

A review on impact of demonetization on Indian Economy

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Abstract

Objectives: To identify the possible impact of recent Demonetisation technique in India by reviewing the existing literature and examining the tax GDP ratio and GDP growth rate and sector wise growth rate before and after demonetisation.

Methods: Since present study is basically a review of existing literature so it is fully based on secondary data. Secondary information is collected from various journals and economic survey of India various issue.

Findings: By reviewing the earlier literature it is observed that from theoretical point of view Demonetisation is not encouraging. The study also found that though the tax GDP ratio has been increased after Demonetisation but GDP growth rate along with growth rate of different sector have fall immediately after Demonetisation.

Future improvements: However due to lack of data, long run impact like impact on recovering black money has not estimated in the present study. So future study can be made in this regards.

Keywords: GDP Growth Rate, Tax GDP Ratio,

1. Introduction

Demonetisation is a process through which either some or all of the currency denominations are considered as ineligible for using in transactions. For most of the countries in the world, main aim behind Demonetisation was to curb corruption and black money. Demonetisation is not a new concept In India. Earlier various times high denomination banknotes were demonetized by RBI. In 1946, for the first time government demonetize notes of denomination ₹1,000 ₹5,000, and ₹10,000. Further higher denomination banknotes such as ₹1,000, ₹5,000, ₹10,000 reintroduced in 1954 and all of them were demonetized in 1978 to curb unaccounted money. However, the result of demonetisation in both the time to curbing black money was not very satisfactory [1]. Likewise, on 8 November 2016, the Indian government demonetized high-value currency notes of denomination 1,000 and 500 which comprises a value of nearly 86.9% of total currency in circulation in India with the aim of curbing black economy and corruption and reducing amount of counterfeit currency.

In a World Bank report it is stated that black money consisted 23.2% of GDP as also the 28 crore worth of counterfeit currency notes estimated to be in circulation in the Indian system up to September 2016 [2]. In the present study an attempt has been made to examine the possible impact of demonetisation by reviewing the earlier literature Moreover, an analysis of the growth pattern of Indian economy after demonetisation also made.

2. Methodology

Since present study is basically a review of existing literature so it is fully based on secondary data. Secondary information is collected from various journals and different issue of economic survey of India. In the first part a brief review of earlier studies has been given to conceptualise the issue. Later on impact of demonetisation on Indian economy has been examined by collecting secondary data. The basic variable considered in the study is tax –GDP ratio, GDP growth rate. Sector wise GDP growth rate are also considered to analyze the impact of demonetisation on different sectors of the economy.

3. Theoretical background

1. Monetary theory

In [3] examined the theoretical perspective of demonetisation and found that from theoretical point of view demonetisation is not the successful one. Identifying the importance of money, monetary theorist argued that an economy run with money provides more benefit than an economy run under barter system [4,5]. So from this point of view, consumption and investment decision of both current and future period will be adversely affected by the process of demonetisation. Moreover, in case of Indian economy where a huge proportion of transactions are done through cash payment, the negative effect will be much more.

Through money multiplier model, some researcher viewed that demonetisation will increase money supply. Because demonetisation will reduce the currency circulation and will enhance the deposits, thereby lending by banks are bound to increase for a definite reserve ratio. However, sometime further increase in deposits as a result of demonetisation may not lead to increase in money supply if banks already hold excess reserves [6]. Moreover, according to [7] that in the modern economy bank creates money not necessarily through the deposits but through loans. Hence the capability of creating money depends on competitiveness of the banking industry, and the availability of profitable investment opportunities rather than amount of deposits. Based on this argument, Indian banks may not be able to create more money after demonetisation. Because with less opportunity for profitable investment and 100% incremental CRR on new deposits, it is highly likely that possibility of creating new loans/deposits and thereby money supply will be very low.

Both formal and informal sector will be affected by demonetisation. For informal sector (Mostly used cash for transaction,), there will be decline in real interest rate, investment, output, employment, as availability of cash will reduce. Whereas for formal sector (used online transaction) price level will decline but there could not be a reduction in output demand and formal labour market since the organized firms can pay wages and salaries to employee in their bank accounts. The total effects on economy will depend on relative contribution of each of the sector to the GDP.

Moreover, consumption, employment and wages of a larger section of population are adversely affected by demonetisation. Demonetisation may leads to closer of many farms in informal sector and even supply of money with new currency after demonetisation may not able to strengthen these farm [8]. Fall in the output of informal sector may also leads to reduction in the consumption demand in formal sector. Moreover, credit in both formal and informal market will be adversely affected by demonetisation. Because both the market get their short term credit mostly form informal credit market like money lender who provide credit in mostly in the form of cash form. Demonetisation will adversely impact this form of credit which will in turn adversely impact functioning of formal market.

2. Behavioral theory

In [9] made an extensive analysis on behavioural economics perspective of demonetisation. The paper put forward various behavioural theories to explain the possible impact demonetisation in the long run. The study added that welfare gains of demonetization can be increased by targeting only those who actually have black income.

Prospect theory also gives the idea about the possible outcome of a public policy [10] which describes the decision of people under different situation of and the estimation about the possible outcome of each of these options. According to this theory, current situation of risk depends on both the current and future perception of gain and loss i.e. current and expected status. In this way, people proposed different pattern of risk preferences as a reaction to a public policy, such as risk-aversion and risk-seeking for gains and losses respectively under high probability; risk-seeking and risk-aversion for gains and losses under low probability [11]. In the context of the demonetisation problem, assuming ready availability and access to cash for transaction purposes as current situation, people are expected to think the move towards a cashless economy as a negative deviation and hence a loss. Further, facing with the perception of high losses with high probability, the holder of black money are being expected to be engaged in high risk-seeking behaviour.

