations, levy and extortions. The illicit money is used to purchase arms and ammunition, food and medicine and daily essentials, apart from distributing it among the ranks and the cadre. Police sources in both Chhattisgarh and Odisha have told the writer that the Maoists have stashed old high denomination notes to the tune of over Rs. 10,000 crore at their dumps in the dense jungles of Odisha- Chhattisgarh boarder. No wonder, with Modi's demonetisation drive, all those illegal money are reduced to paper scrap.

Maoists are in a state of coma and Maoist activities see a crippling blow. Ever since the demonetisation announcement was made, no major violence was reported from the Maoist infested states like Chhattisgarh, Odisha, Andhra Pradesh and Telangana.

9) *Kashmir unrest*

The four-month-long unrest in Kashmir valley is on a backburner, thanks to demonetisation. No stone pelting on security forces has been reported in Kashmir ever since the demonetisation announcement was made. An intelligence estimate suggests that Pakistan sends Rs 1,000 crore annually to the separatists for fueling unrest in Kashmir. The money is transferred through hawala route. With hawala transactions completely choked up, the separatists are now clueless. It won't be wrong to say that "stone pelter" Modi completely shattered the Kashmir unrest with his stone called demonetisation.

10) *North-East insurgency:*

Demonetisation has severely affected the multiple militant groups operating in the North-East. According to intelligence estimate the north-eastern insurgent groups together have a corpus of Rs. 400 crore annually.

3. Negative Impact of Demonetisation

1) *Hardship for marginal/middle income workers*

Although the target for this move was the perceived black money hoarders (more on that next), the real people getting crushed are laborers, maids, farmers who do not have access to any accounts and are most susceptible to the fear mongering that says that their money "is worthless". Most don't even know that the money can be changed later. They would become prime targets for the new currency black market where their old notes are taken at a discount, destroying savings and the little wealth they had in panic.

2) *Creation of another shadow economy*

People are already buying and selling the old notes in a parallel black market. People desperate for cash are already exchanging 500 notes for 400 INR - for the seller of the new notes it's a windfall gain. A lot of wealth will simply be transferred to people who own legitimate currency and are willing to sell it at a premium.

3) *False feeling of black money "destruction"*

The major reason for this move is doing away with black money, and the irony is that cash is the least preferred method of holding of black money (if you were evading tax, would you keep cash lying around?). Most of it exists in gold, assets and a myriad of other instruments that makes it hard to detect. Additionally, individuals evading tax are only going to temporarily and marginally hit - as this article wonderfully explains.

4) Stressing payment infrastructure

To say that the move will migrate a country of 1.2 billion people to the digital payment infrastructure is more of wishful thinking. Banks don't exist for miles in rural India, India has an abysmally low. 1,082 PoS terminal for a million people and digital wallets are largely an urban phenomenon. To expect such infrastructure to magically appear overnight to facilitate cash conversion as well as migration to a "digital" economy is downright bizzare. It's fairly visible that the ATMs in India can't deal with this, and there are people dying while trying to withdraw cash.

5) Contraction in consumption

This is definitely a short term effect that runs opposite to the effect of a well laid out demonetization. With people having no legal tender, most shops and outlets are running with zero footfall and people are buying small ticket items (or even large ones) in smaller quantities. Shopkeepers are resorting to credit and don't have any PoS in place to feed any demand; many are having to turn back customers because they can't service their payments.

4. Impact on Economy

1) Effect on parallel economy

The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee Notes is expected to - remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks, - Temporarily stall the circulation of large volume of counterfeit currency and - curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

2) Effect on Money Supply

With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to reduce in the short run. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money and hence money supply will decrease permanently. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.

3) Effect on demand

The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly:

- Consumer goods
- Real Estate and Property
- Gold and luxury goods
- Automobiles (only to a certain limit)

All these mentioned sectors are expected to face certain moderation in demand from the consumer side, owing to the significant amount of cash transactions involved in these sectors.

