

# The Benefits and Challenges of Demonetisation in India

Preety

Research Scholar, SIMC, Swami Vivekanand Subharti University, Meerut, Uttar Pradesh, India.

**Abstract** – The argument posited in favour of demonetization 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. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. Therefore, it is imperative to evaluate the short run and medium-term impacts that such a shock is expected to have on the economy. Further, the impact of such a move would vary depending on the extent to which the government decides to reconvert. This paper elucidates the impact of such a move on the availability of credit, spending and level of activity and government finances.

**Index Terms** – Demonetization, Black money, Economy.

## 1. INTRODUCTION

On 8 November 2016, India's Prime Minister Sh. Narendra Modi announced the Government of India's decision to cancel the legal tender character of Rs.500 and Rs.1,000 banknotes with effect from 9 November 2016. He also announced the issuance of new Rs.500 and Rs.2,000 banknotes in exchange for the old banknotes. While the announcement essentially rendered the Rs.500 and Rs.1,000 banknotes invalid from 9 November 2016, the Ministry of Finance has been monitoring the implementation of these measures in a number of ways:

- Exchange of old currency notes for new Rs.500 and Rs.2,000 currency notes has been permitted until 31 December 2016 (i.e. 50 days from the date of the announcement)
- Such currency exchanges have been limited to certain specified amounts announced from time to time and excess amounts are required to be deposited with banks subject to applicable KYC requirements
- Cash withdrawals have been limited to ensure adequate supply of new currency notes.
- Usage of old currency notes has been permitted for certain specified periods and purposes, such as at hospitals and pharmacies, gas stations and foreign currency exchange for tourists.

The demonetization of the highest denomination currency notes is part of several measures undertaken by the government to address tax evasion, counterfeit currency and funding of illegal activities. The requirement to deposit currency notes in excess of specified limits directly into bank accounts has

resulted in the declaration of hitherto unaccounted income, subject to higher tax and other penalties.

Indian government has demonetized the high value currencies i.e. currency notes of Rs. 500 and Rs.1000 with objective to unearth the black money, and to curb the corruption, counterfeit currency as well as terror financing. This decision was considered as biggest cleanliness drive against the black money in the history of Indian economy. But there is various view of experts on demonetisation, as some argues that it will hit the black money and other argued in negative.

## 2. DEMONETIZATION HISTORY AND BACKGROUND IN INDIA?

This is not The First time When Indian Currency is Demonetised In India.

The first instance was in 1946 and the second in 1978 when an ordinance was promulgated to phase out notes with denomination of Rs 1,000, Rs 5,000 and Rs 10,000.

The highest denomination note ever printed by the Reserve Bank of India was the Rs. 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data.

Rs 1,000 and Rs 10,000 bank notes were in circulation prior to January 1946. Higher denomination banknotes of Rs 1,000, Rs 5,000 and Rs 10,000 were reintroduced in 1954 and all of them were demonetized in January 1978.

The Rs 1,000 note made a comeback in November Rs.2000. The Rs 500 note came into circulation in October 1987. The move was then justified as attempt to contain the volume of banknotes in circulation due to inflation.

## 3. OBJECTIVES OF DEMONETIZATION

In India all sections of the society are accustomed to use cash transactions, and this habit is unscrupulously misused by some bad elements of the society. Such habit resulted in even people with accounted money are started using cash transaction for high value transactions.

It is resulted into parallel economy with unaccounted money, even much stronger than regular economy. The parallel economy black money, corruption, counterfeit currency and

terror financing. These issues hampered growth and development of the economy.

In this background demonetisation of Rs 500 and Rs 1,000 currency notes as a master stroke, as the move will address issues like black money and corruption and also help the economy become more digital.

The move will either unearth the black money slashed in the form of cash or forces to destroy those unaccounted currencies. Demonetisation will curb the menace of black money and will help check stashing of funds to a large extent.

Similarly it has major impact on corruption that exists in India and also on financing of terror activities in India. Hence it was considered as courageous step in the fight against unaccounted money.

