



## Impact of demonetization (Notebandi) on Indian economy

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### Abstract

What good or bad Demonetization has brought to the country is actually still a conclusion, which remains too distant, industry experts opine the move has set a tone for formalising an economy which is predominantly being run on cash. “Going digital & cashless has helped in formalising the Indian Economy & increasing financial inclusion.” The government doesn’t use the term demonetisation, it prefers “note ban”, and the illegalising of Rs 500 & Rs 1000 notes on November 8 is popularly known as notebandi in Hindi. A bone of contention between the government and the Opposition parties, the note ban was a highly secret move that shook the whole nation, drawing both criticism and praise from different quarters. However, the goalpost on its objective was gradually shifted, with the government saying that the note ban decision would lead to the formalisation of cash economy as money flow through digital means can be tracked easily.

**Keywords:** demonetization, note bandh, Indian economy, financial inclusion

### Introduction

On the evening of 8th Nov 2016, Indian Prime Minister Mr. Narendra Modi announced a sudden denomination of ₹500 and ₹1000 rupee notes. Instead of RBI Governor Urjit Patel, surprisingly Prime Minister announced the news of demonetization that these banknotes would not be legal tender after midnight of the 8th Nov, means the high value notes will not be legal for transaction. Although the old notes can be exchanged till 31st Dec 2016. There were set an upper limit of cash withdrawals from bank is ₹10,000 per day (up to ₹20,000 per week) per account and from ATM ₹2000 per day per account from 10 to 13 Nov which is changed from 14 Nov. to ₹24,000 per week from bank and ₹2,500 per day from ATM per account till 31st Dec., although a needy person can withdraw with valid reason. According to RBI report on 31st march 2016, ₹500 and ₹1000 banknotes consist around 86% of total cash circulation having value of ₹15.44 lakh crore. In this process 97% of old notes around ₹14.97 lakh crore were deposited in bank before 31st Dec.

### Reduction in fraudulent practices

In most branches far from India’s urban centres, banks have run through physical paper trails & passbooks. This often led to small and large-scale cases of fraud for unprepared & underequipped bankers to deal with. With the economy going digital and verification happening through Aadhar, banks are now better prepared to deal with such illicit activities. Online bank statements are now generated and made available for download from bank websites, and numerous software suites offer tools to detect and prevent fraudulent claims, while drastically reducing the time taken for analysing and verifying transactions across the branch network. This has increased the

digital footprint of Indian consumers and bank account operators, offering a wealth of data that can aid in policy formulation.

The cash component of real-estate transactions – usually informal and illegal – has come down drastically. The percentage contribution made by borrowers for purchasing a house after taking a property loan has dropped from 40-50 % to 20-25 %, enhancing the requirement for loans in the market, and introducing many more to the world of formal, financial credit systems.

### Objectives of Noteband

Well, this is truly a master stroke by PM Modi Ji, what a plan he has made, and what a successful declaration he had done about the demonetisation of Rs.500 & Rs.1000 notes. One can hit two birds with one gunshot, but Modi Ji, is a expert player in same, he hit multiple birds at a single gunshot. Some of the important notable objectives on this include:

- Removing Black Money from Country,
- Stopping of corruption,
- Stopping terror funds,
- Curbing fake notes,
- Stopping illegal dabba trading,
- The up elections,
- Betting on us presidential election result, &
- To Send a clear Message that this Government is well inclined towards working for the Development of Nation

### Objectives of study

Before talking about the impact of demonetization whether its positive or negative it’s better to study about the objectives of

the study in relation with its effect:

- Primary objective of demonetisation is to curtail the shadow economy by counterfeiting that is being used to fund illegal activities & terrorism.
- Is to know about the impact of demonetisation on Indian Economy.
- Is to know about how previous incidence of this *Noteband* has actually exaggerated affects around the world. In these cases, what were the real attempt of those countries & what has actually happened to them next, is also being analysed in the study for understanding the possible outcomes of India demonetization to reduce the distrustful & to make the most of the buoyant ones by making a learn from high-quality better decisions taken by an assortment of various countries as well as by the actual blunder of mistakes actually made by them.