4) Effect on Prices

Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

- *Consumer goods:* Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
- *Real Estate and Property:* Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheque transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices (probably charging more on cheque payment).

5) Effect on various economic entities

With cash transaction lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- Agriculture and related sector
- Small traders
- SME
- Services Sector
- Households
- Political Parties
- Professionals like doctor, carpenter, utility service providers, etc.
- Retail outlets

The nature, frequency and amounts of the commercial transactions involved with these sections of the economy necessitate cash transactions on more frequent basis. Thus, these segments are expected to have the most significant impact post this demonetization process and the introduction of new notes in circulation.

6) Effect on GDP

The GDP formation could be impacted by this measure, with reduction in the consumption demand. However, with the recent rise in festival demand is expected to offset this fall in overall impact. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and re-enter the stream once the cash situation becomes normal.

7) Effect on Banks

As directed by the Government, the 500 and 1000 Rupee notes which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there would be withdrawals at the second stage.

8) Effect on Online Transactions and alternative modes of payment

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increase in demand. This should eventually lead to strengthening of such systems and the infrastructure required.

5. Short-term and medium-term impacts

A. Very short-term impact

The demonetisation, by removing 86 per cent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy. This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash. In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing. For instance, transport services, kirana, fruits and vegetables and all other perishables, would face compression in demand which is backed by purchasing power. This in turn can have two effects: while it is expected that supply exceeds demand, there would be a fall in prices, however, if supply too gets curtailed for want of a medium of exchange, prices might, in fact, rise. Thus, while generally people seem to expect prices to fall, it is quite possible that prices would instead rise. Alternatively, to keep the flows going, people might take recourse to credit - both the retailers and other agents in the economy might make supplies on credit in the hope that when the liquidity status is corrected, the payments can be realised. In these cases, the price of commodities might rise instead of falling. In other words, the impact of an incremental reduction in money supply where the demand and the supply chain remain unaffected would be different from a case where there is a drastic reduction in money supply and outputs might adjust rather than the adjustment being in prices. In other words, the expectation that inflation would decline might be belied. A further impact would be a compression of the demand for non-essentials by all the agents in the economy in the face of uncertainty in the availability of cash. The demand from segments which have access to digital medium of exchange would remain unaffected, but that from the rest of the economy would get compressed. This would transmit the effect to the rest of the sectors in the economy as well. Another sector where one expects to see effects in the very short run is the real estate space. With contraction in demand from one set of agents – say agents who have earned unaccounted incomes and placed them within the real estate space – either prices within this segment would fall or transactions would cease to happen. While of itself, this would be considered a positive development and evidence of a correction in the unaccounted incomes, it could lead to a compression in investments in the construction sector which can have adverse income and employment consequences for the economy.

There are likely to be two spin-offs from this change – one, there would be some increase in tax collections in the short term, and second; various IOUs could emerge as currency substitutes. To the extent people attempt to get rid of unaccounted cash balances through purchase of goods and services and/or payment of property taxes, one should witness a spurt in tax collections in indirect taxes as well as property tax in the month after demonetisation which would disappear thereafter. There is evidence already that property tax collections in some cities are higher than last year. Similarly, in the case of currency substitutes, at MCD tax collection centres at the border, people are being given IOUs in lieu of the balance they were entitled to, which would be valid for six months.

6. Medium-term effects

In the medium term, the effects would be related to the extent to which the currency is not replaced within the economy. If the entire currency is replaced, there would not be any major effects on the economy. However, it is to be expected that the entire currency would not be replaced – to the extent currency is extinguished and to the extent some of the currency remains as bank deposits, there would be some impact on the economy. The first effect would be a compression of the economy to the extent the extinguished currency was working as a medium of exchange. The current the banks but not withdrawn, it is argued, would generate an expansion in deposits in the economy.

