A critical study on effects of demonetization on Indian economy

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Abstract

From slowing down the economic growth in various sectors to giving people nightmares of the long queues and the inability to spend liquid cash freely, the hullabaloo created by demonetization is remembered by one and all on its first anniversary. Demonetization was initiated with a wide array of motives like stripping the Indian economy of its black money, push people to pay taxes for the unaccounted pile of cash, curb terrorism, promote the digital India movement and make India a cashless economy. 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. 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 Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it.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.

Keywords: Demonetization, economic growth, Indian economy, denomination

Introduction

Demonetisation means withdrawing the legal tender rights of any denomination of currency. November 2016, the Government of India announced the demonetization of all ₹500 and ₹1,000 banknotes of the Mahatma Gandhi Series. It also announced the issuance of new ₹500 and ₹2,000 banknotes in exchange for the demonetised banknotes. The Prime minister of India Narendra Modi claimed that the action would curtail the shadow economy and reduce the use of illicit and counterfeit cash to fund illegal activity and terrorism. India has a thriving cash economy. A majority of businesses in India run on cash with no transparency or accountability. This money never enters the tax system of the country. It is a ‘leakage’ from the economic cycle adversely impacting the working of the Indian economy. According to reports, two thirds of India’s GDP is cash economy—around Rs 90 lakh crores. It is the honest tax-paying citizen of the country who suffers.

Effects of demonetization on Indian economy

Cash shortage

The scarcity of cash due to demonetisation led to chaos, and people faced difficulties in depositing or exchanging the demonetised banknotes due to long queues outside banks and ATMs across India \(^{(1-4)}\). The ATMs were short of cash for months after demonetisation \(^{(5-8)}\).

Transportation

The All India Motor Transport Congress claimed that about 800,000 truck drivers and conductors were affected with shortage of cash, with around 400,000 trucks stranded at major highways across India \(^{(9)}\). While major highway toll junctions on the Gujarat and Delhi-Mumbai highways also saw long queues as toll plaza operators refused the demonetised banknotes \(^{(10)}\).

Stock market

As a combined effect of demonetisation and US presidential election, the stock market indices dropped to an around six-month low in the week following the announcement.
The day after the demonetisation announcement, BSE SENSEX crashed nearly 1,689 points and NIFTY 50 plunged by over 541 points [13]. By the end of the intraday trading section on 15 November 2016, the BSE SENSEX index was lower by 565 points and the NIFTY 50 index was below 8100 intraday [12]. There was a marginal effects on stock market during November–December 2016. Demonetisation had a negative impact on stock market returns evidenced from NIFTY 50 and other NIFTY sectoral indices [13].

Industrial output
There was a reduction in industrial output as industries were hit by the cash shortage. The Purchasing Managers’ Index (PMI) fell to 46.7 in November 2016 from 54.5 in October 2016, recording its sharpest reduction in three years [15]. A reading above 50 indicates growth and a reading below shows contraction. This indicates a slowdown in both, manufacturing and services industries [16]. The PMI report also showed that the reduction in inflation in November 2016 was due to shortage in money supply [17].

Agriculture
The shortage of cash led to a crash in the prices of crops. Farmers were unable to recover even the costs of transportation from their fields to the market from the low prices offered [18, 19]. Some farmers dumped their produce in protest against the government [20, 21]. Demonetisation resulted in the relative erosion of agricultural wages and weak bargaining power of farmers for their produce [22].

Real GDP growth rate
The GDP growth rate for Q1’17-18 dropped to 5.7%, compared to 7.9% a year ago, the lowest since March 2014. This drop was attributed to demonetisation as well as inventory drawdown by companies due to the forthcoming implementation of the Goods and Service Tax [144][131]. The GDP started to recover from Q2’17-18 and clocked 8.2% in Q2’18-19 [24, 25, 26].

Employment
According to the report prepared by Centre for Monitoring Indian Economy (CMIE), the number of employed people was 401 million in January–April 2016, 403 million during May–August 2016, 406.5 million in September–December 2016. After demonetisation in November 2016, the number fell to 405 million in January–April 2017. So there was fall of 1.5 million in number of people employed [27]. CMIE also reported that the number of persons employed was 406.7 million in 2016-17 which fell by 0.1% to 406.2 million in 2017-18. So the employment had stagnated which resulted in employment rate decline. The employment rate fell from 42.59% in 2016-17 to 41.45% in 2016-17. The unemployment rate also declined from 7.51% in 2016-17 to 4.66% in 2017-18 because of the shrinking employed force. The number of employed force fell from 439.7 million in 2016-17 to 426.1 million in 2017-18. CMIE attributed the impact to demonetisation as well as implementation of Goods and Services Tax in July 2017 [28, 29].