As per the facts nearly 90% of the total cash in circulation has come back into the banking system and hence, the stated purpose of the Demonetization exercise which was to “extinguish” black money has accomplished, but that is just one side of it.

#### Positives

##### The positive of this impact includes

- A good part of black money is eliminated from the economy and this money can be used for development of economy
- With increased transparency, trust on Indian Economy is increased. Thereby foreign investments poured in.
- Demonetization move encouraged cashless transactions, which is a boost to Economy

#### Negatives

##### The negatives of this impact include

- GDP growth was earlier estimated as 7.8%. Post demonization, estimates are lowered to 7.1%.
- Agriculture sector, small & medium scale businesses & informal sectors are worst hit by demonetisation.

Even though demonetization move created adverse short-term policy impact the real impact of demonetization must be assessed in the medium/long term, at this point of juncture we cannot precisely conclude whether demonetization is a failure or a success.

#### Research Methodology

Keeping in view of the objectives, in the present study secondary data has been used. Data has been collected from various research papers, magazines and articles. In addition to this study, data have also been collected from various journals, economic & political weekly and the research is also based on the referred sources- published, unpublished & electronic.

#### Impact of demonetization on economy

According to RBI, banks have received almost Rs. 13 lakh crores in old 500 and 1,000-rupee notes until December 10, 2016. Meanwhile, the banks have issued new currency notes valued at Rs. 5, 92,613 crore to the public over their counters and through their ATMs (between 10th November – 19th December 2016. In this period, the RBI has issued to the

public through the banks and their branches a total of 22.6 billion pieces of notes of various denominations of which 20.1 billion pieces belonged to small denominations of Rs. 10, 20, 50 and 100s and 1.7 billion belonged to higher denominations of Rs. 2000 and Rs. 500. It has been observed that money deposited and money withdrawn has a deficit of Rs. 7,07,387 crore in the system which in the present situation is causing immense cash crunch in the economy ultimately affecting the day to day requirements of people and businesses across the country.

**Table 1:** Summary of withdrawal & deposit balance sheet in wake of demonetization

|                           |                           |
|---------------------------|---------------------------|
| <b>Total Deposits (1)</b> | <b>Rs 13,00,000 crore</b> |
| Remonetised Money (2)     | Rs 5, 92, 613 crore       |
| Deficit ( 2 – 1 )         | (-) Rs 7, 07, 387 crore   |

*Source:* RBI Bureau

Production process not only in the informal sector but also in the formal sector has been impacted directly or indirectly. Cash driven segments such as fruits and vegetable markets, horticulture and floriculture, agricultural and food processing, construction activities, among others have been impacted. Non payment of wages to the workers of cash driven sectors has adversely impacted the employment situation in the informal sector. Also, the formal sector is impacted as demand in the economy has been decelerated significantly.

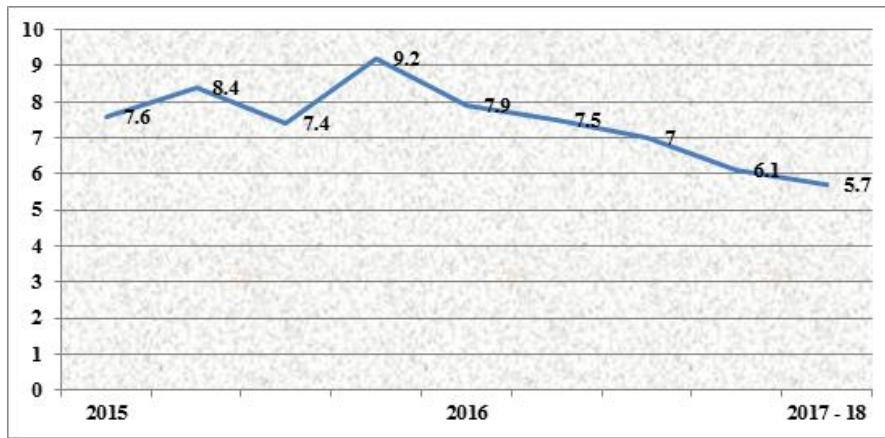
It is expected that removal of black money from the system would create a good scope for reduction in interest rates towards lower inflationary expectations and reduce the incidence of direct taxation. People are expecting that the forthcoming budget will be unconventional and our Hon'ble Finance Minister is going to provide out of box benefits such as increase in the direct tax slabs and enhanced disposable incomes.

