IOSR Journal Of Humanities And Social Science (IOSR-JHSS)
e-ISSN: 2279-0837, p-ISSN: 2279-0845.
PP 11-14
www.iosrjournals.org

Impact of Demonetization – A Concetual Framework

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Abstract: *Demonetization is a cleansing action for economic prosperity. Government initiate demonetization to eradicate counterfeit currency, fight tax evasion, eliminate black money gotten from money laundering and terrorist financing activities, and promote a cashless economy. Though it is a optimistic move by the government on one side; on the others side there is welfare losses to the poor sections of the society who depends on daily income for their livelihood and those doesn't have the digital transaction culture. Hence the papers put forth two major objectives: to study the positive and negative aspects of demonetization and to assess the sectoral impact of demonetization on the economy.*
Keywords: *Counterfeit currency, Tax evasion, Black money and Terrorist financing*

I. Introduction

Demonetization is an action of clearing a currency unit of its virtue. It is technically termed as liquidity shock; a sudden cessation in terms of currency availability. It is essential whenever there is a change of national currency. The old unit of currency is replaced with new ones. It establishes a situation where lack of currencies blocks consumption, investment, production, employment and so on. Its impact will be felt by each and every citizen of the nation. There are multiple reasons for demonetize their local units of currency. Some reasons include curtailing inflation, corruption, and to discourage a cash system. The process of demonetization involves either to introduce new notes or coins of the same currency or completely replacing the old currency with new currency. The government's aim towards demonetization will be to eradicate counterfeit currency, fight tax evasion, eliminate black money gotten from money laundering and terrorist financing activities, and promote a cashless economy. By making the larger denomination notes worthless, individuals and entities with huge sums of black money gotten from parallel cash systems were forced to convert the money at a bank which is by law required to acquire tax information from the entity. If the entity could not provide proof of making any tax payments on the cash, a tax penalty will be imposed.

Objectives Of The Study

The study put forth two major objectives which include:
1. To study the positive and negative aspects of demonetization
2. To assess the sectoral impact of demonetization on the economy

Positive Aspects Of Demonetization

1. Demonetization will have a huge resultant effect on the Indian economy. The clean-up of illegal cash will help turn around the economy. First, it will bring more borrowings to the exchequer, improve inflation outlook and increase India's gross domestic product (GDP). Second, it will revive investment opportunities and give a fillip to infrastructure and the manufacturing sector. Third, it will help reduce interest rates and lower income tax rate.
2. Black money is nothing but a plunder of the nation. Black money operators run a parallel economy which shakes the very foundation of the Indian economy. The demonetization move, will automatically push all domestic black money into the banks with heavy penalty or be simply destroyed.
3. Note bank politics is pulling out of the old currency notes will help make the election process clean and transparent.
4. Real estate cleansing means real estate is an industry built on black money. The extent of black money floating around in the sector is huge. Demonetization will curtail the flow of black money into the real estate sector. This will help in making the much needed correction in the sector.
5. Demonetization will cripple the hawala rackets. Hawala is a method of transferring money without any actual money movement. Hawala route is used as a means to facilitate money laundering and terror financing. Hawala rackets run again on black money.
6. Counterfeit currency seriously devalues the real worth of Indian currency. Most of the fake currencies will be in higher denominations. Hence demonetization reduces counterfeit notes.

7. Terror financing is sourced through counterfeit currency and hawala transactions. Demonetization reduces terror financing

Negative Aspects Of Demonetization

1. Demonetization gives short term liquidity shock which disturbs economic activities.
2. Population who constitute the 'base of the pyramid' uses currency to meet their transactions. The daily wage earners, other laborers, 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 labor 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.
3. When liquidity shortage strikes, it is consumption that is going to be adversely affected first. When consumption curtails it has direct impact on production, employment, growth and tax revenue.
4. A country may risks its position of being the fastest growing economy: reduced consumption, income, investment etc. may reduce India's GDP growth as the liquidity impact itself may last three -four months.
5. Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply takes place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.
6. Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depends upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. Such a nationwide awareness and urge will encourage government to come out with even strong measures.
7. Reduction in money supply can also have a deflationary effect in the economy. However, whether the impact of the reduced money supply will lead to deflation or contraction in demand or a mix of both will vary from sector to sector depending on the nature of goods & services.

Sectoral Impact Of Demonetization

The impact of demonetization will be felt across sectors with differing intensities and across varied time zones.

1.Banking

Demonetization expects a large amount of cash in circulation to be brought within the purview of the formal banking system by way of deposits. This is structurally positive for banks, as part of this cash gets deposited as current account and savings account (CASA) deposits, reducing banks dependence on higher cost borrowing. Deposit deployment remains a challenge in the short to medium term due to the current tepid demand for credit, subsequently pushing deposit rates lower.

Payment banks and others entities which are part of the transaction ecosystem are likely to be long term beneficiaries, as more and more cash finds its way into the formal banking channels. We believe the cumulative measures taken to reign in black money will improve banking habits, create financial and transactional history of the informal & cash dependent segments and could, over the long term, make them 'bankable'. However, to the extent that households have held on to these funds for emergency purposes, there are expected to be withdrawals at the second stage.