Cost to banks
Before demonetisation, the RBI had spent ₹3,421 crore to print banknotes in 2015-2016 (July to June). The cost of printing new banknotes escalated to ₹7,965 crore in 2016-17 and ₹4,912 crore in 2017-18. This resulted in a decline in the dividend paid to the government from ₹65,876 crore in 2015-16 to ₹30,659 crore in 2016-17 and ₹50,000 crore in 2017-18 [31-34]. It was estimated that this decrease in income for the government could cause the fiscal deficit for the financial year 2016-17 to increase from the targeted 3.2% to 3.4% [35]. The Indian Air Force was paid ₹29.41 crore to move banknotes after demonetisation [36].

Welfare schemes
Demonetisation negatively impacted the Midday Meal Scheme due to shortage of funds [37-40].

Deaths
Several people were reported to have died from standing in queues for hours to exchange their demonetised banknotes [41-46]. Deaths were also attributed to lack of medical help due to refusal of demonetised banknotes by hospitals [47, 48, 49]. By the end of December 2016, political opposition leaders claimed that over 100 people had died due to demonetisation [50, 51, 52]. In March 2017, the government stated that they received no official report on deaths connected to demonetisation [53]. Later in December 2018, the then Finance Minister Arun Jaitley reported in parliament that four people, three bank personnel and one customer of the State Bank of India, died during the demonetisation [54].

Legal issues
The government had initially announced that any person who is unable to deposit the demonetised banknotes by 31 December 2016 would be given an opportunity to do so until a later date [55]. However, the government allowed only Non-Resident Indians (NRIs) to deposit demonetised banknotes after 31 December 2016 [56]. As a result, many people were left stranded with demonetised banknotes. People petitioned the courts to allow deposit of the demonetised banknotes [57]. In November 2017 the Supreme Court dismissed 14 petitions related to demonetization, and asked petitioners to file pleas with a constitutional bench which would deal with cases related to demonetisation [58].

Reactions
Reactions of economists
Indian-American economist Jagdish Bhagwati praised the demonetisation [59]. Nobel laureate Amartya Sen, severely criticised the demonetisation move calling it a "despotic action" among other things [60, 61, 62]. Former Senior Vice-President and Chief Economist of the World Bank, Kaushik Basu, called it a 'major mistake' and said that the 'damage' is likely to be much greater than any possible benefits [63, 64, 65]. Pranab Sen, former Chief Statistician and Planning Commission of India member, called it a "hollow move" since it did not really address any of the purported goals of tackling black money or fake currency [66]. Prabhat Patnaik, a former professor of economics at the Jawaharlal Nehru University, Delhi called the move 'witless' and 'anti-people'. He criticised the simple way in which black money was assumed as "a hoard of cash", saying that it would have little effect in eliminating "black activities" while "causing much hardship to common people" [67]. Economist and journalist, T. N. Ninan wrote in the Business Standard that demonetisation 'looks like a bad idea, badly executed on the basis of some half-baked notions' [68]. Steve Forbes described the move as 'Sickening and Immoral' [69]. He stated that "What India has done is commit a massive theft of people's property without even the pretense of due process—"
shocking move for a democratically elected government" [70], Nobel laureate Paul Krugman said that it is difficult to see gains from demonetisation, while there may be significant costs to it [71]. Economic analyst Vivek Kaul stated in a BBC article that "demonetisation had been a failure of epic proportions" [72].

Reactions of industrialists
The decision met with mixed initial reactions. Several bankers like Arundhati Bhattacharya (Chairperson of State Bank of India) and Chanda Kochhar (MD & CEO of ICICI Bank) appreciated the move in the sense that it would help curb black money [73]. Businessmen Anand Mahindra (Mahindra Group), Sajjan Jindal (JSW Group), Kunal Bahl (Snapdeal and Free Charge) also supported the move adding that it would also accelerate e-commerce [74]. Infosys founder N. R. Narayana Murthy praised the move [75].

Deepak Parekh (Chairman of HDFC) had initially appreciated the decision of demonetisation, but later said that the move had derailed the economy, and expressed skepticism about its outcome [76, 77]. Industrialist Rajiv Bajaj criticised the demonetisation, saying that not just the execution, but the concept of demonetisation was wrong in itself [78].