#### GDP Growth rate on Demonetization

Former Prime Minister Dr. Manmohan Singh on Monday said that the demonetisation and 'hasty' implementation of GST have adversely impacted India's economic growth. Dr. Singh was speaking to CNBC-TV 18 on the country's GDP growth. He said: "*Both demonetisation and the GST have had some impact. Both would affect the informal sector, the small scale sector. The sectors today are responsible for 40 % of GDP.*" Dr. Singh's statement has come in the backdrop of India's slowest economic growth in last three years. The country recorded 5.7 % GDP growth during April-June. The previous low of 4.6 % was recorded in January-March 2014.

He has put the blame on demonetisation & GST for the current economic slowdown and said: "*The withdrawal of 86 % of currency plus GST, because it has been put on practice in haste, there are lots of glitches which are now coming out. These are bound to affect the GDP growth adversely.*" He further said that the informal and small scale sectors were badly hit by the demonetisation.

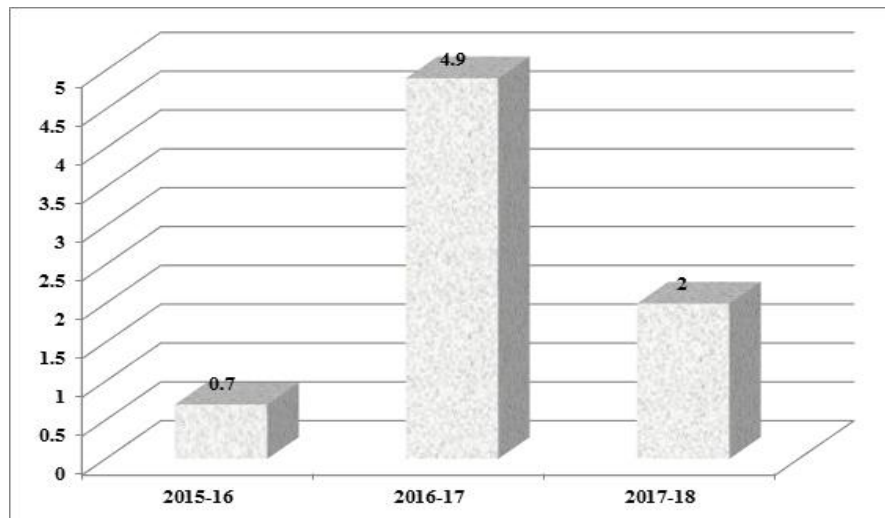
This is not the first time when Dr. Manmohan Singh criticized the Centre's demonetisation move. Soon after the announcement of note ban, the Former Prime Minister in the Parliament called it an 'organised loot and legalised plunder' that would bring the GDP growth down by 2 %.



Source: Economic Times

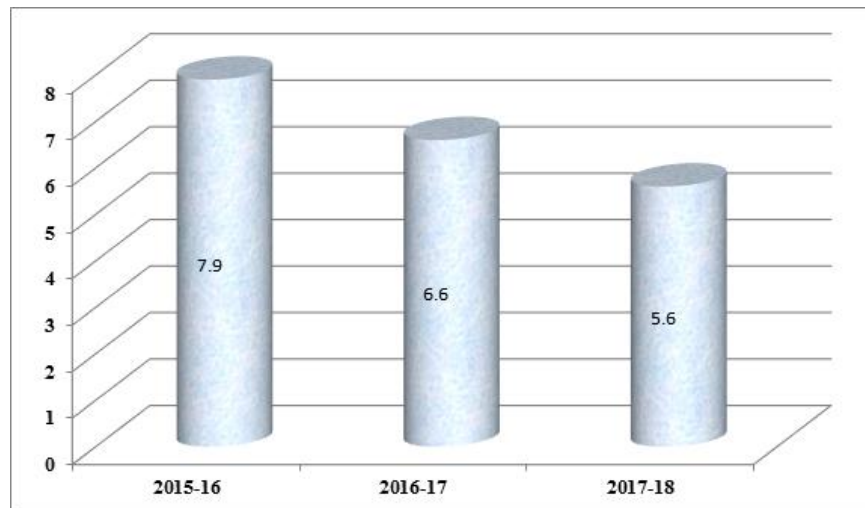
Fig 1: GDP Growth rate slipped to 3 year low (%)

