Demonetisation and its Impact on Indian Economy

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Abstract— Demonetization is a radical monetary step in which a currency unit is declared as an invalid legal tender. This is usually done whenever there is a change in the national currency of a nation. Such a step is especially taken to curb the menace of counterfeiting, black money and money laundering. A recent example is demonetisation of 500 and 1000 denomination currency units in India. The first instance of demonetisation by the government was implemented in 1946 when the RBI demonetised Rs 1,000 and Rs 10,000 notes. Later, higher denomination bank notes (Rs 1000, Rs 5000 and Rs 10000) were re-introduced in 1954. However, Morarji Desai government demonetised these notes in 1978. According to data provided by RBI Rs 10,000 note was printed in 1938 and 1954 and was subsequently demonetised in 1946 and 1978 respectively. This paper discusses the demonetization over black money holders and its impact on Indian economy.

Keywords— Black Money, Impacts, Indian Economy.

I. INTRODUCTION

On November 8, 2016 Prime Minister announced that Rs 500 and Rs 1000 denomination notes will become invalid and all notes in lower denomination of Rs 100, Rs 50, Rs 20, Rs 10, Rs 5, Rs 2 and Re 1 and all coins will continue to be a valid legal tender. He also added that new notes of Rs 2,000 and Rs 500 will be introduced. There was also no change effected in any other form of currency exchange like cheque, Demand draft (DD), payments made through credit cards and debit cards. The move was taken to curb the menace of black money, fake notes and corruption by reducing the amount of cash available in the system. It has been observed that the fake Indian currency notes of higher denomination have rapidly increased making it difficult for ordinary citizens to distinguish them from genuine notes. These fake notes have been heavily misused by terrorists for anti-national and illegal activities. Since India is largely a cash based economy, containing the circulation of black money and fake notes requires the introduction of schemes like this.

Black Money

Black money in India refers to the unaccounted wealth generated through transactions deliberately executed outside the taxation system or through other illegal activities such as corruption or under-invoicing. Most of the black money is hoarded in these high-denomination currency notes (that have now been invalidated), as was noted by enforcement agencies in their investigations. The announcement to demonetise the currency notes was sudden only in order to ensure that unaccounted wealth is not siphoned off via other channels such as gold or real estate property. The presence of black money in the country creates a parallel (or shadow) economy which is outside the purview of the government, leading to loss of tax revenues. This money is also not subject to other instruments normally deployed to steer the economy, say, interest rates.

The government has already declared that information on all cash deposits above INR 250,000 in the banks will be shared with tax authorities and deposits for which income cannot be accounted will be taxed at the applicable rate as well as penalised at 200%. As such, 60% of all black money deposited in accounts will be collected by the government as taxes. The government will also benefit in the scenario that certain amount of black money is not deposited in the accounts due to fear of prosecution and is allowed to be rendered useless. Every currency note represents an obligation on the part of the central bank and therefore any unreturned currencies would imply an equivalent amount offloaded from the central bank's liabilities. The central bank can then proceed to transfer the excess amount as dividend to the government, as has been the practice in recent years.

II. IMPACT IN INDIAN ECONOMY

Short Term Impacts

The growth in the economy will slow down in the short term.

Cash Economy

India is predominantly a cash economy, with majority of the transactions carried out by payment through currency notes. The sudden move (of demonetising INR 500 and 1000 currency notes) has left bulk of currency in the country worthless, with not enough currency in smaller denominations available. While non-cash transactions using debit or credit cards, online banking or funds transfer, mobile wallets, etc. are still allowed as before, the cash economy character implies that most citizens rely on currency notes for carrying out basic transactions. This is especially true for the rural areas. While the government is replacing these notes with new currency notes of INR 500 and 2000, there is initially a cap on amounts to be exchanged thereby causing a disruption in cash flow in the market. With limited cash availability, consumer spending has drastically fallen and is expected to slow down in the medium term. This will negatively impact growth in the economy over the following two quarters. The action the government takes on the black money deposited in bank accounts will also influence sentiment in the market.

Long Term Implications

Demonetisation is arguably the most significant and direct initiative to combat the menace of black money and its parallel
The present move of the government is not likely to affect the forms other than physical notes like gold, jewellery, land etc.

One of the key benefits of the unearthing of black money will be the revenue generated from taxes and penalties imposed on such undisclosed income. Calculations reveal that this revenue could be significant - even almost as much as the fiscal deficit of the government for the entire year.

Such a substantial windfall could be used to lower the fiscal deficit and also increase spending on social schemes for the benefit of the common man and the economy at large. In the long term, transparent transactions and improved tax compliance will increase government revenues from both direct and indirect taxes. Finally, a diminished parallel economy would bode well for the formal economy.

Lending Rates

With Rs. 17,000 billion worth of currencies demonetised, this amount will return to banks. While a portion of it will be immediately exchanged and some possibly allowed to become invalidated, the majority of this amount would end up as deposits in banks, flushing the banking system with liquidity in the near term, which can set off a notable fall in lending rates.

Finally, lending rates could also be driven down by a decrease in demand for consumer goods in the rural economy, in the immediate aftermath of decrease in cash currencies in circulation.

A fall in fiscal deficit due to revenues from taxing and penalising black money, or from a reduction in liabilities of the central bank due to currency not returned, would lead to lower government borrowing and free up liquidity for market lending as well as lower yields on government securities.

Corporate India has time and again complained the higher cost of capital as the reason behind their operations and projects being unviable and the banks are plagued with non-performing assets. As such, a lower lending rate could bring such projects back on track.

Effect on Currency

As cash is in short supply, the currency may appreciate in response. Lower levels of inflation would also have the same effect. This is likely to have a negative impact on trade. Counter moves by the government are expected to ease this. However, the currency will also move subject to non-domestic factors, including if the US Fed moves to hike rates.

III. Conclusion

The system is expected to prove positive for the economy in the long run: It will boost the formal economy in the long run as black money hoarders will not able to make their money white. Middle class citizens may get benefitted from the short term fall in real estate prices. This move along with the implementation of GST is likely to make the system more efficient, accountable and transparent. Government does not have any fair estimate of how much of black money is in the forms other than physical notes like gold, jewellery, land etc. The present move of the government is not likely to affect the other forms of black money. The move will also have little effect on the black money stashed away in the foreign tax havens.

REFERENCES