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Demonetisation in India: A Critical Analysis

Nidhi Jain Vanisha Chabbra

Assistant Professor, LRDAV, Jagraon

Abstract

In an important move, the Government of India declared on 8th of November 2016, that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI will issue Two thousand rupee notes and new notes of Five hundred rupees which will be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. This measure has been taken by the Prime Minister in an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. The argument posited in favour of demonetisation is 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. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy.. This paper elucidates the impact of demonetisation on Indian economy.

Key Words: *Demonetisation, Black money, Corruption*

Introduction

Demonetization is the act of Banning /taking back of 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 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. 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 demonetisation 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-demonetisation 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.This change, if it is executed, would dramatically change the economic environment in the country by forcing agents to move from using cash as a medium of exchange to using cash substitutes. This appears to be a real possibility given that the Finance Minister as well as the Governor of the Reserve Bank of India have repeatedly emphasized that agents should be moving to the use of cashless medium where there are no problems in comparison to the cash based medium. For instance, The Hindu reported that "Reserve Bank of India (RBI) has urged citizens to switch to alternative modes of payments such as pre-paid cards, credit and debit cards, mobile banking, and Internet banking." In a press conference on November 12, the Union Finance Minister too said that "Those in businesses should start using digital payment gateways, cards and banking system. Life will become simpler in the new financial system that is the only viable.These two would have different effects on the economy in the short term and in the medium term, as will be explored below.

1. 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.

2. Short-term effect with complete replacement

The short-term effect on the economy would depend on the speed with which and the extent to which the cash is replaced by the authorities. If the entire cash is replaced within a short duration of time, the effects beyond the very short term of 1-2 months might be little. But a few sectors are likely to be seriously affected. To give an example from two sectors which are supposed to have large employment effect on the economy, we can talk about agriculture, automobiles and construction. This is the sowing season for the Rabi crop in some parts of the country and the harvesting season for the Kharif crop. Most of the purchases and sales in this segment of the economy are carried out through cash. With the elimination of cash from the economy, sale of kharif crop would be difficult unless the crop is sold on the promise of payment in future. Given the limited bargaining power of the farmer, the price they can realize for the crop can be adversely affected. On the other hand, in the sowing activity, people would not get access to the inputs required since most of the inputs are now purchased from the market unless they seek access to credit from the supplier. In other words, with demonetisation, there would be a significant strengthening of the informal sector credit market in the rural economy.

3. Short-term effect with incomplete replacement

If, on the other hand, the authorities choose to replace only a fraction of the total cash that was surrendered by the people to the banking sector, then one would witness some other changes/effects in the economy. For transactions to be restored to the pre-change level, a number of agents who are using cash as a medium of exchange have to move to using digital versions of money as the medium of exchange. While this change is gradually happening in the economy, if it is forced by making cash inaccessible, the compression in demand as well as in income generation in the economy would continue for a longer period until people get familiar with the functioning and use of these media.

4. 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 currency that is placed inthe banks but not withdrawn, it is argued, would generate an expansion in deposits in the economy. In the discussions on demonetisation, there is a consistent reference to the resultant increase in credit creation in the economy. Like Finance Minister Arun Jaitley says, “Bank deposits will increase and they will have more capacity to support the economy.” The total cumulative credit that can potentially be generated is defined in terms of the reserve ratio. Total credit potential = incremental deposit generated*(1/reserve ratio).

Objectives of the Study

1. To study the impact of demonetisation on black money & financial inclusion.
2. To study the short term & medium term impact of demonetization.
3. To study the major hurdles in the transformation of economy into cash-less economy.

Research Methodology

Data used in the study are secondary in nature and mostly collected from the newspapers, & from the report of research tax team of 14th of November 2016. The study covers a period from Nov 2016 to Dec 2016. Four parameters namely financial inclusion, black money, & benefits of this move by the government, major hurdles in the transformation of economy have been used to study the impact of demonetisation.