### GDP Growth rate on Demonetization – affecting various sectors of economy



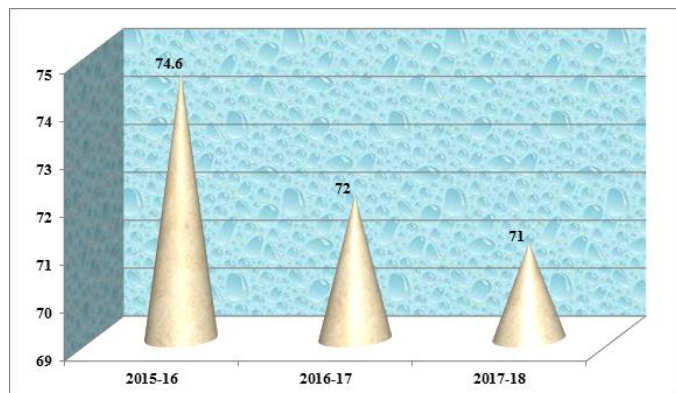
Source: Economic Times

Fig 2: Agriculture is hurting despite rainfall (in %)



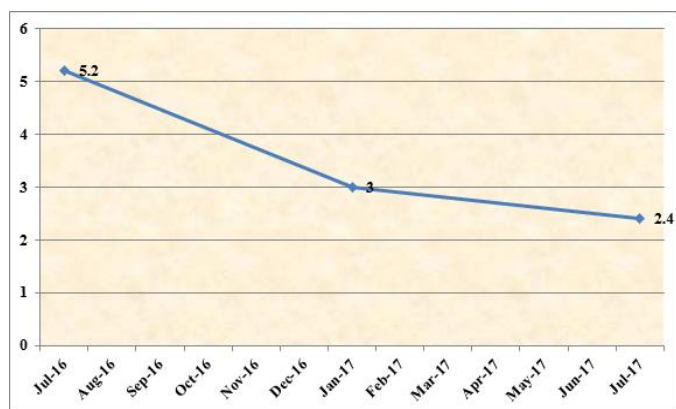
Source: Economic Times

Fig 3: Gross value added to the economy has slowed down (in %)



Source: Economic Times

Fig 4: Industry capacity utilisation is slipping (in %)



Source: Economic Times

Fig 5: Index of industrial production slowed down (in %)

Reading the signals from the growth numbers is proving a tricky affair — especially as answers have to be shifted from multiple, intertwined narratives: the political, the economic as well as the purely business. There are multiple villains to blame, too, the most immediate being the damper of demonetisation of November 2016 and the implementation of the goods and services tax (GST) in July this year.

Growth has been slowing for five quarters now, and the government’s target of over 7% for 2017-18 suddenly looks untenable. At least there is some agreement on that. Bank of America Merrill Lynch brought down its annual growth estimate to 6.9% from 7.2% while Japanese Nomura dragged it to 6.7% from 6.9%.

Pronab Sen, who headed the National Statistical Commission till last year, feels that numbers are telling him that people are trying to protect themselves. He is looking at high gold imports, high investments in insurance and a trend of moving away from bank deposits and real estate. “This is kind of unusual. I don’t recall seeing anything like this before.” (See “People are Trying to Protect Themselves”.)