7. Transition Issues

There are a number of transition issues that need to be managed for this transition to be effective:

1) Infrastructure Issues

There is need for a significant upgrade of the banking system as well as in the telecom infrastructure that would provide the backbone for digital transactions. For people to be able to transact at any time and *place as well as for them to consider it a reliable medium of exchange, it is important that not only the banking system is upgraded to ensure that transactions can be completed without a hitch, but the supporting infrastructure too is up to the mark. For instance, in many parts of the economy, there is limited and intermittent supply of electricity as well as mobile connectivity. In these areas, it would be difficult to expect people to shift to electronic medium of exchange.

2) Consumer behavior Issues

Apart from the technological issues, there is a behavioral change that is being expected in people from using cash as a medium of exchange to using other cash substitutes both for making payments and receiving payments. This transition requires individuals to make two changes in their behavior: one, agents need to move from tangible means which can be seen and felt to forms which are less tangible or not tangible, and second, they have to learn to rely on technologically advanced tools to undertake regular day to day operations. The latter requires agents to be educated to the extent of comprehending the content of transactions. If this transition is not suitably managed, agents might be tempted to move to non-official cash substitutes.

3) Accessibility in language

In addition to all of the above, most of the banks and the mobile instruments for transaction are currently adapted to a single to two languages. If the bulk of the population of this country needs to come on board, it might be important to make these facilities available in a myriad of Indian languages to ensure that the user can comprehend the transaction that they are entering into.

4) Transition issues for banking sector

There are multiple issues here.

a. The banks too might have a transition issue to deal with. Banks would have a model of the fraction of deposits that they can safely lend without an excessive risk of withdrawal of the amount. This is important since, while banks can borrow money from the call money market, the costs of such borrowings can be large. These models, however, might need to be altered in the new regime since the character of the new deposits that come into the bank would be different from the pre-existing deposits. In the latter, while a fraction of the deposits would be for transactional purposes – e.g. salary earners – another fraction would be depositing only savings into the account. By eliminating high value currency notes, these agents who were operating through cash, would now have to move to non-cash instruments and hence, the balances in their accounts would not be savings but transaction values which will be retained in the account for shorter durations of time. The banks therefore would need to re-model their decisions on how much of the deposits can be lent out and for what duration. It is, for instance possible, that a larger proportion of the deposits would be retained for short-term lending and can even be dedicated to the call money market.
b. Second, while 1/reserve ratio defines the potential maximum amount of credit that can be generated in the economy, the actual credit generation would be defined both by the demand for credit and the extent to which cash intervenes in the functioning of the economy. For instance, if people who receive credit from the bank make payments through cheques alone and they in turn make payments through cheques, then the potential credit creation can be realised. However, if on receipt of payment, the agent withdraws the money to cash and makes payments, only a fraction of the credit/deposit will return to the banking system. Thus, larger is the extent to which cash is used as a means of transacting, smaller is the total credit that can be generated. With a withdrawal of cash from circulation, the deposits will continue to remain in the bank, it would merely shift from account to account or from bank to bank. Thus, even on the earlier deposits, the amount of credit that can be generated would be larger. This is another reason why the banks would need to remodel their investment decisions corresponding to a given level of deposits.
c. A third issue that might arise as a transition issue is because of the mismatch between people's preferences for cash and the availability of cash. In the interim, until people adjust to the use of non-cash instruments, there would be an increased demand for the cash that is available and that might generate a situation where the agents have to pay a premium to access legal tender. In periods of scarcity of coins for instance, it is commonly known that people pay a premium to get the change. While this can be considered a transition issue, there are two different implications of such a development:
d. If the premium on cash is high, it would encourage both the shift to non-cash instruments on one hand, and to informal substitutes of cash on the other. ii. This might undermine the confidence that people have in the currency and hence, encourage move to other currencies.

