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DEMONETIZATION – IMPACT ON VARIOUS SECTORS

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ABSTRACT

On 8th November 2016, the government of India stripped Rs 500 and Rs 1000 denomination currency notes of their legal tender status. When any Government withdraws the legal tender rights of any denomination of currency, it is known as demonetization. The primary goals were to rid the economy of fake currency and hit out at tax evaders who had amassed their illegitimately acquired wealth in the form of high value currency notes. Demonetization completely disrupted the social, political and economic spheres of the world's second largest emerging market. All 500 and 1,000 rupee notes were instantaneously voided, and a 50 days period ensued where the population could redeem their canceled cash for newly designed 500 and 2,000 rupee notes or deposit them into bank accounts. A month into India's demonetization initiative, long lines of people looking to exchange notes still spew out of banks, some sectors of the economy continues struggling with the lack of readily available cash, grassroots businesses are still being revolutionized with electronic payment capabilities, and masses of people continue transitioning towards new ways of payment for basic goods and services.

Keywords: Demonetization, Plastic money, cashless transactions,

1.INTRODUCTION

Demonetization is the act of stripping a currency unit of its status as legal tender. The government has implemented a major change in the economic environment by demonetizing the high value currency notes of Rs 500 and Rs 1,000 denomination. Demonetization was planned in secret by a small, tight- knit group led by Prime Minister Modi, and it overtook the country like a flash flood. The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. The reasons offered for demonetization are two-fold:

(a) To undermine or eliminate the black money i.e., to make black money worthless.
(b) To control counterfeit notes that could be contributing to terrorism i.e., a national security concern.

The annual report of Reserve Bank of India (RBI) of 31st March 2016 stated that total bank notes in circulation valued to 16.42 lakh crore of 500 and 1000 banknotes. As per the press release of RBI dated on 29th November 2016, the total amount of old notes which are now withdrawn of value of 8.11 lakh crore has been deposited by the customers till 27th November 2016. Banks started accepting deposits from 10th November but within a period of 18 days around half money has been received by the banks. But between this the Government again provided the scheme of pay tax and converts your black money into white money scheme launched.

There are two ways in which the pre-demonetization money supply will stand altered in the new regime: One, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange. Cashless transaction systems have been encouraged across the board, which will not rid India of its massive shadow economy but may make it a little tougher to conduct business. The Finance Minister as well as the Governor of the Reserve Bank of India have repeatedly emphasized that agents should be moving to the use of cashless medium where there are no problems in comparison to the cash based medium. For instance, The Hindu reported that "Reserve bank of India has urged citizens to switch to alternative modes of payments such as pre-paid cards, credit and debit cards, mobile banking and internet banking." In a press conference on November 12, the Union Finance Minister too said that "Those in businesses should start using digital payment gateways, cards and banking system.

2.OBJECTIVES OF THE STUDY:

The study has been made:

- To analyze the impact of demonetization on banking system.
- To know the problems of ordinary people.
- To understand the problems with cashless transactions system.
- To understand its effect on various sectors.
- To get an idea about demonetization.

3. METHODOLOGY OF THE STUDY:

The entire Range of discussion has been made on the basis of secondary sources. The different books, journals, newspapers, and related websites especiallyRBI website have been consulted in this regard.

4. REVIEW OF THE LITERATURE

- Tax Research Team (2016) – In their working paper stated in favour of Demonetization. Its main objective is to analyze the impact of demonetization on Indian economy. This paper shows the impact of such a move on the availability of credit, spending, and level of activity and government finances.
- Global Media (Reuters – The New York Times, Financial times & Alike) have been reporting on the pains and sufferings faced by common citizens, whereas Indian local media, more so the omnipresent TV News media have been presenting the bold move for better days ahead, and the difference in the reporting style may not be purely accidental.
- Dr.Raghuram Rajan & World Bank Chief Economist & Former Chief Economic advisor of Government of India, Dr.Kaushik Basu have expressed their reservations on the demonetization drive.
- Annamalai, S. and Muthu R.Liakkuvan (2008) in their article "Retail transaction: Future bright for plastic money" projected the growth of debit and credit cards in the retail transactions. They also mentioned the growth factors, which leads to its popularity, important constraints faced by banks and summarized with bright future and scope of plastic money.

5. IMPACT OF DEMONETIZATION ON VARIOUS SECTORS

The demonetization, by removing 86 percent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy. This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash.