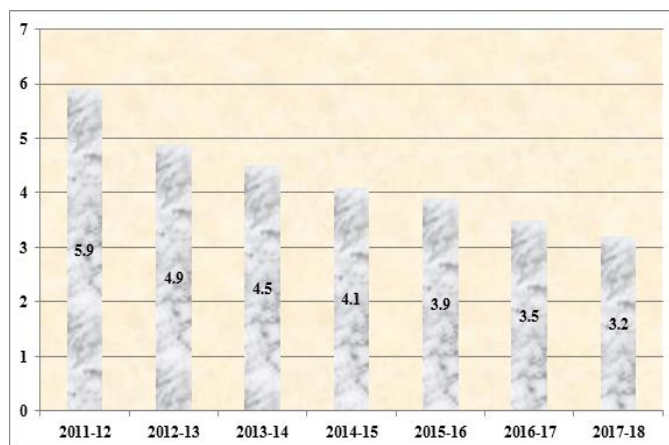
**Indian demonetization drive has boosted banks & start-ups, but it’s still a failure**

If there’s one sector that’s done particularly well as a result of government’s move, it’s the banking sector. Banks received deposits worth ₹6 trillion (US\$88 billion) and overall banking deposits with the Reserve Bank of India reached a record high

of ₹4.3 trillion (US\$63.1 billion) within two weeks of the currency ban. So the demonetisation was a well-planned move in terms of the health of the Indian banking system. Five months before the drive, the total amount of gross non-performing assets (loans are classified like this after 90 days of non-payment of interest or principal) for public and private sector banks was around ₹6lakh crore (US\$88 billion).

To understand how big this problem was, one needs to see the figure against the total loans given out by India’s banking system. That ratio corresponded to 11.8% of total credit advanced in Sep 2016, and it’s expected to reach 12.5% by Mar 2017. The bulk of these non-performing assets are from public sector banks, and were mainly lent to finance the basic metal and metal products sector, the textile industry and the beverages sector.

In its Dec 2016 Financial Stability Report, the Reserve Bank noted that the asset quality of public sector banks had deteriorated further between Mar and Sep 2016. This reflected the failing health of the Indian banking system, which is a major provider of credit to industry and business. If not checked in time, it can have serious repercussions for the economy.



Source: Economic Times

Fig 6: Fiscal deficit in progression (in %)

**It Ain’t Over Yet**

The billion dollar question is: When will the private sector join the party? Gross fixed capital formation, a reflection of investments made, slipped from 31% to 29.8% in the April-June quarter of 2016. “The average for last six years was 32% of GDP. It is not a rosy picture,” says Bhardwaj of Kotak. Arun Singh of D & B adds: “If you compare the investment numbers of the last three quarters with the preceding 10 quarters, you will see there is almost zero incremental investment happening now. With rising non-performing assets and pressure on lending, this is a volatile scenario.”

Mahesh Vyas, CEO of the Centre for Monitoring Indian Economy, feels the government is not adequately focused on ensuring growth, job creation and investment. Vyas stresses that the urgent need is to get the private sector to start investing. Instead of incentivising India Inc to invest, administrative decisions like demonetisation may have actually hindered investment.

### **Another winning sector**

Amid the frenzy after demonetization, another sector that got a big boost was that of financial technology start-ups, including digital wallet and other mobile payment companies. Due to the cash crunch, many people turned to digital wallets that can be used in conjunction with mobile payment systems, allowing them to pay for purchases with their smart phones. Digital wallet companies saw an unprecedented surge in the number of people signing up for their services and adding money to their wallets after demonetisation.

Among mobile wallet companies, Paytm was the biggest beneficiary. We can gauge the impact of the demonetisation drive on its business by looking at the company's user base, which has reached 160 million – a fourfold increase since May 2016. Paytm's traffic rose by 435%, app downloads grew by 200%, and the company saw a 250% rise in overall transaction value. In fact, "Paytm karo" (literally, "do Paytm") became one of the most common phrases during the early parts of the demonetisation drive, and sectors that have been traditionally cash-based, for example small shopkeepers and public transport, such as taxis and auto rickshaws, started accepting Paytm.

