

Impact of demonetization on the indian economy



Introduction:

When developing countries have issues with people evading their taxes or even taking part in illegal monetary transactions, demonetization is a popular mechanism used to help curb them. It is act of a liquidity shock that disturbs economic activities, where people are unable to get sufficient volume of the popular denomination of currencies. Demonetization has an immediate effect on many areas, such as consumption, investment, production, and employment. The intensity of its effects depends on the duration of the liquidity shocks.

One of the developing nations that uses demonetization is India. India has used it on a few occasion earlier in 1946 and 1978; there was also one in more recent years. The first demonetization in India occurred in 1946, which was used to increase the revenue by capturing tax avoiders. This occurred by removing the 5000 and 10, 000 rupee notes from circulation. Though it targeted a small portion of the population, it was still impactful. The second demonetization by the government of India (GOI) occurred in 1978. This was conducted to prohibit black money, which refers to money used for illegal activities ranging from tax evasion to financing terrorism that was not accounted for on their taxes. The latest demonetization initiative by the Prime Minister Narendra Modi and the GOI in 2016 was put into place to rid the economy of fake currency, find tax evaders who had wealth in the form of high-value currency notes, and move a large fraction of population into a cashless economy.

The demonetization initiative from 2016 involved banning the 500 rupee and 1000 rupee notes. These notes constituted about 86 percent of the total currency notes in circulation. Because they were no longer going to be recognized as legal currency, the Indian people had fifty days to deposit these notes in the bank or exchange them. This change immediately triggered huge lines of customers in banks and ATMs. One of the issues they ran into was the unpreparedness of the Reserve Bank of India (RBI) to replace the recalled currency notes with new 500 rupee notes and/or the 2000 rupee notes. This caused an insufficient cash flow for the population and businesses for their daily transactions (Zhu et al. , 2018). As a result, different sectors in India were affected: such as, micro, small and medium enterprises (MSME), agriculture, banking, rural and urban area business.

Abda (2017) says demonetization is measured with both benefits and drawbacks in several sectors in the short run. In addition to this, some of the previous research says in the long run demonetization will have a positive impact on digital payment and monitoring the black currency. Hence for this study, I explore the impact of demonetization - benefit and drawbacks on the Indian urban and rural economy.

Objectives:

The primary objective of the study is to elucidate the benefits and drawbacks of demonetization on a large scale, looking into businesses, firms, agriculture and on a smaller scale looking at how it affected the people of India. The secondary objective is to measure the long term benefit of demonetization on improving the digital payments in urban and rural areas of India.

Overview of Literature review:

This study will focus on the impact of demonetization- benefits and drawbacks on the Indian economy. I will cover the following sections for literature review using the previous study.

- 1) Understanding demonetization techniques – covers meaning and purpose
- 2) Demonetization in India – why GOI implemented the demonetization
- 3) Understanding the effect of demonetization on different sectors – MSME, agriculture, banking, rural and urban industries, and also its impact on the common people.

Literature review:

Previous research on the impact of demonetization has involved a wide range of sectors covering the span of India's economy. Important findings from previous research along with a discussion about how these findings are relevant for current research are discussed below.

According to Bose (2019), demonetization techniques are used by many countries. Even though demonetization is being used by many countries, it is used for many different reasons. For example, Zimbabwe used demonetization to combat the inflation by removing their significant currencies including the 100-trillion notes from circulation. India used demonetization to eliminate corruption, increase the tax base, and fight the

terrorism; however, sometimes it unintentionally causes consequences or more of a burden on the people. In the case of India, Bose concludes the demonetization exercise actually created more issues in most people's lives because it increased transaction costs for the poorer people. On the other hand, he says demonetization in India increased the interest in digital payments. In a different study by Midthanpally (2017), he looked at how demonetization and remonetization are managed in India and their effects on the economy. In his results, he concluded recent demonetization measures resulted in an immediate cash crisis, due to the RBI having inadequate supply of newer notes to exchange with all the outdated notes.

This immediate cash crisis leads into effects of large-scale macroeconomic shocks. The existing research into the effects of large-scale macroeconomic shocks on the different sectors and the livelihoods of households are explored by several researchers. Kurosaki (2018) examined the effects of demonetization on the MSME in the urban city of New Delhi, India, covering both manufacturing and service firms. She chose these areas because they are perceived as labor-intensive sectors in reducing poverty. She distinguished the micro and small enterprises into more formal and informal, which means registered with the government and unregistered with the government, respectively. The results from this study indicated informal enterprises were adversely affected by demonetization, unlike the formal firms. This is most likely because informal firms depending more on cash transactions. This adverse effect caused a problem not only for the businesses, but also the people working for them. This is how the poor people working at lower wage jobs were affected by demonetization.