4. BENEFITS OF DEMONITISATION

Merit	Details
<i>Lack On Black Money Holders</i>	<ul style="list-style-type: none"> <li>• People who possess huge amounts of black money in hard cash are at a complete loss now .</li> <li>• Their black money in hard cash is now a pile of trash.</li> <li>• Now If a black money holder want to deposit money in bank account Than he/she has to Show ID .</li> <li>• There will be 200 % Penalty on Income tax amount .</li> </ul>
<i>Death Knell To Fake Currency Rackets</i>	<ul style="list-style-type: none"> <li>• Most of the fake currencies used to be be in the denominations of Rs. 500 and Rs. 1000 .</li> <li>• By banning Rs. 500 and Rs. 1000 notes, Modiji has busted all these unethical rackets completely .</li> <li>• Now there will be no use these money</li> </ul>
<i>End Of Terrorist Funding</i>	<ul style="list-style-type: none"> <li>• Huge sums of money especially in hard cash in the denominations of Rs. 500 and Rs. 1000 was used to fund Islamic terrorists , Naxalites and other non-state actors</li> <li>• Now , these Organizations will suffer from shortage of funds .</li> <li>• Most of these terrorist ,Maoist Organization used these funds for buying Arms and Weapons</li> <li>• Buying arms is an extremely difficult task now after this ban .</li> </ul>

<i>Transparency</i>	<p>Online transaction = More transparency = Financial Intelligence Unit will tack all online transactions</p> <p>Now there will be more transparency in real estate sector</p>
<i>End of Huge Donations</i>	<ul style="list-style-type: none"> <li>• Huge amounts of donation that is taken in the private education and healthcare sectors would be stopped.</li> <li>• Schools, engineering and medical colleges and hospitals ( private ones) used to take huge amounts of money as donations especially in the form of hard cash in the denominations of Rs. 500 and Rs. 1000 .</li> <li>• These money-minded people running these institutions won't be able to make any easy money now.</li> <li>• Same applies to the real estate sector.</li> </ul>
<i>Towards A Cashless Economy</i>	<ul style="list-style-type: none"> <li>• While it is practically impossible to have a 100% cashless economy , the proportion of hard cash in the economy will decrease and our economy will get more digitized.</li> <li>• This will result in greater transparency.</li> <li>• Now government has put some limitation for cash withdraw from bank accounts. People Will go for online payments ,They will use PayTM or other online payment Companies for buying goods or making payments.</li> <li>• More Use of Debit and Credit Card</li> </ul>
<i>Hawala Transactions End</i>	<ul style="list-style-type: none"> <li>• Most Hawala transactions used to be carried out in the denominations of Rs. 500 and Rs. 1000 .</li> <li>• With this ban ,Modiji has delivered a fatal blow to the unethical Hawala traders as they can't trade anymore using denominations of Rs. 500 and Rs. 1000 .</li> </ul>

5. CHALLENGES OF DEMONITISATION

General Impact:

Demerit	Details
<i>Rush At Banks</i>	<ul style="list-style-type: none"> <li>• Banks will be extremely over-crowded by people.</li> <li>• People will forget everything else and throng to the places where the</li> </ul>

	banned notes are being officially exchanged leading to a tremendous chaos .
<i>Shortage of Money To Common People</i>	There will be shortage of money for common people.
<i>Stock Market</i>	<ul style="list-style-type: none"> <li>• Due to currency being sucked out of the market coupled with Trump's victory, the mood at the stock market was completely bearish .</li> <li>• Sensex lost 1600 points at open.This can adversely have a negative effect on trade in general .</li> </ul>
<i>Problem For House Wives</i>	<ul style="list-style-type: none"> <li>• Many Indian housewives store money secretly so that they could be of help during times of financial crisis in their households .</li> <li>• The accumulated money of our respected Indian housewives is of no use now until they exchange in the banks and post-offices .</li> </ul>
<i>Short Term Inflation</i>	<ul style="list-style-type: none"> <li>• Due to shortage of money in the market , a short-term cost push inflation will occur .</li> <li>• The price of gold has already become sky high .</li> <li>• Prices of vegetables and fruits have also soared burdening the common man .</li> </ul>
<i>Marriage Season</i>	Difficult for those families those have weddings.

