

15 DEMONETIZATION: WAY AHEAD FOR INDIAN ECONOMY

Dr. Sumesh Kumar

Assistant Professor, International Institute
of Health Management Research, Dwarka
Sector-18, New Delhi

Abstract

Government of India announced demonetization of one thousand and five hundred rupee notes on 8th November 2016 as a measure to control corruption. Suddenly there was shortage of cash in the market and queues started building up in front of banks and ATMs. Views started coming out from different agencies and thinkers about the step of demonetization. According to some thinkers the step is going to be a big failure as the economy will suffer because of sluggishness in demand. This paper shows the other side of the coin and on the basis of pre-established economic theories; it reveals that demonetization is going to benefit the economy in the long period if the flow of money would be towards economically weaker section of the society. The facts that have been given in the paper are based on certain assumptions. Later the paper also discusses the major challenges in the way to demonetization in the country.

Keywords: Demonetization, Money Supply, Demand, Currency, Corruption, Black Money

Introduction

Currency is accepted by the people of any country as medium of exchange. It includes notes and coins that are legal tender and people use currency in their day to day transactions. Currency makes buying and selling easy because of its unique features such as measurement of value and acceptability or liquidity. It is important to manage currency according to economic condition of any country to avoid high inflation or recession. There are various measures to manage quantity of currency and one such measure is demonetization. Demonetization is a state when the current currency does not remain legal tender and new currency takes its place. Recently on 8th Nov. 2016 India faced the demonetization of one thousand and five hundred rupee notes to curb black money and fake currency. Demonetization is not new in India. In the past also Government had demonetized ten thousand and one thousand rupee notes. The present paper is trying to find the way ahead for the Indian economy after demonetization. The paper links demonetization with different economic variables and measures the impact.

Demonetization Some Global Examples

Demonetization is not a new word in the history of Indian Economy. India has witnessed demonetization third time when Prime Minister Narendra Modi declared that five hundred and one thousand notes are no more legal tender on 8th November 2016 with the aim to curb corruption. India is not the only country that has tried demonetization as a weapon of war against black money and fake currency; there are some other countries of the world that have tried it earlier such as Russia, North Korea, Zaire, Myanmar, Ghana, Venezuela etc. In all these countries, the step of demonetization proved to be a failure and could not meet the objective mainly because of unrest among the people of the country. On the other hand, apart from these countries there are countries such as USA, Pakistan, and European Union etc. where it was successful as in these countries the timing of demonetization was appropriate and the idea was carried out nicely by the Governments of the respective countries.

In almost all the countries where demonetization failed, the people of

the country were against the decision and they started agitations. As a result, either the Government rolled back or the system collapsed. This is where India has an advantage, people of the country are welcoming the step of demonetization and have shown great patience and enthusiasm in fight against corruption. People are opting cashless transactions as substitute of cash and are supporting the step of demonetization to a great extent. So, India can expect better results from demonetization.

Objectives

The main objectives of this paper are:

- 1) To analyze the concept of demonetization in Indian context.
- 2) To analyze the expected short term and long term impact of demonetization.
- 3) To see the challenges in the way of successful demonetization in the country.

Concept of Money supply in India

Before going into the details of impact of demonetization, it is important to understand the concept of money supply. The four

concepts of money supply that prevails in our country are:

M1

M1= Currency with public + Demand deposit in all banks (e.g. current account, savings account) + other deposits with RBI

M2

M2= M1 + Post office bank savings

M3

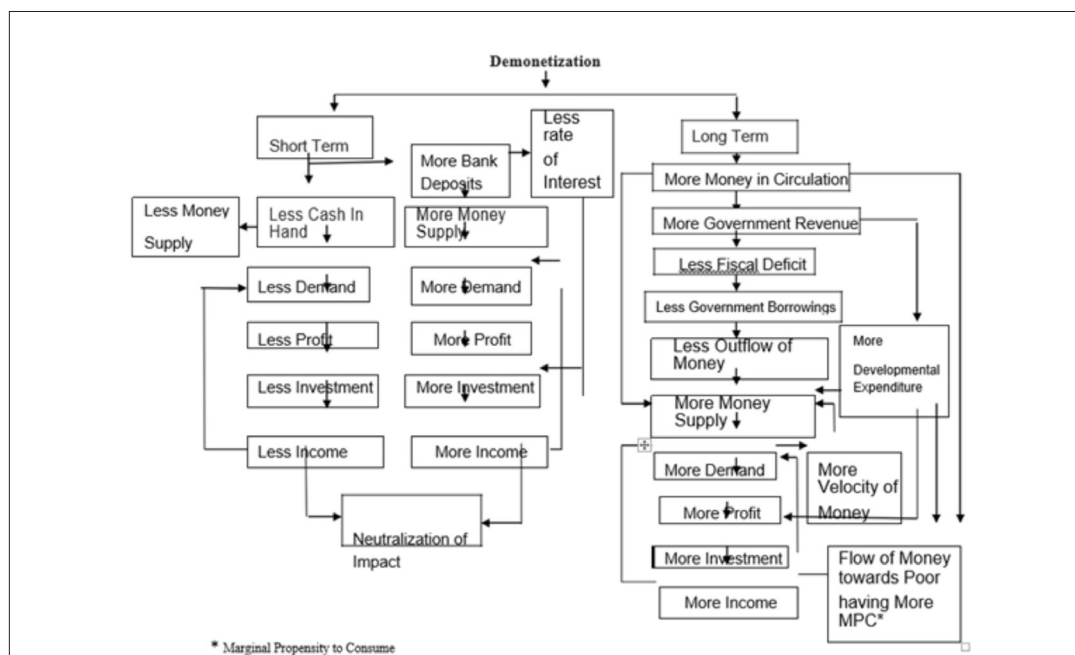
M3 = M1 + Time deposits with commercial banks (Fixed deposits, Recurring deposits).

