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Impact of demonetization on the Indian economy

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Abstract

Demonetization is the process of withdrawing a currency from circulation. Sometimes, a country completely replaces the old currency with new currency. It outlines the effects of demonetization on GDP growth and impact of demonetization on business. The frequent change in the narrative on objectives of the demonetisation to its visible impact on the poorest of the poor made other critiques calling government's narrative as spins in view of the "pointless suffering on India's poorest.

After one and a half year of Demonetization, Indian Economy seems to have done away with all the negative impacts of Demonetization. The Economic Survey of India 2017-18, released just before the presentation of General Budget 2018 in Parliament has emphasized that all the negative impact of Demonetization of Rs.500/- and Rs.1000/- currency notes has ended.

The Finance Minister Arun Jaitley on November 7, 2017 came out with a spirited defence of demonetisation announcement on November 8, 2016 calling it a "watershed moment for the Indian economy".

Keywords: Demonetization, Indian economy

1. Introduction

The term demonetization has become very popular in India after 8th November 2016. On that day PM Narendra Modi declared suddenly demonetization in India. This is not the first time that demonetization occurred in our country. Earlier demonetization has occurred in India in 1946 and 1978. Though government wanted to make some economic growth in the country through demonetization, as a sudden declaration of demonetization lots of chaos and confusion occurred in the country.

After demonetization about 15.44 lacs, crore worth of Rs 500 and 1000 notes stopped being legal tender. But only 10 to 12% new notes had been issued by the government immediately which created cash shortages in the country.

As result of demonetization in India, we have seen a decline in corruption in the country. On the other hand, the circulation of duplicate currency in India by some anti-national groups had become an alarming problem in the economic growth in the country. The circulation of the duplicate currency has been stopped. Again illegal fund flow to the terrorist groups had been stopped after demonetization in India. But the Black money has not been seen brought out so far. Only for that failure, some economist calls demonetization a failure by government.

Impact of Demonetization on Indian Economy On GDP

India's GDP which grew at 7.6% in FY 2015-16 is likely to slow down by 0.5% to 1.5% as per reports of various agencies. This is due to less availability of cash in cash-intensive sectors like manufacturing and real estate. Even the automobile industry which was growing rapidly earlier has seen a contraction in the October-December quarter of 2016. Purchasing power of consumers has been negatively affected due to cash not being readily available.

We need to remember that Indian economy is largely cash driven with more than 90% transactions taking place in cash and digital transactions accounting for just the remaining 10 percent.

Banks have also been focusing on the single task of deposit and withdrawals with the result that their core function of issuing loans has been adversely affected. Also current account customers, who are largely business owners, need large amounts of cash at short notice have

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not been able to access cash and credit owing to restrictions on withdrawals and inability of banks to focus on the task of issuing loans.

On Tax Compliance

India's tax-to-GDP ratio is quite low at 16.6% compared to other emerging economies. It is estimated that since more money, including black money, gets accounted for this will lead to better tax compliance owing to better targeting of income. The positive impact could be lower tax rates as the tax base widens and more people start paying taxes. The digital push of the government will also result in higher indirect tax revenue for the govt. in the form of service tax. Moreover businesses that under-reported their revenue earlier, will have to make proper disclosure, especially, of revenue received through digital or cashless means.

On Small and Medium-sized Enterprises (SMEs)

The small and medium-sized enterprise (SME) sector, is a big chunk of the economy, contributing to eight percent of the GDP whilst employing more than 80 million people year on year.

The labour wages in this sector are largely paid in cash and wages have been adversely affected by the demonetisation move. Unemployment has also been reported owing to decline in demand of SME goods as the purchasing power of the consumers has contracted in the short term. Other sectors within the SME space like restaurants and transport operators have also been negatively impacted since economic activity has declined and also due to the fact that there is high tendency in this segment to accept payments through cash only.

Wholesale vegetable markets have been witnessing declining demand and prices of tomatoes and other food items have fallen drastically making it economically unviable for the farmers to produce these crops.

On Agriculture

This is one sector where all transactions are in cash and, given the values involved, involve the higher denomination notes. The withdrawal of the old currency notes has put pressure on the mandis; farmers are having problems in selling their produce as both the parties have to agree on the mode of payment. Also since there is acute shortage of Rs 500 denomination notes presently, change for the high denomination Rs 2000 notes is not readily available with the vegetable and fruit vendors. This is also taking the buyers away from these vendors to big retail markets thus impacting the livelihood of the unorganised sector.

On Employment Generation

Since consumer demand has slowed and consequently industrial production has declined, employment generation has been adversely impacted by the currency demonetisation drive. Since the manufacturing sector which accounts for the highest employment of skilled and semi-skilled labourers, is witnessing slowdown in production; not only less jobs are being created but lay-offs are also taking place at a higher rate.