History of Demonetisation in India

1. First - 12 Jan 1946 (Source: RBI History 1935-51, pg. 706)

Following the action in several foreign countries, including France, Belgium and the U.K., the Government of India decided on demonetisation of high denomination notes, in January 1946. It is interesting that as early as April7, 1945, suggested similar action in India as 'one more concrete example for the Indian Government to follow in its fight against black market money and tax evasions which have now assumed enormous proportions .

2. Second - 16 Jan 1978 (Source: RBI History 1967-81, RBI Balance Sheet, RBI Currency and Finance Report)

On 16 Jan 1978, the ordinance was announced via All India Radio at 9 a.m. The Ordinance provided that all banks and government treasuries would be closed on 17 January 1978 for transaction of 'all business except the preparation and presentation or the receipt of returns' that were needed to be completed in the context of demonetization. This time public was given even lesser time of 3 days to exchange Rs.1000, Rs.5000 and Rs.10000 notes.

3. Latest Demonetisation in India

The demonetisation of 500 and 1,000 banknotes was a policy enacted by the Government of India on 8th November 2016. All 500 and 1,000 banknotes of the Mahatma Gandhi series ceased to be legal tender in India from 9th November2016. In the announcement, Modi declared that use of all 500 and 1,000 banknotes of the Mahatma Gandhi Series would be invalid from midnight of the same day and announced the issuance of new 500 and 2,000 banknotes of the Mahatma Gandhi New series in exchange for the old banknotes. However, the bank note denominations of 100,50,20,10 and 5 of the Mahatma Gandhi Series remained legal tender and were unaffected by the policy. The move by the government to demonetize Rs.500 and Rs.1000 notes by replacing them with new Rs.500 and Rs.2000 notes aims to tackle the menace of black money, corruption, terror funding and fake currency. The total value of oldRs.500 and Rs.1000 notes in the circulation is to the tune of Rs.14.2 trillion, which is about 85% of the total value of currency in circulation. The World Bank in July, 2010estimated the size of the shadow economy for India at 20.7% of the Gross Domestic Product (GDP)in 1999 and rising to 23.2% in2007. Assuming that this figure has not risen since then (quite unlikely though)and that the cash component of the shadow economy is also proportional (it could be higher), the estimated unaccounted value of the currency could be to the tune of Rs.3.3 trillion. Now, post the announcement of demonetization by the government this money would have to either accounted for by paying the relevant tax and penalties or would get extinguished.

Positive Macro Benefits of this move by the Government

This move by the government is likely to have long term benefits for the economy. The extinguishing of the major proportion of unaccounted currency would reduce from the liabilities of the government and would add to its finances. This would mean that while interest rates can be low, the government spending on large infrastructure projects would kick start capex cycle and push economic growth higher in the medium term. The move is also likely to have a habit changing impact in the Indian populous and there could be increased belief of keeping cash in the banks rather than stashed at home and use formal banking channels for their spending needs. Also with more money being kept in the banking channel, some of these low cost deposits may be sticky and improve the medium to long term Current Account and Savings Account (CASA)ratio of the banks. Another element of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable to some extent. This may be visible more in the rural belt, where many non-farming entities purchase fertile farmland, not for farming but for money parking purpose. The demonetisation and consequent reduction in shadow economy would bring the demand for such farm lands down. This move is likely to lead to better tax compliance, raise the Tax to GDP ratio and improved tax collection. Also with lower cash transactions in the near term, inflation may see downtrend in the near term. Also with higher tax to GDP ratio, the government may also get enough headroom to reduce the income tax rates, which can lead to higher disposable income with people and can improve consumption demand in the medium to long term.