M4

M4= M3 + Total post office deposits

Impact of Demonetization on the Indian Economy

There are many views regarding the impact of demonetization. Many thinkers give their views that it will lead to shortage of money and recessionary trends in the economy. Some thinkers give their views that demonetization will not be successful in its objective to curtail corruption. This paper highlights different aspects of demonetization and is trying to elaborate the best possible effects with the help of following framework.



The impact of demonetization can be seen in two ways- short term impact and long term impact. In both the time periods it affects the economic variables differently as shown below:

Short term impact

In the short period, the impact can be categorized as stimulus impact and deterrent impact.

Deterrent impact

The Government of India is trying hard to supply new notes in the market but it is clear that in the short term there would be less

cash in hand and it seems that there is less money supply. Less cash in hand compels people to buy less. The demand for goods and services will fall and it is difficult for the entrepreneurs to earn profit. Falling profit causes the investment to come down. Because of backward effect of multiplier, there will be less income generation in the economy. Low level of income generation again becomes the cause of less demand and this circle continues unless Government does pump priming or any other stimulus factor that pushes the economy out of this recessionary situation.

Stimulus impact

The above mentioned deterrent effects are only one side of the coin. In reality, though cash in hand is less but money supply has not come down. It is evident from the M1, M2 concepts of money supply that includes the currency, bank deposits and deposits with the post offices in the money supply. The deposits are increasing with the banks and that leads to lowering interest rates. Banks will create credit and money supply will increase further as it is said that banks create money when they lend. In the discussions on demonetization, there is a consistent reference to the resultant increase in credit creation in the economy. Like Finance Minister Arun

Jaitley says, "Bank deposits will increase and they will have more capacity to support the economy" (NIPFP). Low interest rates will be an incentive for the investors to invest more and with positive multiplier effect the income will increase and that will create demand for goods and services.

Deterrent and stimulus effects seem to be neutralizing each other and economy will run as usual after a specific time period.

Long term impact

The real benefit of demonetization can be seen in the long run as in this time period, there is no deterrent effect but there is only stimulus impact. With demonetization, idle cash has come out which was not there in the circulation and it was in the form of black money. So there is more money in circulation and that has increased the government revenue in terms of fines, penalties and taxes. One should witness a spurt in tax collections in indirect taxes as well as property tax in the month after demonetization. There is evidence already that property tax collections in some cities are higher than last year (NIPFP). On one side it decreases the fiscal deficit and on the other hand it leads to more expenditure on the developmental activities. Developmental expenditure turns the flow of

money towards poor people and they have comparative more. Marginal Propensity to Consume (MPC), that indicates high demand in long term. Less fiscal deficit causes few government borrowings both internal and external. There is less outflow of money and more money supply in the economy that generates demand, profit, investment and income. With rising economic variables the velocity of money also positively contributes in the stimulus factors.

The overall analysis of long period indicates that the demonetization will positively affect the economic variables and will strengthen the economy. The above analysis is based on certain pre-assumptions that are required for the proper working of economic variables depicted in the chart.

Assumptions

- 1) Idle money will come out with demonetization.
- 2) The flow of accumulated money after demonetization will be towards the poor and middle class population.
- 3) Developmental expenditure will be increased by the government.
- 4) Marginal Efficiency of Capital remains high.

Challenges in the way of demonetization

- 1) Timely and sufficient supply of new currency is the major challenge for the government as there is sudden surge in the demand of new currency notes.
- 2) A large number of Indian population is illiterate and is not technology friendly. People are not aware of electronic mode of payments.
- 3) In many parts of the country infrastructure required to electronic payments is inadequate such as smart phone or mobile connectivity, electricity etc.
- 4) Many people do not consider electronic payments safe and convenient. They

are very much familiar with the cash as medium of exchange as they have been using cash for many years for payment of goods and services they purchase. This is the reason that a major part of Indian consumers prefer to make and accept payments in cash only. Their switch to cashless economy requires a big behavioral change and that is a major challenge.

- 5) A major part of the black money is kept in the form of land, gold and is deposited with foreign banks, so demonetization will not affect directly a major part of black money accumulated in other forms than cash.
- 6) Another major challenge before Government is that how to pump the accumulated capital again in the economy and in which form, so that poor and middle class people should get the major share of the benefit. If Government succeeds in this step, it will reduce the gap between rich and poor.

Conclusion

The step of demonetization is a daring step as about eighty six percent currency in circulation has been wiped out by the Government mainly to limit black money. The dearth of cash disturbed the life of a common man in the initial days of demonetization but people stood by the decision and the situation improved with passage of time. Idle cash has come out in circulation that has been accumulated in the form of black money. Government fiscal deficit has come down as the Government revenue has increased in the form of fines, penalties and taxes. The increased Government income will flow towards poor or the middle class population in the form of developmental expenditure. The super multiplier effect will further enhance investment, income and consumption in the economy. Moreover, the economy is moving towards cashless transactions and that will be a great stimulus factor and indicator of economic

development. The path of demonetization is not smooth there are certain hindering factors that should be tackled properly and timely by the Government to make demonetization a success.

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