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Impact of Demonetization on the Indian economy

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Abstract

Demonetization is a major landmark in the Indian economy. It creates fear among the people who are engaged in illegal activities like tax evasion, money laundering etc. Indian Government on November 8, 2016 announced that the 500 and 1000 rupee notes will have no legal tender. About 86 percent of the country's total value of cash supply is in the form of 500 and 1000 rupee notes. Here the main objectives of the Government was to curb inflation, eliminate black money, eliminate terror funding, fight against tax evasion, root out counterfeit currency and to promote a cashless economy. Due to this announcement the common people faced a huge problem in meeting their daily transaction. We also observe that the growth rate of the economy falls due to this demonetization. Demonetization also creates some adverse effect on the Indian economy. Many economists and politicians have questioned regarding the way how demonetization was implemented on the Indian economy. Many people also opposed this decision of the Indian Government. In this paper we try to analyse the different aspects of demonetization. We see that in the short run demonetization creates some problems on the economy, but it is not the high time to comment what will be the impact of demonetization on the Indian economy in the long run.

Keywords: Demonetisation, cashless economy, digital economy, blank economy

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Introduction

Indian Government on November 8, 2016 announced that the 500 and 1000 rupee currency notes will have no legal tender. About 86 percent of the country's total value of cash supply is in the form of 500 and 1000 rupee notes. Government announced that the Indian citizen can deposit their old currency notes of Rs 500 and Rs 2000 or exchange them till 31st December'2016. When a currency note of a particular denomination ceases to be a legal tender, it is termed as demonetization. In India, first demonetization was taken place in 1946 and then in 1978. That time the highest denomination note in India was Rs 10000 and this highest denomination note was ceased to have legal tender then. Since this highest denomination notes were in the hands of few people only and most of the people did not have such notes, this demonetization did not have a big impact on the country. But the demonetization of 2016 had a great impact on the country and it affected the common people very badly in the short run. Due to this announcement the common people faced a huge problem in meeting their daily transaction. We also observe that the growth rate of the economy falls due to this demonetization. Demonetization also creates some adverse effect on the Indian economy. But the long term effects of demonetization are yet to be felt.

Objectives of demonetization

The objectives of demonetization are as follows:-

- (i) It tries to eliminate black money from the economy
- (ii) It tries to stop terror – funding
- (iii) It tries to promote a cashless economy
- (iv) It tries to root out counterfeit currency
- (v) It tries to curb corruption in the economy
- (vi) It tries to reduce inflationary rate in the economy
- (vii) It fights against tax evasion.

History of Demonetization in different countries of the world

Apart from India, many countries in the world introduced demonetization policy in different times to control black money of the economy, to curb corruption etc. India first introduced demonetization policy in 1946 and then in 1978 to curb unaccounted money in the economy. That's why India Government cancelled the legal tender of all higher denomination currency notes of rupees 1000, 5000 and 10000 in 1978. In 2016 also India Government introduced demonetization policy and that time the India Government cancelled the legal tender of currency notes of rupees 500 and 1000 to control black money, to curb corruption and for some other reasons. The aim of the Government is to promote Indian economy as a cashless and digital economy.

List of different countries in the world that had done demonetization

Sl. No	Name of the country	Year of demonetization	Objectives for demonetization	Remarks
1	Germany	1923	To control high domestic prices	Inflation rate was reduced to some extent.
2	India	1946	To curb black money from the economy and to control inflation rate in the economy	Demonetization did not have a big impact on the economy.
3	USA	1969	To curb black money from the economy.	Demonetization was successful.
4	Britain	1971	To bring uniformity in different currencies	Did not get desired result.
5	India	1978	To curb black money from the economy and to control inflation rate in the economy	Demonetization did not have a big impact on the economy.
6	Ghana	1982	To control black money in the country	People turned to foreign currency.
7	Nigeria	1984	To fix debt burden and to control inflation rate	Economy collapsed
8	Myanmar	1987	To control black money in the country	Demonetization led to political dispute and thousands of people

				died.
9	Zaire	1990	To withdraw obsolete currency from the system	It failed to give desired result.
10	Soviet Union	1991	To fight against black money, to stop earning from illegal activities and to stop smuggling and corruption	It failed to give desired result and the economic system of the USSR was essentially crushed.
11	Australia	1996	To curb black money in the country and to improve security features on the notes	Demonetization became successful.
12	North Korea	2010	To curb black money in the country	Demonetization became miserably failed.
13	Zimbabwe	2010	To curb black money in the country and to control inflation rate	It failed to give desired result.
14	Pakistan	2015	To get rid from black money, counterfeit currency	It completely messed up.
15	Phillippines	2016	To preserve the integrity among different currencies	It failed to give desired result.
16	India	2016	To curb inflation, eliminate black money, eliminate terror funding in the economy and to fight against tax evasion, root out counterfeit currency and to promote a cashless economy.	In the short run demonetization creates huge problems in the economy but the long term effect of demonetization is yet to be felt.