This may leads to occurrence of large instances of corruption and facilitating money laundering by senior employ under public sector banks, who can collude with black money holder on mitigating adverse impact of demonetisation on black money [12].

4. Discussion

1. Indian experience of demonetisation

In [13] analyses the different countries experience of demonetisation across the world to examine the possible impact of demonetisation in India. They viewed that most of the country across the world has adopted the demonetisation technique to eliminate black money, counterfeit currency and controlling inflation. Except USA and Australia, most of the economy collapsed after demonetisation. They also added that, in short run, all sector are expected to be adversely affected due to reduction of cash, however, in long-run informal economy may turn into formal one. Again new entrepreneur will be benefited because as money supply decreases, rate of interest will fall and there will be more access to loan. Moreover, they also added that after Demonetisation Indian economy is expected to move towards cashless economy. According to [14] addressing the problem of corruption and black money, reduce the extent of counterfeit money, movement towards electronic money, improved information about the cash economy are some of the identified benefit of demonetisation.

In [15] examined the importance of digital economy in the discussion of demonetisation. Demonetisation has created an environment for learning about digital transaction such as paytm, e- banking, M- banking etc. Analyzing the immediate effect of demonetisation in the life of common people, [16] observed that common people accepted the hardship in the demonetisation process in the hope of eradication of corruption. Moreover, micro and small industries got adversely affected by this move as it affected the cash flow. Demonetisation process will move the country to cashless economy in future.

In contrary to this [9] found demonetization has failed in reducing the amount of cash transaction and moving towards cashless economy because as per RBI report, the volume and value of overall digital transactions after six months of the demonetisation exercise has been declined [17], and average number of cash withdrawals from ATMs has been increased. Examining the impact of demonetisation on Indian economy, [18] found that the GDP growth slightly declined after demonetisation as compared to previous year. Moreover, all the sectors in the economy, i.e. agriculture, manufacturing and service adversely affected by demonetisation. In [19] viewed that the objective of cashless economy through demonetisation failed in Economy. He stated that with 60% of the economy under informal sector and only 50% of the household having access to banking facility, it is very hard to move towards cashless economy. Moreover cash GDP ratio is very high in India (12%) as compared to world average (4%). Similarly, cash transaction value is also high in India (78%) as compared to other industrialized country (20%-25%).

2. Growth Scenario of India: Before and After Demonetisation

Tax GDP ratio of India before and after demonetisation are depicted in the following (Table 1). The table shows that Tax GDP ratio has slightly increased after demonetisation from 8.2% to 8.9 %. Moreover, the ratio is increasing from 2011-12 onwards.

Table 1. Tax GDP ratio trend India before and after demonetisation

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Tax GDP ratio	7.2	8.0	8.3	8.5	8.2	8.9

Source: [20]

Table 2 reveals that the GDP growth rate before, after and during demonetisation. The table reveals that GDP growth rate declines as a reaction to demonetisation.

Before demonetisation, GDP growth rate was 7.3%, which decreased to 7% during demonetisation. After demonetisation, the growth rate further declined to 5.7 % in April-June 2017. After that it slightly increases to 6.3% in July-September, 2017.

Table 2. GDP growth rate of India before and after demonetisation

Year	GDP growth rate	GVA at basic price
Jan Mar 2016	7.9	7.6
Apr Jun 2016	7.1	6.8
Jul Sept 2016	7.3	6.7
Oct Dec 2016	7	5.6
Jan Mar 2017	6.1	5.6
Apr Jun 2017	5.7	6.1
Jul Sept 2017	6.3	6.1

Source: [20]

Similarly, in case of gross value addition (GVA) also, provides a declining trend after demonetisation. GVA falls from 6.7% before demonetisation to 5.6 % after demonetisation. After that it slightly increased in April to June of 2017.

Table 3. Sector-wise growth rate before and after Demonetisation (in pc)

Period	Agriculture	Industry	Service
Jan Mar 2016	2.5	7.4	9.0
Apr Jun 2016	4.1	5.9	7.8
Jul Sept 2016	6.9	6.2	6.9
Oct Dec 2016	5.2	3.1	7.2
Jan Mar 2017	2.3	1.6	8.7
Apr Jun 2017	1.7	5.8	7.1

Source: [20]

Table 3 depicts the performance of agriculture, industry and service sector before and after Demonetisation. Growth of Agriculture and industry has declined immediately during and after Demonetisation. However, it reveals a slight improvement during second quarter of 2017. Whereas, Service sector shows the reverse trend. It has shown an improvement immediately after Demonetisation then slightly declined in April to June in 2017.

5. Conclusion

Demonetisation was initiated in India in order to curb black money, counterfeit currency and corruption and moving towards cashless economy. However, reviewing the earlier literature it can be concluded that demonetisation is not successful one in India, both theoretically and empirically. Cash withdrawal has been increased after demonetisation as reported by Reserve Bank of India.

However, long run impact of demonetisation cannot be analyzed in the present study since these will require long run data. In order to see the long run impact on curbing black money long run data will be needed. Common people are accepting the difficulties during demonetisation in the hope of elimination of black money and corruption. Though the tax GDP ratio has been slightly increased after demonetisation, but the GDP growth rate has declined. Agriculture and industry growth rate declined; whereas service sector growth increased as an immediate reaction to demonetisation in the first quarter of 2017.

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