



# Demonetization: Impact of the Monetary Shock

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## Abstract:

*The paper gives a bird eye view on the move of demonetization in India taken by central government on 8<sup>th</sup> November, 2016. The purpose of the paper is to study the objectives and immediate consequences of the scheme on economic environment of the country.*

**Keywords:** *Demonetization, Economic Environment*

## 1. Introduction

Demonetization is the act of stripping a currency unit of its status as legal tender. It is a process of removing a currency from general usage or circulation of money in a country. It is an act where the old unit of currency gets removed and replaced with a new currency unit. It can also be considered as withdrawal of a specific currency from market.

## 2. Quick Glance at the Past

It is not the first time that demonetization has happened in India. It has occurred twice earlier. The 1<sup>st</sup> time demonetization was undertaken on the 12<sup>th</sup> January 1946 during which Rs1,000 and Rs10,000 banknotes were withdrawn but the same Rs1,000, Rs5,000 and Rs10,000 notes were reintroduced in 1954. The second time demonetization happened on the 16<sup>th</sup> of January 1978 during which Rs1000, Rs5000 and Rs10000 which were introduced in 1954 were removed from the circulation with a notion of curbing counterfeit currency and black money.

The demonetization of denominations Rs 500 and Rs 1,000 banknotes was a policy decision carried out by the Government of India on 8th of November 2016. In the declaration, the use of denominations of all Rs. 500 and Rs 1,000 banknotes were made and replaced by new notes of Rs500 & Rs2000. The Rs500 note accounted for 47.8% of all the currency in circulation and Rs 1000 accounted for 38.4% of the same. This added to be a total sum of Rs 14.5 lakh crores.

## 3. The need for Demonetization

The main agenda of the NDA government to withdraw Rs. 1000 & Rs 500 notes as legal tender was to get rid of the counterfeit currency and the black money which was in circulation. This counterfeit was being used to fund terrorism and also run the parallel black economy. The supply of currency notes has increased by 40% during 2011-2016. With the increase in money supply there has been mounting inflation and tax evasion. Thus with a single scheme the Government of India aimed to target multiple problem like corruption, tax evasion, inflation, check the rise of back money and fighting terrorism. A minor goal was also to increase the use of digital and electronic platforms for payments.

## 4. The Road Map

With the launch of the scheme individuals were allowed to deposit all the demonetized currency in their bank accounts by 31<sup>st</sup> December 2016. The amount of cash deposited if exceeded Rs 2,50,00 required valid proof of the entity depositing the money and a proof of tax payment. In case of no proof a penalty of 200% was imposed. The money launders and individuals holding large amount of unaccounted black money had no option but to exchange it through the banking system. Moreover,

the government provided the provision of exchanging an amount of Rs 4000 over the counter at the banks. This limit was later reduced to Rs.2500 as there was a scarcity of new notes.

## 5. The Immediate Consequences

The 8<sup>th</sup> of November brought an entire economy to a standstill where even the richest felt poor. The immediate impact of demonetization created a panic among people. The banks and ATMs witnessed long queues where every individual was in a rush to change his or her currency. In rural areas and in small towns where banking facilities or even an exchange mechanism do not exist the effect was nothing less than catastrophe, with people unable to purchase daily necessities such as food and fuel. In addition, small farmers were unable to sell their perishable produce to middle-men, since these transactions are almost always conducted in cash. The greatest impact has been on the working class, other toilers and the poor who comprise the overwhelming majority of India's 1.2 billion people. On the morrow of the November 8 announcement, many were unable to eat as they did not have valid currency for making food purchases. Others were unable to obtain urgent health care. Selected sectors have been covered in paper to emphasize on the impact of demonetization

- 1. Banking Sector:** The first aim of the government's demonetisation scheme was to inject much needed cash into India's state-owned banking sector. As the Public Sector Banks (PSBs) have mounting "Non-Performing Assets" (NPA), primarily business loans that are not being repaid or paid only sporadically, the threat from them is so large that banks have cut back their lending to India's capital-starved and already overstretched business houses. As of June 2016, the banks' total NPS stood at Rs. 6 trillion (\$90 billion). However, by November 14, just 6 days after demonetisation, total new Indian bank deposits already exceeded Rs. 4 trillion (\$60 billion). Although most of these deposits are expected to be withdrawn for spending, the head of the giant State Bank of India, Arundhati Bhattacharya, estimated that about 10-15 percent of these deposits will be retained within the banking system. By compelling cash-holders to deposit their funds into the bank, the government is also hoping to collect a tax windfall so as to help plug its large fiscal deficit.
- 2. Real Estate Sector:** The Indian real estate sector is one of the most effective means to convert black money into white. The decrease in the money supply has adversely effected this sector with a drop in purchases. The sellers have no option but to wait. The land market is at a standstill and the prices of land and properties are expected to drop in the next 3-6 months. Even the prices have dropped in the secondary markets.
- 3. Consumer Packaged Goods & Durable Goods Industry:** There has been a fall in the discretionary expenses of household which have lowered the sales of wholesalers & kirana stores by 20-25%. The durable goods industry too witnessed a drop in sales to one-fifth compared to last month. The loss in liquidity has led to drop in sales.
- 4. Organized Retail Sector:** A sector that has largely benefitted from demonetization is the organized retail sector which largely accepts non-cash payments. Their sales have nearly gone up by 25% since the policy has been undertaken.
- 5. Micro Finance Institutes:** There has been a lowering in the of the disbursement rate post demonetization. Unavailability of cash has also slowed down the collection of installments.
- 6. Small Scale Business Enterprises:** SMEs account for a about 1% of the GDP. These business are largely dependent on cash transactions. The unavailability of cash in wake of demonetization has led to a stagnation in their day to day business.

## 6. Conclusion

The scheme was initially supported by millions who considered it as revolutionizing the country. India which has a large parallel black economy, this scheme claimed to wipe out atleast 12% of the black money. In the following days after the declaration of the scheme banks received large deposits. The figures in the Jan Dhan accounts also went up. Figures provided by 47 local bodies to the Union urban development ministry showed that their tax collection increased by 268% in November 2016 compared to the same last year. These municipalities collected Rs 3,607 crore last November. But the

corresponding figure till November 22 this year is Rs 13,192 crore already. A majority of this tax was collected after November 8. On the other hand, business environment suffered. Excise duty and service tax collection growth slowed in November. Moreover, the demonetization brought with itself economic hardship to the common man.

Whether this scheme will fulfill its long-term objectives is yet to be seen but looking at the immediate effects and ongoing conditions this policy has definitely caused turbulence in the economic environment of the country.

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