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Ashok kumar P Rathod
Research Scholar, Ph.D.
Gujarat University, Gujarat,
India

An overview and impact of demonetization on Indian economy

Ashok kumar P Rathod

Abstract

Demonetization is a process of replacing the flow of old currency in an economy with a new currency. The aim of demonetization includes controlling inflation, to combat to corruption and to discourage the cash system in an economy. Demonetization enhances the use of digital payment gateway and encourages transparency in economy. India is one of the largest retail markets all over the world which have high cash basis transaction. Demonetization leads the economy from cash basis to paperless basis. This paper attempts to clarify the prime objectives of demonetization and the effect of it on various sectors of Indian Economy. This paper also attempts to analyse the effect of Demonetization on the growth of GDP.

Keywords: Gross Domestic Product (GDP); POS (Purchase on Sales); Black Money; Reserve Bank of India (RBI)

Introduction

Demonetization is the process in which a particular currency or valuable mineral tender degraded as a legal tender. This happens when a certain currency of origin, or when a newer currency comes into circulation. There are multiple reasons why nations demonetize their local units of currency. Some reasons include combating inflation, to combat corruption, and to discourage a cash system. The process of demonetization involves either introducing new notes or coins of the same currency or completely replacing the old currency with new currency.

Demonetization means discontinuity of particular currency from circulation and replacing it with a new currency. It can also be considered as a withdrawal of a specific currency from the market.

Meaning of demonetization

“Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit”.

History of demonetisation in India

First Demonetization - 12 Jan 1946 following the action in several foreign countries, including France, Belgium and the U.K., the Government of India decided on demonetization of high denomination notes, in January 1946. It is interesting that as early as April 17, 1945, suggested similar action in India as 'one more concrete example for the Indian Government to follow in its fight against black market money and tax evasions which have now assumed enormous proportions.

This is not for the first time Government Demonetizing the currency. Earlier to this India has witnessed demonetization twice. For the first time demonetization took place in pre independence period. In January 1946, for the first time demonetization took place in India. During this demonetization British Raj withdrawn currency notes of 500, 1000 and 10000 Rs. from the circulation and new currency notes of 1000, 5000 and 10000 denomination rupees were introduced in the year 1954. On 16th January 1978, Government of India demonetized the currency notes of 1000, 5000 and 10000 rupee notes as a means to

Correspondence

Ashok kumar P Rathod
Research Scholar, Ph.D.
Gujarat University, Gujarat,
India

Counterfeit money and black money. The present demonetization is the third occurrence in Indian Economy and it is the second Demonetization in the post-independence period.

“November 8, 2016, would be remembered as a watershed moment in the history of Indian economy”. It was the third time when demonetization was announced in India by our honourable prime minister Shri Narendra Modi Ji through which Rs. 500 and 1000 Rs. Notes were scrapped from the economy. For that new 500 rupee notes will be issued and a new currency note of 2000 denomination has been introduced in the economy. New currency notes issued to the public through commercial banks and post offices across India by depositing the demonetized currency notes by the people.

According to the RBI's (Reserve Bank of India) Annual Report for April 2015 to March 2016, the value of the currency notes at the end of March 2016 was 16.42 trillion Indian rupees. Earlier demonetization was done in 1946 and 1978 but with no success. Last year demonetization was different from earlier one as it not only scrapped 86% currency from the market all of a sudden but it was combined with secrecy. The objectives that were told by the government were fourfold: to curb corruption; counterfeiting the fake currency, to stop the use of high denomination notes for terrorist activities; and to prevent the accumulation of black money generated by income that has not been declared to tax authorities. In one stroke, the government removed 86.4% of the currency in circulation by value. In terms of volume, the currency notes of these two denominations formed 24.4% of a total 90.27 billion pieces.

Main objectives of demonetization

1. To analyze the impact of Demonetization on GDP.
2. To analyze the impact of Demonetization on different sectors of economy.
3. To analyze the future impact of Demonetization on Indian Economy.
4. Check black money.
5. Fake currency notes

Reasons behind demonetization

1. Black Money

A recent study had pegged India's black market economy at over Rs 30 lakhs crore or about 20 % of total GDP. This is even bigger than the GDP of countries like Thailand and Argentina. So now after this Decision black money holders are left with just two options – either route this money through banks, declaring it to be their income or burn the stashed file.

2. Fake Currency & Terrorism: Terrorism is a frightening thing. But have you ever thought about how these terrorists get their money? Enemies from across the border have run their operations using fake currency notes. This has been going on for years.

3. Unorganized Trading

a. Prices hike in Real estate sectors is mainly because of the involvement of black money, but after taking this decision the prices of property will surely come down to their real value..

- b. Unorganized dealing in share market will also be eliminated after this decision and this will gain positive result in the economic condition of the country.
- c. The problem of inflation will get solved with this step as the government will get more money in its pocket in form of taxes and undisclosed income.
- d. Banking system will also get strengthened as banks will be flooded with huge amount of money. This will also result in more economic development in the nation as the money will be channelized properly through banks.

4. Less Cash Economy

It is not possible to make India Cash-Less economy, but for the development and making transparency in the economy we can say use of less Cash is possible. So for making people familiar with E-Payment and use of plastic currency demonetization is required.

Benefits of demonetization

1. Rise of the Cashless Economy

Spread of the digital payment culture will start the 'formalization' process in the economy. It will reduce the use of physical cash as well. Once bulk of the economic transactions is digitalized it will result in revealing the expenditure made by individuals to the tax authorities especially big transactions.