Impacts of Demonetisation

Here is an expecting effect of the demonetization on the GDP growth for the current financial year and the resulting cash crunch on various sectors, which are included for GVA estimation. The impact period considered is 7 weeks (from the of demonetization announcement on 8th November'16 till end of December'16).Certain projections have been made for the losses or gains in each sector week wise, which have been accounted for in final expected GVA for FY17 which will get reflected in the GDP growth number. A point to note is that some of the losses in GDP incurred in these 7 weeks will be recovered in the next quarter, particularly for consumer goods where there would be only deferment of purchase. However the same doesn't stand for losses in services sector. Nonetheless, the expected recoveries in have been netted off while considering the overall impact in these 7 weeks .For individual sectors the proportion of output likely to be affected has been used as the basis for extrapolating the potential loss of output on a weekly basis till December end when it is assumed conditions normalizes. The impact hence varies across these 7 weeks with the intensity being highest in the first two weeks which keeps tapering downwards towards the end of the terminal period. As the judgments made on these effects is critical to assess potential loss of GVA, the methodology works on the basis of two alternative approaches which will help to formulate a range for the same.

1. Conservative Approach: Here the premise is that the expected impact is moderate as the assumption is that there would be minimal level of distortions on growth in output.

2. Aggressive Approach: In this model the assumption is that there would be extreme distortions to begin with which will subsequently taper down proportionately over time. This becomes significant especially in the services sector. The services sector is expected to be affected the most under both the approaches, mainly on account of losses in trade, hotel, transport etc. due to the volume of cash transactions involved in these economic activities. Importantly, these losses, due to their inherent nature, can't be recovered in the next quarter. SMEs in industry will have a major problem in adjusting production schedules as both payments and receipts flow in cash given their structures. Hence, Industry is also expected to be impacted which will be more significant in the first 2-3 weeks post the announcement. The gains would be positive for the banking sector due to the increase in deposits which would be countered by slowing down of other sectors in the group like real estate. Agriculture is expected to least impacted with major shock being absorbed in the first 2-3 weeks.

Impact on financial inclusion

RBI has also issued licenses to open new-age small finance banks and payments banks which are expected to give a push to financial inclusion and bring innovative banking solutions. Things are also falling in place in terms of technology for India. The recently launched Unified Payments Interface by National Payments Corporation of India makes digital transactions as simple as sending a text message. It is possible that a section of people which has used electronic mode of payment for the first time due to the cash crunch will continue to transact through this medium, but there are still a number of hurdles in making India a cashless economy. First, a large part of the population is still outside the banking net and not in a position to reduce its dependence on cash. According to a 2015 report by Pricewaterhouse Coopers, India's unbanked population was at 233 million. Even for people with access to banking, the ability to use their debit or credit card is limited because there are only about 1.46 million points of sale which accept payments through cards. Major hurdles in the transformation of economy into cash-less economy are following:-

Physical infrastructure

Not enough physical infrastructures are available. So there is need to improve the availability of physical infrastructure in India. Number of citizens on mobile: Not all Indians use mobiles and not everyone is connected. The latest figures from the Indian telecom regulator TRAI show that, as of July 31, 2016, India had a tele-density of83%, Note that these are the number of connections, not users, so you will have to discount this significantly, because many users have multiple SIM cards. The proof: Delhi has a tele-density of234.77%. Urban wireless tele-density is 148%, and rural is50.72%. And of the 1,034.23 million connections, 88.88% areactive.

Payment and mobile network capacity

What we've seen with demonetisation and the increase in usage of cards and online payments is that somewhere in the value chain, banks and/or payment gateways were not in a position to handle the load. Transactions failed and we were told that Visa wasn't able to handle the load.

At present, there isn't sufficient capacity to accommodate escalated usage if everyone starts transacting digitally. More importantly, do we have the network capacity to deal with this? What happens in an emergency situation?