#### Impact of Demonetization

These demonetization measures have had significant and immediate impact on the state of the Indian economy. These measures are also expected to result in long-term impact on certain industries and sectors. These measures have resulted in a significant decrease in liquidity in the short term, which is expected to ease gradually with the introduction and circulation of the new currency notes. As a result of these measures and increased deposits with banks, the bank deposit base has increased significantly, and financial savings are expected to increase as a result of the shift from unproductive physical asset based savings to interest-bearing financial assets. This, in turn, is expected to enhance the liquidity position of banks, which can be leveraged for lending purposes. An increase in the deposit base may also enable banks to lower the blended cost of funds as higher CASA (current accounts, savings accounts) deposits enable replacement of higher borrowing costs and decrease overall cost of funds. With cash transactions impacted by a decrease in liquidity, alternative payment methods, such

as e-wallets, online transactions using e-banking, debit and credit card usage have increased significantly. This will increase usage of such payment systems, and enable a shift towards an efficient cashless infrastructure. Reduced liquidity has also caused a sharp decline in the availability of disposable income, affecting spending patterns and consumption trends in the economy in the short term. These trends, together with certain industry-specific issues discussed below, are expected to affect India's GDP growth rates adversely in the fiscal year ending March 31, 2017. While rating agency Fitch has projected a decrease in India's GDP growth by approximately 50 basis points, other projections peg India's GDP growth rate for fiscal years ending March 31, 2018 and 2019 lower by approximately 30 basis points. These forecasts indicate that an upgrade of India's credit ratings for the next two years remains unlikely, although India's current sovereign credit rating of 'BBB-' is expected to remain steady in the long term.

#### *1.Real Estate and Construction :*

The real estate sector in India has traditionally involved a significant level of informal funding in the form of cash transactions. As the demonetization measures are expected to result in decreased informal funding sources, the real estate sector is expected to be adversely affected. Cash transactions are most common in secondary sales, and resale transactions are expected to decline. While these measures are expected to in the long term promote transparent pricing in the real estate sector, decreased liquidity resulting from lower informal funding sources is expected to significantly weaken the demand for resale properties. Luxury and high-end real estate transactions have also typically involved large cash transactions, with a significant proportion funded from informal sources, and not from banks and other financial institutions. Luxury property rates are therefore expected to decrease as a result of fewer purchasers with significant liquidity. These measures are expected to adversely affect investors in projects with insufficient audit and KYC funding procedures. A decline in resale property rates is also expected to adversely affect real estate investors that intend to leverage existing real estate investments for investment in new projects. In turn, this is expected to affect the primary market as funding new projects become more challenging, and is also expected to affect industries related to the real estate, infrastructure and construction sectors, such as the steel and cement industries. The real estate market is however expected to stabilize with the increase in bank deposits, gradual stabilization in banking operations and resultant lower cost of funds. Large institutionalized real estate developers are however not expected to be directly affected by such demonetization measures. Since infrastructure development projects are typically part funded by the government, these measures are not expected to impact such projects directly. However, the unorganized and middle tier real estate developers that in the past were predominantly dependent on cash funding are

expected to increasingly rely on institutional investors for funding projects. These institutional investors may also be more inclined to invest in the real estate sector now compared to that in the past, with a more transparent pricing structure and anticipated stability in the medium and long term. The long term impact of these demonetization measures on the real estate sector is expected to be positive, and complement other measures undertaken by the Government of India, including the introduction of the Real Estate (Regulation and Development) Act, 2016 (RERDA) and the implementation of the Benami Transactions (Prohibition) Act, 1988 (BTPA). The RERDA contemplates the establishment of the Real Estate Regulatory Authority (RERA) to regulate residential and commercial real estate transactions. It requires all real estate projects involving land exceeding a specified area to be registered with the RERA. In order to ensure appropriate application of earmarked project funds, it also requires developers to maintain a significant percentage of the project funds in a dedicated account. The BTPA prohibits property transactions, including transactions undertaken for and on account of a third party beneficiary funding such transaction, irrespective of complicity of the named owner; such transactions are now subject to criminal penalties as well, and the relevant property may be subject to confiscation.

## 2. Automobiles and Auto Ancillary

These demonetization measures are expected to impact cash transactions in the automobile industry in India, particularly for two-wheelers, used vehicles and other secondary automobile and auto ancillary industries. These measures may indirectly affect OEMs as well as potential automobile customers may find sale of older vehicles more challenging as a result of the reduced liquidity. In particular, these measures are expected to significantly affect rural and semi-urban regions, as well as tier 2 and tier 3 cities and towns that cater largely to the two-wheeler and used vehicle markets primarily driven by cash transactions. While OEMs and auto component suppliers continue to monitor inventories, automobile dealers have focused on funding initiatives with banks and other financial institutions in order to offer schemes for cashless purchases and zero down payments. The short term impact of these initiatives on the automobile, auto ancillary and related industries, including banks and vehicle financial institutions focused on these markets, has been significant.