2. Growth Of The Formal Economy Will Be Another Associated Long Term Gain

If additional measures like cleaning the real estate sector and bringing all traders under the digital payment system, the unorganized sector transaction will be made accountable. Even if it is a slow process, bringing the informal sector into the formal economy will reduce black money.

3. Social Shake Up

Black money can be eliminated only if we eliminate the deep rooted social mentality that dealing with black money is economically rewarding and legally feasible. Demonetization may bring a social shake up in the country by destroying this mentality. It will spread an attitude against black money. People will be averse to deal with black money if they know that they are easily traceable and harder legal steps are initiated against them. Such an awareness and conscience can reduce the area available for the activation of black money.

4. Demonetization will reduce the circumference available of parallel economy

Demonetization is not an isolate arm or not only one against black money. It may be complemented by several other steps. One such supportive step is making PAN compulsory for high value transactions up to Rs. 10000. Similarly, PAN documentation should be made compulsory against all investment in physical assets like gold, land etc., if these happens, parallel economic activities can be reduced substantially.

5. Large number of new tax payers may appear with demonetization

This is because demonetized money will reveal their income size and tax officials may check them in future, compelling to pay tax.

6. Cleaning of the real estate sector will be associated long term gain of demonetization:

Modification of stamp duty structure is badly needed to provide energy to the sector at the same time, making it accountable.

7. Rise in financial savings

At present, more than 50% of household savings are in physical savings like gold and land. Significant portion of these are in black money. Now with the low reward in the real estate and gold holdings, people may tempt to save in financial forms like bank deposits, mutual funds etc. As Krugman suggested, demonetization is a highly disruptive way to fight black money and it is only a one time effort to flush out hoard money. We cannot do it always. Similarly, only a fraction of black money is stored in liquid cash. All these indicate that fight against black money will be successful in the long term only if the other measures suggested here are adopted. Above all, the legal system should be prudent to prevent people to invent new ways of hoarding and dealing with black income.

Impact of demonetization on Indian economy

Government of India demonetized the currency as a tool to fight against corruption and black money, which are the major problems of Indian economy. The present demonetization will be having some effects on Indian economy. Some of the major effects of demonetizations are as follows:

1. Effect on Parallel Economy

One of the major objectives of the demonetization is to fight against the black money. With the demonetization the black money within the economy will be blocked as the owners of the black money in the form of 500 and 1000 rupee notes cannot replace it and deposit it in the banks as it is not having the proper documents. In this way the parallel economy will be affected to a greater extent which is the positive impact of demonetization.

2. Short Run Effect on Money Supply

Money supply will be reduced in the market due to withdrawal of currency notes from circulation. This effect will be the short run impact of demonetization. The problem of money supply will be solved when the new currency notes widely circulated in the market.

3. Effect on Consumption

Decrease in money supply as a result of demonetization is also having an impact on production and consumption. Due to decrease in money supply production decreases and it affects consumption negatively.

4. Fall in the Prices

Prices for different goods will fall with demonetization of currency. The prices of consumer goods and the prices of real estate sector are expected to fall.

5. Increase in Bank Deposits

The demonetization increases the deposits in current account and savings bank account. As government announced the demonetization, the money held by the household sector for the emergency purposes will be

deposited with the banks, which will increase the deposits in the banks.

6. Increase in Alternative Modes of Transactions

Due to demonetization the cash transactions are facing a reduction, which increases the other alternative modes of transactions like use of credit cards, debit cards online payments and transactions etc.

7. GDP will Decrease in the Short Run

GDP will be hurt due to the demonetization. GDP of India may fall as a result of demonetization. The extent of fall may be very less and it exists only for a short duration of time. This fall may not affect the growth of the economy.

8. Effect on Anti-Social Activities

Demonetization is a mighty blow on the anti-social activities. Due to the demonetization funding of anti-social activities, smuggling can be curbed. These anti-social activities weaken the economy. It is difficult for the anti-social activists to recover from this. So the anti-social activities can be curbed to a greater extent.

9. Effect on Agriculture

Demonetization will have short run impact on agriculture, small traders, small vendors etc. as agriculturists are dealing with the perishable commodity, not having other mode of payment other than cash transactions and lack of demand will affect the farmers negatively.

Conclusion

Demonetisation done by our honourable Prime Minister Shri Narendra Modi in the year 2016 was with the very good intention to reduce corruption and black money from the economy, bring transparency and greater formalization in the economy. This was why general public was with him and is still standing with his decision no matter how many hardships they faced during demonetization days and after it whether it was standing in the queues before banks, cash crunch or job losses. Now it is the responsibility of the government to reap the benefits of it when all the cash that once was lying idle or with business persons has come into accounting.

Hence manufacturing is low. Bank credit is also low. Investors are not coming, so no new jobs and employment. Now it is the responsibility of the government to take the economy out of this slump by decreasing the taxes both direct and indirect, increase in public expenditure by starting new big infrastructure projects, etc. The government should move towards removing all obstacles coming in effective implementation of GST by being sensitive to businessmen problems, reduce taxes and stamp duties, giving booster dose to MSME and unorganized sector so that the people who have lost their jobs or businesses due to demonetization may join back the formal economy and live a dignified life. If government want to increase digital transactions in the economy it should provide proper e-economy infrastructure along with cyber security besides providing incentives of using digital transactions like no charges through payment of POS machines or debit and credit cards, cash back through payment of digital transactions etc. if government apply all these measures in true sense not only economy will come out of slump but the pain of people due to demonetization will also be less, and the economy will

move towards greater formalization with increased transparency and less black money.

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