Security issues

The weakest security link in any transaction is not the technology system but the user and a lack of understanding of security issues. For instance, to withdraw money from ATMs, some people were giving others their card and PIN numbers. But there are other risks, too. In 2011, it was believed that payment gateway CC Avenue was hacked. HDFC Bank, too. And just last month, HDFC and Axis Bank were hacked. The difference between depending on cash and digital payments is that using cash limits the damage from losing a note or a number of notes. When it comes to digital transactions, the risks are higher. Language compatibility: Paytm has recently updated its application with some features enabled in Indian languages. Mobikwikhas done English and Hindi. Phone works in English, Hindi and Tamil. However, most mobile handsets don't have an Indian language interface and that's the case for most mobile apps and services, too. Ola is available in Indian languages only for drivers, not passengers. Apart from Snapdeal, no e-commerce company has tried going the Indian language way. There's a part of the population in India which still isn't able to read and write, let alone read and write English. The digital divide here is massive and that's why physical notes worked.

Merchant costs

Merchants need a working internet connection to accept digital payments. They also need to pay a monthly cost torrent a machine or own a smartphone with an application to accept payments. On credit cards, merchants are charged a merchant discount rate (MDR), an inter-bank exchange fee, of 1.7%-2.5%per transaction. On debit cards, they need to pay 0.75% per transaction below Rs. 2,000 and 1% for transactions aboveRs.2,000. For UPI, merchants are charged 0.75% per transaction plus other costs (on par with debit cards).

Customer costs

You need a smartphone and an internet connection, plus you'll need to pay USSD charges (Rs. 0.5 per session) and data charges when applicable. Cash might be more expensive for the government, because of tax evasion, corruption, the need to keep re-circulating old, spoiled currency, and the cost of enabling transfers, but digital is very expensive for citizens. What is happening here is a transfer of the cost of money from the government to citizens, as well as a massive collection of data. Using cash isn't the same as using digital payments because:

- Not enough people have mobile connections or internet connections, and the internet isn't prepared to accommodate a massive surge in use at times of emergency. What's more, many don't use the internet regularly and smartphones and mobile apps that support all Indian languages aren't available.
- Internet connectivity isn't reliable, available or as cheap for users as cash.
- The process of making digital payments in India is not easy and it's time consuming.
- Making digital payments costs more for both the merchant and the customer.
- Digital payments can lead to major security risks and currently there aren't adequate processes in place to address issues among either merchants or customers. Above all, not enough is being done to educate the consumer, the weakest link in the chain.
- Digital payments aren't a single standard like cash: money in one type of account is not the same as in another type of account, and it is not interoperable, unlike cash. The important thing is to give people choice, and switch people to living cash-free gradually. Parity between cash and digital money is probably impossible to achieve, but there are means of getting closer to it by creating an incentive structure for that switch. That involves making cash more expensive than going cash-free, and ensuring better enforcement.

Conclusion

There is a general preference for cash transactions in India. Merchants prefer not to keep records in order to avoid paying taxes and buyers find cash payments more convenient. Although cashless transactions have gone up in recent times, a meaningful transition will depend on a number of things such as awareness, technological developments and government intervention. For instance, mobile wallets have seen notable traction, and it is possible that a large number of Indians will move straight from cash to mobile wallets. A study by Boston Consulting Group and Google in July noted that wallet users have already surpassed the number of mobile banking users and are three times the number of credit card users. Presently, people face difficulties in making electronic payments even in metro cities because of poor network. The biggest beneficiaries of this transition, banks and related service providers will have to constantly invest in technology in order to improve security and ease of transaction. People will only shift when it's easier, certain and safe to make cashless transactions. The government will also need to play its part. It will have to find ways to incentivize cashless transactions and discourage cash payments. Implementation of the goods and services tax, for example, should encourage businesses to go cashless. There is an imperative need to modify the credit and financial services delivery system to achieve greater inclusion. The latest solution is demonetisation. Even though there will be pain and confusion in the short term for common people and economy, a disruptive measure was perhaps the only way to shake up the system to a new compliance normal. It is expecting that demonetisation provides a boost to Government's financial inclusion drive.

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