Such was a stardom of Paytm that it featured in a Harvard Business School case study of the company's transformation from online recharge platform to India's largest mobile payments platform.

### **One year of demonetization: Hits & Misses**

The old Rs 1,000 and Rs 500 notes - 86 % of currency in circulation - were scrapped after Prime Minister Narendra Modi made an unexpected announcement during a surprise television address. He also gave the nation's 1.3 billion people a 50-day window to either deposit them into bank accounts or exchange them for minted notes. Intended to be a surprise tactic to destroy the black market, the move didn't go as smoothly as planned. From shortage of new banknotes to uncalibrated ATMs to people suddenly finding themselves standing for hours in queues, India started feeling the pinch.

The move eventually started taking its toll on small businesses, farmers who reportedly couldn't buy seeds, taxi and rickshaw drivers who didn't have any way to receive payments and employers who were in a fix. It's been 12 months since the announcement was made and by now, the economic impact of the note ban has been discussed threadbare.

While the first quarter of demonetization created initial disruption in the Indian economy, industry as well as consumers eventually witnessed the positive impact of demonetisation within the first year of its implementation. Post demonetization, analysts feared that the move would damage India's consumption story and slow down economic growth, but the turnaround came quickly, with domestic equity benchmark Sensex plunging over 1,800 points in eight sessions following the note ban.

According to the Reserve Bank of India's annual report that was recently released, all but 1 % of Rs 1,000 and Rs 500 denomination banknotes invalidated on November 8, 2016 had been returned by the end of June, 2017. The then attorney general, Mukul Rohatgi, while defending demonetization in the Supreme Court in Nov last year, had said that around Rs 4-

5 trillion would probably not find its way back into the system. However, with the RBI report stating that 98.96 % of the money had returned to the system, the Opposition was quick to tag demonetisation as a "failed" move. Moreover, though demonetization was successful at wiping out all of the fake notes in circulation in the beginning, counterfeits of the new Rs 2,000 notes soon started emerging.

Meanwhile, the other main goal of disrupting the cash-centric economy was soon met by getting a larger slice of the population onto the digital economic grid. When it comes to the debate on the demonetization move, the focus has always been on the economic consequences; not enough attention has been paid to the politics of this decision. The shock move invited widespread criticism. The winter session of Parliament saw the Opposition parties locking horns with the government over demands for a vote on demonetisation. This tussle even washed out the entire winter session.

Now, the historic ban on high-value currency notes has approached its first-year anniversary, but the Congress-led Opposition still has a gap to close with the National Democratic Alliance (NDA) led by the Bharatiya Janata Party (BJP) over the viability of the reform. The political mobilisation against the exercise is still proving to be difficult. While the BJP is celebrating the one-year mark of Prime Minister Narendra Modi's mantra of a "corruption-free India" as an "Anti-Black Money Day" today, the Opposition is all set to protest against it by observing a "black day."

Speaking about the note ban, Congress leader and senior lawyer Kapil Sibal told ANI, "It was not demonetisation, but demonization. The manner in which Prime Minister Narendra Modi declared currency ban, the result of that we are seeing today." "Unemployment has increased, small business firms got completely destroyed and meanwhile, more than 100 people lost their lives in queues. The PM should now admit the negative impact of demonetization on GST. Their decision converted black money into white money. Demonetization is the biggest scam in the country since independence," he added.

Echoing the same sentiment, Janata Dal (United) rebel party leader Sharad Yadav told ANI, "Demonetization has been represented as a solution of black money, but the country was destroyed due to this. Employment went into a toss; real state went downhill, farmers got frustrated, 100 people died. Still, they are celebrating. Prime Minister implemented currency ban but Finance Minister is answering the questions." However, the BJP till date hails demonetization as a great moral project to clean up the national economy.

Speaking about it, BJP leader C.K. Bose asserted, "Demonetization has been a historic, bold and necessary step taken under the leadership of Narendra Modi Ji. It not only curbed black money generation but also arrested the terror money in circulation. It had a multi-fold positive impact on the economy of the country." "Yes, there were certain difficulties faced by the people. For any move, certain troubles and difficulties would come up but as a nation in a whole, we stood up for demonetization," he added.