Various sectors which are adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organized retailing. For example, kirana, fruits and vegetables, transport services, etc., would face compression in demand which is backed by purchasing power. It is expected that supply exceeds demand, there would be a fall in prices, however, if supply too gets curtailed for want of a medium of exchange, prices might, in fact, rise. Alternatively, to keep the flows going, people might take recourse to credit – both the retailers and other agents in the economy might make supplies on credit in the hope that when the liquidity status is corrected, the payments can be realized. In these cases, the price of commodities might rise instead of falling. In other words, the impact of an incremental reduction in money supply where the demand and the supply chain remain unaffected would be different from a case where there is a drastic reduction in money supply and outputs might adjust rather than the adjustment being in prices.

There are likely to be two spin-offs from this change:one, there would be some increase in tax collections in the short term, and second, various IOU's could emerge as currency substitutes. To the extent people attempt to get rid of unaccounted cash balances through purchase of goods and services and /or payment of property taxes, one should witness a spurt in tax collections in indirect taxes as well as property tax in the month after demonetization which would disappear thereafter. Similarly, in the case of currency substitutes, at MCD tax collection centres at the border, people are being given IOUs in lieu of the balance they were entitles to, which would be valid for six months. On property taxes, some local bodies have given people a window of opportunity to pay old as well as current taxes in the scrapped notes. This would result in an increase in revenue collections in property tax. With compression in the economy, there could be a reduction in the tax collection. In the unlikely event of people choosing to deposit unaccounted balances in the bank and pay taxes and penalty on the same, or if the tax department through investigation finds that some of the deposits are not explained income tax collections would increase. In other words, the government cannot expect to get major collections in terms of the tax and penalty on unaccounted incomes revealed.

Another sector which could be adversely affected would be the construction sector. The works in this field will be carried with a significant amount of cash. A Significant impact in the short-run will be on the daily/weekly wage employment in the informal sector. The construction sector has one of the highest employment multipliers. The key segments of the economy where cash transactions play a vital role are real estate, gold and the informal sectors, which may face near term contraction. With more money coming into the banking ambit, deposit growth is likely to improve and positively impact the savings rate. The medium to long-term gains are likely to outweigh the short-term pains. It could lead to a compression in investments in the construction sector which can have adverse income and employment consequences for the economy.

Farmers are the backbone of Indian economy. This is the sowing season for the Rabi crop in some parts of the country and the harvesting season for the Kharif crop. Most of the purchases and sales in this segment of the economy are carried out through cash. With the elimination of cash from the economy, sale of kharif crop would be difficult unless the crop is sold on the promise of payment in future. Given the limited bargaining power of the farmer, the price they can realize for the crop can be adversely affected. On the other hand, in the sowing activity, people would not get access to the inputs required since most of the inputs are now purchased from the market unless they seek access to credit from the supplier. In other words, with demonetization, there would be a significant strengthening of the informal sector credit market in the rural economy. Further, if there are agents who do not get access to credit from the informal sector agents, their sowing activity and hence their incomes in the next season would be adversely affected.

As directed by the Government, the 500 and 1000 rupee notes which now cease to be legal tender are to be deposited or exchanged in banks. This will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there would be withdrawals at the second stage. Banks flush with liquidity, in a falling interest rate scenario, is a perfect recipe for boosting lending. But tepid borrowing appetite by highly-leveraged corporate and banks' reluctance to lend, has failed to spur loan growth, even after a substantial fall in lending rates over the past year. Even before demonetization, credit growth had slipped to 8 per cent levels in the beginning of November. According to the RBI's latest figures (as on December 23), credit growth has fallen to a meager 5.1 per cent, down from 10-odd per cent levels last year. The growth had already fallen to 5 per cent levels in November, as credit to industry shrunk by 3 per cent.

The extent currency is extinguished and to the extent some of the currency remains as bank deposits, there would be some impact on the economy. The first effect would be a compression of the economy to the extent the extinguished currency was working as a medium of exchange. The currency that is placed in the banks but not withdrawn, it is argued, would generate an expansion in deposits in the economy. 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." The total cumulative credit that can potentially be generated is defined in terms of the reserve ratio. Total credit potential is equal to incremental deposit generated. In India, the cash reserve ratio is 4 percent while there is a statutory liquidity ratio of 22 percent. In determining the credit creation, it is important to take into account only the CRR and the additional credit creation can be 25 times the amount of money deposited in the banks as a result of the proposed demonetization. This amount however, will be generated only if there exists an equivalent demand for credit in the economy. The official SLR is 22 percent but some transactions and deposits with the banks have been excluded from the requirements of SLR. There the effective rate of SLR is lower.

