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EFFICACY OF THE DEMONETIZATION - 2016

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Introduction

Demonetization is the act of changing the existing currency in another form. The old units should be retired and replaced by new currency. In other words, demonetization means either introducing new notes or coins of the same currency or fully replacing the old currency with new currency. There is a one important thing exist on economics, which is remonetisation, in which forms of payment is restored as legal tender. There are so many reasons, why government demonetized their nation's currency. Some reasons are like resisting inflation, resist corruption, and discourage a cash system in the country. On the evening of Tuesday Nov 8, 2016, the Government of India announced that the 500 and 1000 rupee notes will no longer be legal tender from midnight, November 8th 2016. The Government also announced that it has accepted the recommendations of the RBI to issue 2000 rupee notes and new notes of 500 rupees will also be placed in circulation. The Prime Minister also announced a series of steps that will help overcome the potential problems arising out of the Demonetization.

The Prime Minister in his address to the nation stated that the steps taken by the Government would strengthen the hands of the common citizens in the fight against corruption, black money and counterfeit notes. He also shared the insight into how the magnitude of cash in circulation is linked to inflation and how the inflation situation has worsened due to the cash deployed through corrupt means. The Prime Minister added that it adversely affects the poor and the neo-middle class people. The efforts taken by the Government to eradicate black money over the past two and a half years, which include formation of a Special Investigation Team (SIT) on black money, law passed in 2015 on disclosure of foreign bank accounts, levy of strict rules to curtail

benami transactions in 2016, and scheme to declare black money in 2016, have resulted in more than ₹1.25 tn of black money being unearthed. This big-bang initiative supplements the earlier steps taken by the current Government to move towards a cashless economy like the Jan Dhan Yojana, payment banks, Digital India, Unified Payment Interface amongst many such moves.

With this background the present paper intend to assess following aspects in detail

1. Major challenges in the Indian Monetary System
2. Effectiveness of Demonetization -2016.

Major Challenges in the Indian Monetary System

India remains a cash-based economy, hence the circulation of Fake Indian Currency Notes (FICN) continues to be a menace. Counterfeit/FICNs are used for various subversive activities such as espionage, smuggling of arms, drugs and other contraband in India. Notes in circulation as a percentage to total money supply in India is around 14%. Out of this, 86% comprises of ₹500 and ₹1000 denominated notes. The value of notes in circulation as a percentage of GDP in India stood at more than 12% in FY16, which is significantly higher than other developing economies such as Brazil and China. As per the RBI, the number of counterfeit notes detected in the banking system has increased from 1.24 lakh notes in FY06 to 6.33 lakh notes in FY16 with the share of high denomination notes (₹ 500 notes and ₹1000 notes) increasing from 10.4% to around 64.0% during the same period.

Measuring the Size of the Shadow Economy in India

As per the IMF report 'The Revenue Administration: Managing the Shadow Economy', the

estimated size of India's shadow economy grew from 23.6% of GDP in 2002 to 25.6% of GDP in 2007. Assuming that the pace of growth (2002-2007) of the shadow economy had remained the same since 2007; in 2016, the size of India's shadow economy would be approximately 30% of GDP i.e. around ₹41 tn (calculated at current prices). Rerouting this into the formal economy would immensely boost the tax collection and increase the share of the organised sector.

Under The Income Declaration Scheme (IDS), 2016, only 64,275 declarations were filed up to the midnight of Sep 30, 2016 with an aggregate of ₹652.50 bn worth of hitherto undeclared incomes in the form of cash and other assets being declared. Under the Voluntary Disclosure of Income Scheme (VDIS), introduced in 1997, income disclosed amounted to ₹330 bn.

Data shows that while India's shadow economy grew 7.4 times over the period of 14 years (2002–2016), the disclosed income in 2016 under IDS were only twice the income declared in 1997 under VDIS. India ranked 3rd in illicit financial outflows after China and Russia in 2013, when US\$ 83 bn of illicit money was siphoned out of India, according to the report 'Illicit Financial Flows from Developing Countries' released by Global Financial Integrity, a non-profit, Washington DC based research and advisory organisation. The report defines the illicit financial flows to be generally the product of tax evasion, corruption, bribery and criminal activities.

Trade Mis Invoicing

Has been the only source of outflow for illicit money in India while Hot Money Outflows has been nil unlike China and Russia. In India, average trade mis invoicing outflows as a percentage to total trade for the period 2004-2013 was 10.30 percent, the cumulative amount of which was US\$ 505.6 billion during the period. The report also points out that out of the US\$ 1 trillion in illicit flows leaving poor nations annually, over 83 percent

is due to trade mis invoicing. Each year over US\$ 800 billion in illicit trade exits developing countries.