Political reactions
Indian National Congress spokesperson Randeep Surjewala welcomed the move but remained skeptical on the consequences that would follow [79]. Chief Minister of Bihar Nitish Kumar supported the move [80, 81, 82]. The demonetisation also got support from the then Chief Minister of Andhra Pradesh Nara Chandrababu Naidu [83, 84, 85]. Former Chief Election Commissioner of India S. Y. Quraishi said demonetisation could lead to long term electoral reforms [86].

Indian social activist Anna Hazare hailed demonetisation as a "revolutionary step" [87, 88]. Former President of India Pranab Mukherjee welcomed the demonetisation move by calling it a "bold step" [89, 90, 91, 92]. Chief Ministers of several Indian states like Mamata Banerjee, [93] Arvind Kejriwal [94] and Pinarayi Vijayan [95] have criticised and led major protests against the decision in their states and in parliament. Initially, the move to demonetise and try to hinder black money was appreciated, but the manner in which it was carried out by causing hardships to common people was criticised [96].

On 16 November 2016, Mamata Banerjee led a delegation comprising political parties of Trinamool Congress, Aam Aadmi Party, BJP ally Shiv Sena and National Conference to Rashtrapati Bhawan to protest against the decision of demonetisation. A memorandum was submitted to the President of India Pranab Mukherjee demanding rollback of the decision [97, 98].

Prem Chand Gupta, a member of the Rashtriya Janata Dal, questioned a statement of Modi from the unscheduled TV broadcast on 8 November, "If it was planned 10 months ago, how did RBI Governor Urjit Patel sign on new note?". Praful Patel, a member of the Nationalist Congress Party, stated that "the government was not even prepared to recalibrate the ATMs while announcing the move. People's suffering are unimaginable. Nobody is questioning the government's intention, but you are unprepared to execute the move". Later, the former Chief Minister of Uttar Pradesh Mayawati stated the situation to "a financial emergency", by saying "It looks as if Bharat has shut down." Also, Sitaram Yechury from Communist Party of India, questioned the government on the demonetisation move by stating "only 6% of black money in India is in cash to drive his point that demonetisation won't curb illicit wealth" [99].

On 17 November 2016, a rally against demonetisation, led by Chief Minister of Delhi Arvind Kejriwal and his West Bengal counterpart Mamata Banerjee at Azadpur Mandi, the biggest vegetable and fruits wholesale market in New Delhi was organised [100].

International reactions
By and large, initial international response was positive which saw the move as a bold crackdown on corruption [101, 102]. The International Monetary Fund's spokesperson Gerry Rice told that it supported the efforts to fight corruption and illegal finances but cautioned about the disruptions [103].

The demonetisation also came in for sharp criticism from media outside India [104] with the New York Times saying that the demonetisation was "atrociuously planned" and that it did not appear to have combatted black money [105] while an article in The Guardian stated that "Modi has brought havoc to India" [106]. The Harvard Business Review called it "a case study in poor policy and even poorer execution" [107]. The frequent change in the narrative on objectives of the demonetisation to its visible impact on the poorest of the poor made other critiques calling government's narrative as spins in view of the "pointless suffering on India's poorest" [108].

Long term impact
In 2019, India experienced the economic slowdown which was attributed to demonetisation and several other factors [109].

Conclusion
The move by the government to demonetise old currency and replacing it with the new one has taken the country by surprise. The move was an effort to handle the threat of illegal money, corruption, terror funding and counterfeit currency. The decision regarding demonetising the old currency was considered as a surgical strike against the undeclared money in the history of Indian Economy, it may be a move towards the cashless economy. The demonetisation is followed by a liquidity crunch in the country, banks and ATMs across the country faced severe cash shortages with detrimental effects on various small business, agriculture and transportation. Currency ban by the government of India created chaos in short-term as most people with old currency notes faced difficulties exchanging them in long queues outside banks and ATMs across India. The total value of old currency notes in the circulation was to the tune of Rs 14.2 trillion, which constitute about 86% of the total value in circulation. The black money has either been accounted by paying heavy taxes and penalties or has reached the bank accounts through direct or indirect channels. Demonetization would bring a positive impact on Indian economy as it encourages the digital mode of payment like E-wallets and apps, online transactions using E-banking, usage of plastic money etc. Demonetization is beneficial for the economy in the medium to long-term.

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