The common man is called “ the aam aadmi” in Hindi (one of the national languages of India), which refers to a person who works for a in a lower wage job and is most likely at or below the poverty line (Pokharel). The livelihood of the aam aadmi is often affected by demonetization and is examined by a few people. Joshi (2017) analyzed the effect of demonetization on the life of the common man. This study used the field survey covering 100 randomly selected people in the Mumbai area, which is an urban area containing many slums with poorer people living there. The results of this study showed along with a daily income decrease, there was a decrease in job opportunities due to the shortage of new currency. The author suggests that demonization created the short term hassle for the common man’s life due to the unpreparedness of RBI to redistribute currency that was given for exchange with the new currency notes. In another study that studied Mumbai, Krishnan and Siegel (2017) surveyed 200 families living in 28 slum or lower-income neighborhoods in Mumbai in early December 2016 to examine the immediate and short-term impact of demonetization by the GOI. The surveyed families worked in service jobs, such as domestic helpers, cooks, and drivers. These people were the main interest of the study because they face uncertainties in their wage income day to day. The results show family member’s incomes, expenditures, and savings is decreased during the demonetization. These studies highlight the effect of demonetization on the aam aadmi in an urban setting.

Now that we have examined the effects of demonetization on the urban aam aadmi, we can move on to the effect of demonetization on the rural aam

aadmi. To truly examine this population, it is important to understand they mainly rely on subsistence agriculture as their source of income. In addition to this, they have poor access to banks and, therefore, transact exclusively in cash. The impacts of demonetization on these rural Indian household behaviors were examined by Zhu et al. (2018). These authors collected the data one month before and two months after the demonetization in 2016 to estimate its effects on households' expenditure patterns. They found the economic losses for poor rural households averaged about 15.5% over the two months after the policy change. This decrease in rural income is most likely due to the unemployment caused by demonetization, along with the cost of converting the old currency to new. The authors conclude in short-run demonetization has a negative impact on common man; however, they explain there could be long-run benefits from forcing a more informal sector of financial activity into the formal banking system.

Not only is the Indian agricultural sector a primary source of income for people in rural India, but it is also a primary sector of the Indian economy. It accounts for 18% of Gross Domestic Product (GDP). Due to the importance of this field, it was evaluated for the impacts of demonetization. The short term impacts of demonetization on the domestic agricultural trade was evaluated by Aggarwal and Narayan (2017). They used the difference in difference technique. This study used the data on arrivals and prices from close “ to 3000 regulated markets in India for 35 major agricultural commodities during the period 2011-2017” (Aggarwal 2017). The results show demonetization displaced over 15% of daily trade, which they found were mainly price

declines for perishable commodities. Overall, the authors suggest the estimated impacts from their study offer us an insight into the slowdown in the GDP growth rates in the three quarters following the 2016 demonetization.

From the latest demonetization in India, there are many researchers who say one of the main objectives is to promote digital payments (Pandya, 2017; Shah, 2017). The digital payments offer the population a safe, secure way to make purchases. There are several modes of digital payment in India, and firms, along with a few people in urban areas use digital payments for business and personal transactions. Kathial (2018) explored how demonetization affected these digital payments in India, using data from the banks' websites. The results from his study reveal that the demonetization forced people to use electronic payment options to buy goods and services. However, the results also indicated that online electronic transactions RTGS, IMPS, and NEFT systems fell both in value and volume in November 2016 as compared with October 2016. The author suggested there is a need to make awareness about digital payment in India to enhance the cashless economy. The researchers, Chandrashekar and Ghosh (2017), continue the discussion of demonetization as it relates to the GOI promoting digital payments in India. In order for the GOI to properly obtain a cashless economy, it would involve an enormous cost to implement due to the necessity of the creating adequate infrastructure. In this article, the authors conclude the attempts to push a rapid transition into a cashless economy are infeasible at this stage.

Overall, demonetization has its benefits and its drawbacks for India from the studies mentioned in this review. For the common man of India, it seems to

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be detrimental to their way of life as it decreases their wages. It seems to hurt the agricultural sector as well. For the people in urban areas, the cashless economy should be helpful in making business and personal transactions faster and easier; however, the Indian government is finding out the rapid push to a cashless economy is not as feasible as it once believed. In the long run though, this push for cashless economy will also help build the informal firms into formal firms, which would make those businesses more efficient and less likely to evade paying taxes. India is working to better their economy via demonetization and there have been some short-term issues, but there will most likely be long term gains from making these economic changes.

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