In November 2016, the Indian government has taken a bold step to demonetize the Rupees 500 and 1000 (were fully banned) Currency notes, these two biggest denominated notes accounted 80 percent of the currency supply. The government's main objectives of note ban is, to eradicate counterfeit currency, resist tax evasion, destroy the black money, and terrorist financing activities, and to encourage the country towards the cashless economy. This decision taken by government is for welfare of the nation, but so many questions comes in mind that, would note ban decision actually eradicate the black money, if does then at what extent black money will come out. What should be the impact of this decision on Indian economy? Would Indian economy be prosperous or would be poor.

Effectiveness of Demonetization - 2016

Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs 500 and Rs 1000 notes, there occurred huge gap in the currency composition as after Rs 100; Rs 2000 is the only denomination. Absence of intermediate denominations like Rs 500 and Rs 1000 will reduce the utility of Rs 2000. Effectively, this will make Rs 2000 less useful as a transaction currency though it can be a store value denomination.

Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy. The intensity of demonetization effects

clearly depends upon the duration of the liquidity shocks. Following are the main impacts. Demonetization is not a big disaster like global banking sector crisis of 2007; but at the same time, it will act as a liquidity shock that disturbs economic activities.

Liquidity crunch (short term effect): liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favourable denomination in daily life. It constituted to nearly 49 percent of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of the liquidity crunch. Current reports indicate that all security printing press can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 mn Rs 500 notes were in circulation as on end March 2016. Some portion of this were filled by the new Rs 2000 notes. Towards end of March approximately 10000 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy for the next four months.

Welfare loss for the currency using population: Most active segments of the population who constitute the 'base of the pyramid' uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy uses cash frequently. These sections will lose income in the absence of liquid cash. Cash stringency will compel firms to reduce labour cost and thus reduces income to the poor working class. There will be a trickle up effect of the liquidity chaos to the higher income people with time. Consumption will be hit: When liquidity shortage strikes, it is consumption that is going to be adversely affected first.

Nevertheless, although India's demonetization move was apparently mismanaged in the beginning, the effects at micro level look advantageous. For instance, all sorts of illegal activities, like terrorist financing, etc. have been completely hit after the announcement. The demonetization process has also repaired India's counterfeiting problem for the near to mid-term. The cash-centric black market for the most part ceased to

function with the nullification of the bulk of its currency. It has also been reported that the new 500 and 2,000 rupee notes are less vulnerable to counterfeiting, having advanced security features. It is also thought that the drive will wipe out a measure of corruption and tax evasion in India's real estate market. Growth in cash-intensive sectors such as real estate, construction and FMCG is likely to take a hit in the short term as consumers are deferring purchases. The real-estate market is likely to come to a standstill with property prices likely to fall and the possible tax inquiries following demonetization will affect both consumption and investment in the formal and informal sectors. However, there is a positive side to the story, over the medium term, there would be benefits through higher government spending and greater financial inclusion. Also, the movement of household savings from physical to financial will help boost growth, according to Yes Bank BSE 0.90 percent report.

With exchange of the old currency notes coming to an end, many people are forced to open accounts to save their money. It is estimated that banks have opened about 30 lakhs (and still counting) new accounts since the demonetization drive began on November 8. India's largest bank, State Bank of India (SBI), with its 17,097 branches — half of which are in the rural and semi-urban areas — is opening 50,000 accounts a day. The leading consumer internet companies in India (Flipkart, Snap deal, Shop clues, C C Avenues, Ola and Oyo Rooms) have applauded the move, saying it will pave the way for digital payments, aid the process of financial inclusion and the overall transformation in the economy will translate into long-term benefits for the industry. Payments companies Paytm and Free charge saw a surge in adoption of their digital wallets. According to market experts, the growth of digital payments and wallets is the first phase of the impact and will give big boost to lending and credit as the digital records of merchants will expand and create more demand in the second phase.

Conclusion

Demonetization in India is a great effort taken by Indian government to combat with black money and corruption. It is a bold decision taken by government. The main purpose of demonetization is eradicating the black money and reduces the corruption. Government of India has become success to some extent. Most of the black money has been crushed. Thus Demonetization as a cleaning exercise may produce several good things in the economy. Unmeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

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