8. Conclusions

The demonetisation undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be "black money" and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the

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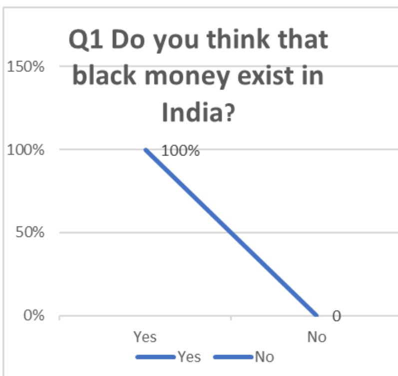
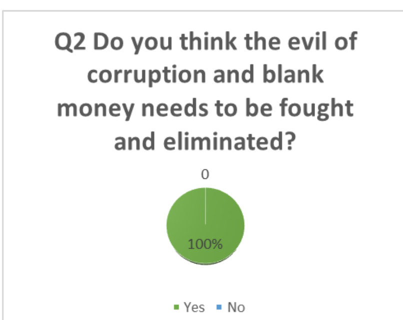
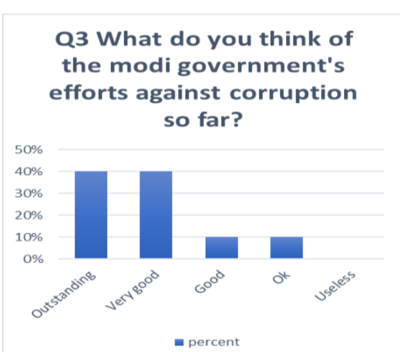
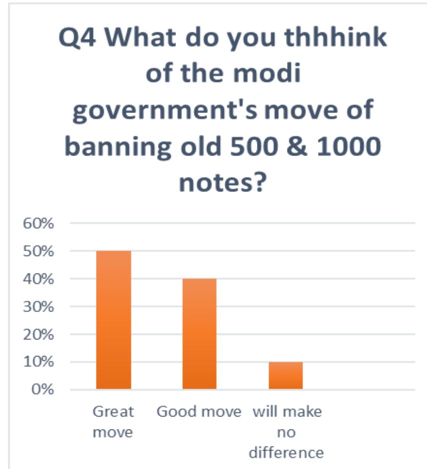
economy and that is a cost that needs to be factored in while assessing the impact of the demonetization on the economy and its agents.

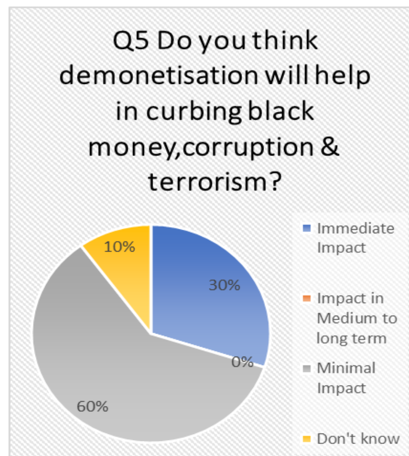
It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits was earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

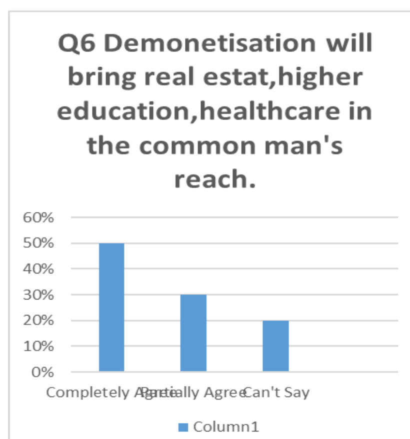


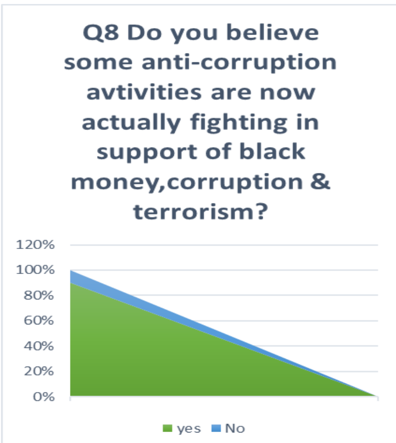












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