3. Economy The removal of these Rs. 500 and Rs.1000 notes and replacement of the same with new Rs.500 and Rs. 2000 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.

4. Money Supply With the older Rs.500 and Rs.1000 notes being scrapped, until the new Rs.500 and Rs. 2000 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.

5. 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.

6. 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).

7. 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.

8.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.

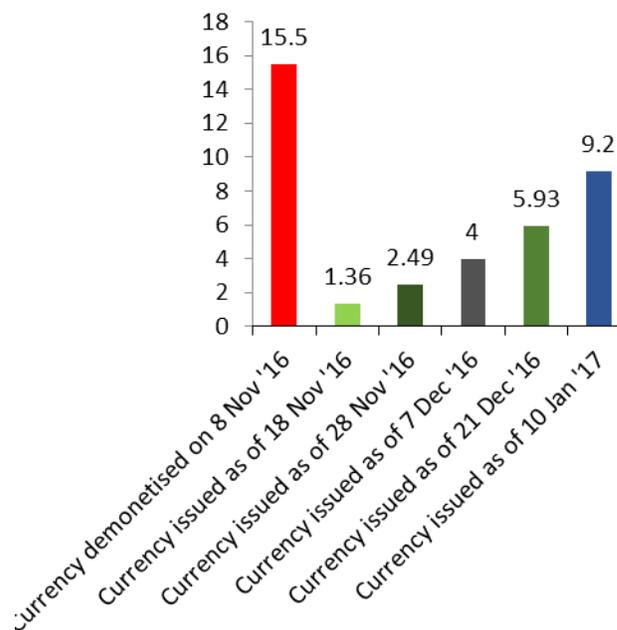
9.Banks As directed by the Government, the 500 and 1000 Rupee notes which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in savings and current account of commercial banks. This in turn will 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.

10. 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.

## 6. FACTS AND FIGURES

Up to 97% of the demonetised bank notes have been deposited into banks which have received a total of Rs.14.97 trillion (\$220 billion) as of December 30 out of the Rs.15.4 trillion that was demonetised. This is against the government's initial estimate that Rs.3 trillion would not return to the banking system.

Of the Rs.15.4 trillion demonetised in the form of Rs.500 and Rs.1000 bank notes of the Mahatma Gandhi Series, Rs.9.2 trillion in the form of Rs.500 and Rs.2000 bank notes of the Mahatma Gandhi New Series has been recirculated as of 10 January 2017, two months after the demonetisation.



## 7. CONCLUSION

Central government's recent decision to demonetise the high value currency is one of the major step towards the eradication of black money in India. The demonetization drive will affect some extent to the general public, but for larger interest of the country such decisions are inevitable. Also it may not curb black money fully, but definitely it has major impact in curbing black money to large extent. As with most economic reforms, there are costs that are immediate, obvious, and asymmetrical while the gains are diffuse and often hard to measure. In the case of demonetisation, Shri N. Modi has staked his position as a leader capable of making bold decisions. The unprecedented boldness of the decision itself seems, at least in urban and semi-urban India, to have played in his favor. In my own interactions with individuals from various walks of life and income levels, there is clearly a willingness to suffer through the inconveniences so that corruption can be brought under control. However, this support is not unconditional and depends on the speed with which the current liquidity crunch is resolved, and also how well the battle is played out in the media (tales of suffering citizens vs the stream of news about tax raids and cash seizures). And while Shri N. Modi may own the narrative now, much of the success depends on the next steps that his government introduces to tackle black money. In other words, demonetisation would be the first step. In economics, when evaluating the costs and benefits of a new policy, we ask

if those that are harmed can be compensated adequately. In this respect it is clear that the Modi government has come up short and one wonders why he did not put in place an action plan to help those who were likely to be the most inconvenienced. The ones who are most likely to suffer are also the ones who are most vulnerable to vote buying. If things go downhill, his political foes may have no need to buy votes.

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## Author



Preety, Research Scholar, SIMC, Swami Vivekanand Subharti University, Meerut, Uttar