Source – Author's compilation from various sources

Impact of demonetization on the Indian economy

(1) On Gross Domestic Product (GDP)

The Indian economy is cash driven economy. So demonetization has largely affected its growth. In India, in 2015 – 16 the GDP growth rate was 8.01%. It fell to 7.11% in 2016 – 17 after demonetization. It happened due to less availability of cash in cash intensive industries like manufacturing and construction.

(2) On daily wage workers

A major portion of the Indian work force is engaged in informal sector. They use cash to meet their expenses. Due to demonetization many daily wage workers lost their jobs due to unavailability of cash. According to CMIE's Consumer Pyramids Household Survey report about 1.5 million daily wage workers lost their jobs during the final quarter of the financial year 2016 – 17. This report showed that during this period the employment was 405 million as compared to 406.5 million during the previous four months.

(3) On small scale industries

Some low capital enterprises like textile industry, salons, restaurants, some seasonal businesses who work on the basis of liquidity preference affected very badly due to demonetization.

(4) On black money

Demonetization tried to curb black money from the country. But it failed to control black money completely from the economy as most of the people who had lots of black money or earned huge income from illegal activities deposited their old 500 and 1000 rupees currency notes in banks or exchanged them in the stipulated time.

(5) On the General Economic Situation

General economic situation was disturbed due to demonetization. Common people find huge difficulty to exchange their old currency notes for new ones in the stipulated time. Households had no liquid cash in hand and that's why they face great difficulty in day to day transactions. They were unable to purchase their daily items due to shortage of

liquidity. Some small businessman faced a huge loss and they were bound to shut down their business.

(6) On inflation

The Reserve Bank of India (RBI) in measuring inflation considers both Wholesale Price Index (WPI) and the Consumer Price Index (CPI). Inflation was reduced slightly during demonetization as due to demonetization the consumers had to cut down their spending and aggregate demand had fallen considerably. Due to demonetization the availability of cash with the public had fallen and the people had to reduce their spending.

(7) On Terror funding

One of the important objectives of the demonetization was to clean up of the economy where fake currency notes of India would be checked. By cancelling the legal tender of 500 and 1000 rupees currency notes Indian Government tried to affect the illegal funding of terror groups in different parts of India.

(8) Towards a digital economy

Due to absence of liquid cash people use cheque or transfer their account for their transaction. People also switched to virtual wallets like paytm where electronic transfer of money takes place. It ultimately leads to a digital economy where all transactions are being recorded. In this case the problem of black money will reduce considerably. It will also increase the Government's tax revenue.

(9) On rural and informal economy

Due to demonetization the rural and informal economy suffered very badly as here transactions are generally cash based. Due to shortage of liquid cash, demand fell and it ultimately leads to a sharp decline in the wholesale price index. Due to demonetization the prices of fruits, vegetables, and pulses declined. Moreover, the sales of two wheelers, car etc declined sharply. The slowdown of the economy started before demonetization. But it aggravated after demonetization.

(10) On employment generation

Just after demonetization the availability of liquidity cash has decreased. So the consumers demand less and consequently industrial production has declined. So employment generation has been adversely affected. Manufacturing sector where highest amount of skilled and semi skilled workers are employed, witnessed slowdown in production. Many workers lost their jobs due to demonetization. The problem is much more for daily wage workers. Job loss rate is higher in labour intensive industries like textiles, garments, leather and jewellery.

(11) On agriculture

In the agricultural sector all transactions are made in cash. Most of the transactions are made in higher denomination notes. Due to cancellation of old currency 500 and 1000 rupees notes, all the persons associated with the agriculture sector, vendors of fruits and vegetables find great difficulty in their daily transaction.

(12) On tax compliance

India's tax to GDP ratio is 16.6%. It is very low compared to other emerging countries. It is assumed that due to demonetization the black money could be recovered and that's why the tax compliance would be better owing to better targeting of income. Tax rate could be reduced as the tax base widens and more people start paying taxes. Indirect tax revenue of the Government will also be higher in the form of service tax as the Government tries to make the economy a digital economy. Some business where revenue was under reported earlier will have to disclose their actual revenue now which will be received through digital or cashless means.

Conclusion

The objectives of demonetization were good. But it is criticised on several grounds. Many economists and common people have questioned regarding the way by which it is implemented. In the short run, Indian economy is suffering from various problems like liquidity crunch, unemployment problem, lower growth rate etc. Many major economic activities have been disrupted. But we are not sure what will be the impact of demonetization on the economy in the long run. Many people argued that the Indian economy will be benefitted in the long run due to demonetization. They argued that in

the long run the Indian economy may be benefitted by increasing tax compliance, financial inclusion and by improving the state of the economy. It may increase our GDP and the economy will ultimately moves to digital modes of payment. Demonetization tried to reduce the ill – gotten wealth, corruption, terrorism and fake currency to some extent. But how much it will be able to fulfil these objectives is questionable. Its adverse effect on the economy is much high than that its positive effect specially in the short run. Centre for Monitoring Indian Economy (CMIE) estimated that due to demonetization, Indian economy has to incur a huge cost of Rs 1.28 lakh crore. This huge burden will be imposed on common people of the country. Both rich and poor people will be affected by this. Moreover, it will create huge unemployment of the economy and the industrial structure of the country will be break down. Till now its magnitude of loss exceeds its gain.

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