As per report, Industry is staring at temporary job losses due to demonetisation, as production gets hit, especially in labour-intensive sectors like textiles, garments, leather and jewellery. As many as 4 lakh people, mostly daily wagers, may have either lost their jobs or shunned work temporarily

due to the lack of payment so far, and the number is only going to grow if the cash crunch persists

Impact of Demonetisation on Black Money

Fighting black money rampant in the economy was one of the foremost objectives of this entire exercise and we will discuss in detail whether this objective was realised or not.

The cash component forms just 6% of the black money in the Indian economy and currency demonetization will target just this 6% black income. If various reports are anything to go by, most of this black income has been converted into white by depositing it in Jan Dhan accounts, depositing in individuals own accounts by breaking into smaller chunks, by exchanging for new currency notes through hawala dealers, by buying last-minute luxury items like jewellery and high priced mobiles, by paying advance wages to employees etc.

As per various announcements by the govt. from time to time that deposits by housewives and those exempt from tax will not be scrutinized has provided a way out for black money hoarders to convert their money into white.

However there have also been some positive impacts like one time removal of counterfeit or fake currency from the economic system. The demonetisation cannot and will not prevent future generation of black money since black money problem is more of a cultural mindset in India than a legal problem. It will also be easier for the corrupt and black money hoarders to deal in Rs 2000 currency notes as compared to Rs 500 and Rs 1000 notes since higher currency value can now be carried with greater ease.

A total of Rs 3185 crores in black money of which Rs 86 crores in new notes has been seized by the Income Tax authorities since the launch of the demonetisation drive on 8th November. This implies that on the one hand black money is getting unearthed and on the other leakage of new currency notes is taking place; most probably through the banking system itself.

Impact of Demonetisation on Terror Funding and Fake Currency

The initial reports suggest that terror related activities in J&K witnessed a noticeable halt in the days following the demonetisation drive, including, stone pelting by misguided youths; the Nagrota attack shows that terrorism is continuing in the valley. Although the availability of cash has surely declined among the terror groups presently.

The government also claimed that the new currency notes contain very high security features and are almost impossible to replicate. But this claim does not seem to be true since many stories of counterfeit currency have come to light since the note ban was announced on November 8th. The circulation of fake currency has definitely slowed down considerably since the infrastructure set up to print fake currency notes in neighbouring countries like Pakistan has been rendered useless by the demonetisation drive.

Impact of Demonetisation on Cashless Transactions

The cashless transactions account for only 10% of all transactions on daily basis. The government in order to divert some of the blame for the poor implementation of this demonetization exercise announced mid-way that making India a cashless or less cash economy was one of the important objectives of this demonetization drive. Towards this end, the Finance ministry, RBI and NITI Aayog

announced a host of incentives to boost cashless transactions. This was also done to ease some of the problems that have resulted due to acute shortage of cash in the economy.

Some of these incentives include

- No Service Tax on cashless transactions below Rs 2000
- Providing cash backs ranging from 0.25-0.75 percent on various transactions like paying for fuel, government utility bills, stamp papers, property registrations etc.
- Encouraging use of Point-of-Sale (PoS) machines and mobile wallets like PayTM by businesses and individuals
- Reducing self-assessment tax from 8% to 6% on businesses with annual turnover of less than Rs 2 crores
- Announcing monthly jackpots for people using cashless transactions in government services
- And other incentives

As a result, use of mobile wallets and cashless transactions, as a whole, has increased by about 300% since the launch of demonetisation exercise. However we need to remember that this 300% increase is against a very low base of digital transactions and most of this increase has been noticed in the urban areas where people have ready access to PoS machines, internet banking, and mobile wallets.

Cashless transactions are still rarely used in rural areas and in the informal sector like road side vendors, small shops, buying seeds, wage payments etc.

Conclusion

Demonetisation of old currency notes surely has had some positive impact like reducing the cash flow to terror organisations, dismantling of counterfeit currency infrastructure, better income tax and indirect taxation, boost to digital economy. However, it has come at a huge social and economic cost.

Demonetisation is a one-time event and will not have much long term effect. It alone is not sufficient to counter black money and corruption in the country; rather other measures are more crucial like bringing the offshore tax evaders to book whose names figure in the Panama papers, raid on benami properties, making donations to political parties open to public scrutiny and making it mandatory for all donations above Rs 2000 to political parties and religious places to be through digital means only.

This entire exercise seemed more like a carpet bombing than a surgical strike where the vast majority of honest and law abiding citizens had to undergo terrible hardships in order to catch the few black sheep who have hoarded black money and who also managed to convert their black income into white.

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