Making India cashless was one of the ambitious goals behind demonetization. The PM himself endorsed the concept and encourages the people to use debit/credit cards, internet banking, mobile transaction apps, etc to avoid the hassles of paying cash amid the ongoing economic crisis. In his November's 'Mann Ki Baat' program, he agreed that a cashless society is not possible immediately, and appealed the people especially the youth to come forward and be a part of 'less-cash' society. This will pave the path for being cashless in the better future. The idea is great and envisages a bright future for the nation but the timing is quite adverse. India has to work heavily in improving the infrastructure in order to afford a cashless economy. At present, the country entertains 46% banking penetration and 19% of its population lives without electricity or with unreliable connection. Moreover, of the 14 million merchants, only 1.2 million have Point of Sales devices. In addition, the digital literacy is almost non-existent among above 40% of people live below poverty line; it is not that cake walk for them to afford a smartphone or at times, even a basic phone. Before making the country completely cashless, it is inevitable to address these real challenges. Plastic money has also several strings attached with it both for the merchants and for the consumers. For business people, applying for a obligations such as payment for merchant fees, KYC documentation and certifications related to transaction security. Additionally, card payment is quite time consuming. Likewise, consumers have to pay annual fees for cards in addition to convenience and surcharge fees. To be precise, India has only 22% internet connectivity, and in several areas, the internet is blocked due to various reasons. In such situations, it is beyond one's imagination to opt for online transactions are e-wallets. Even the banks need to be duly equipped and should have proper infrastructure in order to deal with the rise in e-transactions or to open more bank accounts.

Business Standard on 20th July, 2011, there are only 7% internet banking customers of the banks. Surprisingly only 15% Indians are the active bank customers. Now, after demonetization, several cash withdrawal limits has been implemented by the Reserve Bank of India (RBI) and banking industry is suffering from cash crunch. Government focused on cash less transactions and E-money transfers with the use of Internet banking but it is really difficult for the people of rural areas. On the other hand they are unaware from the technology and on the other hand they have a fear of cheating. In our country, many people are using cash as a medium of exchange and have to move to using digital versions of money as the medium of exchange. While this change is gradually happening in the economy, if it is forced by making cash inaccessible, the compression in demand as well as in income generation in the economy would continue for a longer period until people get familiar with the functioning and use of these media. There is need for a significant upgrade of the banking system as well as in the telecom infrastructure that would provide the backbone for digital transactions. For people to be able to transact at any time and place as well as for them to consider it a reliable medium of exchange, it is important that not only the banking system is upgraded to ensure that transactions can be completed without a hitch, but the supporting infrastructure too is up to the mark. For instance, in many parts of the economy, there is limited and intermittent supply of electricity as well as mobile connectivity. In these areas, it would be difficult to expect people to shift to electronic medium of exchange.

Apart from the technological issues, there is a behavioral change that is being expected in people from using cash as a medium of exchange to using other cash substitutes both for making payments and receiving payments. This transition requires individuals to make two changes in their behavior: one, agents need to move from tangible means which can be seen and felt to forms which are less tangible or not tangible, and second, they have to learn to rely on technologically advanced tools to undertake regular day to day operations. The latter requires agents to be educated to the extent of comprehending the content of transactions. If this transition is not suitably managed, agents might be tempted to move to non-official cash substitutes. In addition to all of the above, most of the banks and the mobile instruments for transaction are currently adapted to a single to two languages. If the bulk of the population of our country needs to come on board, it might be important to make these facilities available in a myriad of Indian languages to ensure that the user can comprehend the transaction that they are entering into. There is growing literature that points out to the possibility of changes in spending behavior as a result of moving to instruments other than cash.

MSME is one segment of the economy which is credit constrained. Expansion in the potential credit in the economy could expand the credit available to this segment of the economy which is more employment intensive than the organized manufacturing. In other words, if the access to credit for this segment can be improved, it can generate many positive spin-offs. One reason why this segment might get better access to formal sector credit would be if all their transactions move to the digital format, thereby making available to the lending institutions evidence of credit worthiness. However, for this the transactions need to move digital before they can get access to credit. In other words, unless the banking sector is exploring more risky asset categories, they would not be the beneficiaries of the expansion in potential credit. It should kept in mind that credit is not the only constraint faced by the MSME's. There is a cost of compliance with regulation in the formal sector both of tax legislation and other legislation which would increase the cost of operation. In the absence of economies of scale, after incurring all these costs, some of the MSME's might not be viable in the new environment. In other words, the decision to move from the informal sector to formal sector is a non-trivial decision for the units and merely changing the access to credit might not be adequate to alter the status quo. Under those circumstances, they might explore the use of alternative currencies as a means for survival.

6. CONCLUSIONS

The unanticipated shock of demonetization, making 80% of cash with the public illegal, is a massive disruption for the Indian economy. In spite of the initial hiccups and disruptions in the system, eventually this change will be well assimilated and will prove positive for the economy in the long run. 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. 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.

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