1. Online Transactions and alternative modes of payment

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increases in demand. This should eventually lead to strengthening of such systems and the infrastructures required.

2. Financial investments

Investors in the short term will now believe that Cash is not the safest asset and there is little point in hoarding it. This will shift them from physical asset to financial assets where returns are also higher

3. Real Estate

We expect that the real estate demand from end users is unlikely to be impacted, since a majority of them are backed by funding from bank loans. Demand from investors for real estate however may come down since in some cases, investors prefer cash transactions. If the proportion of earlier transactions in the real estate sector, which were allegedly done through partial cash payment reduces, the registered prices for real estate will go up. We expect the supply of real estate in the secondary market, which is strongly rumoured to have a large cash component involved, to suffer in the short term, which may in turn improve demand for residential real estate in the primary market. In the medium term, the prices in this sector could regain on many fronts as developers rebalance their prices (probably charging more on cheque payment).

4. Sales of used cars

Sales of vehicles in the second hand market for original equipment manufacturers will get impacted, which will cause a ripple effect on New Car sales, as buyers will not be able to dispose of their old vehicles easily.

5. Consumer Durable Goods

Sales of White Goods like TV, Refrigerator & Washing Machine could slump as much as 70% as a good portion of the market is driven by Cash. This may continue for next Six Months till the dust settles down and there is adequate circulation of the new currencies. Prices are expected to fall only marginally, due to moderation in demand, as use of cards and cheques could compensate for some purchases.

6. Gems and Jewellery

We can expect the demand for gems and jewellery to decline in the next two to three quarters. This would result in a weakening in the credit profile of industry players due to the high working capital cycles and high operating leverage. The unorganized segment will be hit particularly hard, given the large proportion of unaccounted inventory and high proportion of cash sales. Over the medium-term the organised industry players will benefit at the cost of the unorganized players. Gold imports through the unofficial channels are likely to reduce. There will be no significant impact on jewellery exporters because it is mostly an organized market and sales are against invoices.

7. Retail Markets

We expect the impact on high end fashion retail and luxury goods to be more pronounced as discretionary demand in this segment will be curtailed. In case of Quick Service Restaurants, although 60%-70% of the transactions are currently in cash, the impact is likely to be moderate due to the low ticket size of purchases and high likelihood of patrons adapting to plastic money. We expect a limited impact to be caused on the food and grocery retail sub-segment, given the non-discretionary nature of purchases in this segment, since the buying cycle for the current month would have been largely influenced.

8. Educational Institutions

Since Private Educational Institutions take huge amounts of donations in Cash which is 40 % to 50%, we expect that this move will impact the Private Education Institutions receipts.

8. Medical Institutions

Again, as Medical Institutions like Hospitals and Colleges take huge amounts of donations in Cash which are more than 100 % of fees, we can keep on expecting that this move will impact not only the admissions but also the receipts.

9. Credit Impact across Sectors

Impact of this policy measure will flow to the economy mainly through the Real Estate sector, which has strong linkages with sectors such as cement and steel and which will turn credit negative in the short-run. 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.

10. Dabba Trading

It may kill Dabba Trading. Trades done outside bourses, Satta Bazaar & Illegal Betting market may die a natural death as currency gets a new face. Demonetization was a jolt for Dabba traders, who were thriving in equity markets for many years now.

11. Economic entities

The key segments of the economy where cash transactions play a vital role are real estate / construction, gold and the informal sectors as such. The role of cash transactions in case of real estate and gold is mostly dubious, however in case of the informal sectors it is the lifeline. For example, small and marginal

farmers in the fruits and vegetables category typically require off-loading of their produce in the local Mandi in cash and could see an immediate impact. A sudden demonetization will adversely impact this segment of the economy and it will witness immediate contraction, though this impact will diminish over time.
With cash transactions lowering in the short run, until the new notes are naturalized widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- Agriculture and related sectors
- Small traders
- SME
- Services Sectors
- Households
- Professionals like doctors, carpenters, utility service providers, etc.
- Retail outlets

The nature, frequency and amounts of the commercial transactions involved within these sections of the economy necessitate cash transactions on a more frequent basis. Thus, these segments are expected to have the most significant impact post this demonetization process and the introduction of new notes in circulation.

II. Conclusion

To conclude, most of the Rural Economy is based on Cash, demonetization will impact the Rural Economy and sectors with a sizeable magnitude of Cash transactions such as Real Estate, Construction, Jewellery, high-end retail, White Goods and travel & tourism are expected to adversely affect. Demonetization will push the economy because of flow of more money into the banking system. In the long term, the economy will benefit from the reduction of the black money, which will lead to higher tax collection, better business environment, less corruption & transparency. It will improve the situation of Fiscal Deficit of the Country and hence reduce the fiscal deficit. Interest rates will decline further because of decrease on Inflation as banks are flushed with huge inflows.

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