Bose also spoke about former Prime Minister Dr. Manmohan Singh's recent scathing attack on the government, wherein he termed demonetisation as a clear case of "organised loot and legalised plunder." "If Dr. Manmohan Singh as an economist

would have made a statement, we would have appreciated it. But it is Manmohan Singh, a politician controlled by Sonia Gandhi who is making the statements. So it has no value for the people of our nation. It was the first time in Independent India that black marketers were put in their place," he said. "Mamata Banerjee is calling demonetization a disaster because her party was directly affected by it," he added. UP BJP spokesperson Rakesh Tripathi also shared similar views over the note ban. "The Indian public, by making BJP victorious in Uttar Pradesh and other states, have proved that demonetisation had a positive impact. The parties who lost in the elections are troubled with demonetisation and therefore are making such statements. The demonetisation gave a new height to country's economy by creating more jobs," he said.

### **Demonetization – tax terrorism, on 19<sup>th</sup> March 2018**

Former Union finance minister Yashwant Sinha today said demonetisation had led to "tax terrorism" and likened Prime Minister Narendra Modi to a medieval era Delhi king known for his whimsical decisions. Sinha made these remarks at the launch of a book, *Demonetization and the Black Economy*, by economist Arun Kumar, who has been critical of the exercise. Suspended BJD MP Baijayant 'Jay' Panda & Congress leader Prithiviraj Chavan were also participating in the panel discussion. Though demonetization failed to meet any of the stated objectives, the government had won the "perception battle", Sinha said.

Sinha said "*tax terrorism*", which the BJP was critical of when it was in the opposition, has returned because of the note ban, and claimed the income tax department registered 1.8 million cases following the decision and was ill-equipped to probe them all anytime soon. "What has been the other side-effect? Tax-terrorism, which the BJP had criticised when we were in opposition. It has come back now. 1.8 million Cases have been started by the income tax department (since demonetization)" he said. Is the department equipped to handle so many cases and how much time it is going to take to bring those cases to a final conclusion, he asked, claiming people will never know how much black money was actually recovered until investigation in all those cases are complete.

"This will go on and on like the counting of the notes by the Reserve Bank of India. It will never finish, not at least until the next Lok Sabha election so that the perception of this (demonetisation) was having succeeded continues to hold," he said. Asked how he would have tackled the flow of black money, Sinha quipped, "*Demonetization and the Goods and Services Tax (GST) are subjects to write books upon how things should not be done.*"

### **Ultimate Failure**

The demonetization drive, then, could be seen as a blessing for India's move towards a cashless economy and for encouraging consumers to use digital payment platforms. It also supports the government's Digital India initiative, which aims to encourage cashless payment solutions across the country by putting technological infrastructure in place. But it's difficult to assess whether India is ready for a cashless economy. Traders tend not to reveal their actual income to avoid taxes and people are so used to paying for services in

cash that for them to shift to new mode of payments requires a big habitual change.

The government's demonetization drive, then, can be seen as an effort to curb the corruption and the flow of black money as stated, but also to force the general population to embrace digital payment options. Unfortunately, it seems to have failed in both aspirations. Even though the main stated aim of demonetisation was to curb the extent of black money in the economy, during the first two months of the drive, almost 90% of the scrapped and demonetised notes were back in the banking system. This stands in contrast to the government expectation that roughly ₹3 lakh crore (US\$44 billion) of the scrapped notes would never return because they would be part of black money hoards.

The second consequence of moving towards a cashless economy may also be a failure. When cash returns to the system, many Indians are likely go back to the cash-based transactions given the over-dependence on cash-based transactions in the country due to limited connectivity and privacy issues related to transactions.

Ultimately, the demonetization drive has been successful in making the banking sector healthier, but not what it was projected to do in terms of bringing in "black money" and turning the country into "digital India".

### **Conclusions**

The demonetization undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued 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, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetization on the economy and its agents.

It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

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