IOSR Journal Of Humanities And Social Science (IOSR-JHSS)
e-ISSN: 2279-0837, p-ISSN: 2279-0845.
PP 50-54
www.iosrjournals.org

Impact of Demonetization on Indian Economy

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Abstract: *Demonetization for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as an official mode of payment. Demonetization is the act of stripping a currency unit of its status as legal tender. In an important move, the Government of India declared that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI will issue Two thousand rupee notes and new notes of Five hundred rupees which will be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. The reasons of it are as under:This article has made an attempt to assess how the tool of Demonetization can be used to eradicate parallel economy. Demonetization is one of the big steps initiated by Government in addressing the various issues like black money, counterfeit currency, corruption, terrorism etc.*
Keywords: *Demonetization, Indian economy, Black money, Tax evasion, Swiss bank, corruption*

I. Introduction

In popular parlance, the unofficial economy goes by the name of black money and the official of white money. Black and white are also variously substituted by number two and number one, unaccounted and accounted, unreported and reported, unrecorded and recorded and so on…"
"It is stripping a currency unit of its status as legal tender. *Demonetization is the old unit of currency must be retired and replaced with a new currency unit".*

Money is the life blood of every economy. With the growth of civilization and mankind, the needs of human beings increased. In order to fulfill humans unlimited wants barter system emerged. But over a period of time, the invention of money became a strong pillar to build an economy. Money exchange appears to be more convenient than barter because it obviates the "double coincidence of wants" and is capable of sustaining relatively complex economy. Money exchange facilitates ease of doing business, facilitates taxation and national integration. All activities such as production, exchange, distribution, services etc. form an economy. It is called formal economy. An informal economy is neither economic activity/activities that is neither taxed nor monitories by Government, contrasted with a formal economy. Presence of corruption, black money, counterfeit currency, poor governance etc. promotes and establishes parallel economy.

Reasons of Demonetization

- *To promote a Cashless economy*
- *To eradicate counterfeit currency*
- *Eliminate black money*
- *To combat corruption*
- *To combat inflation*
- *Crackdown on terrorism and Naxalism*
- To promote a cashless economy.

Meaning

The dictionary meaning of DEMONETIZE is "To deprive (a metal) of its capacity as a monetary standard" or "To withdraw from use as currency" So, demonetization is the act of stripping a currency unit of its status as legal tender. It is the act or process of removing the legal status of currency unit. A currency on which Governor of RBI on behalf of Central Government guarantees by making statement "I promises to pay the bearer, the sum of money ……" which empowers it a legal status. From the date of demonetization, all old currencies which are demonetized will cease to be a legal tender. Such currency cannot be used as money to do any transaction henceforth, but to replace with a new currency.

II. History around the World

Demonetization is not new to India or to the outside world. Various Governments across the world have decided to ban currency note in circulation, rendering huge amount of cash useless overnights, due to plethora of reasons. These include fighting counterfeiting, stopping terror activities, battling black money etc. Many countries have adopted this process of demonetization to overcome hyperinflation, to curb black money, to bring economic stability, to remove counterfeit currency etc. One of the best and recent examples of demonetization is that of adoption of Euro currency among the nations of European Union. In order to switch to the Euro currency, authorities first fixed exchange rates for the varied national currencies into Euros. When the Euro was introduced, the old national currencies were demonetized. However, old currencies remained convertible into Euros for a while so that a smooth transition through demonetization would be assured.

- To study the experience of impact of demonetization in various countries in past years;
- To analyze the current the immediate impact of demonetization on Indian economy;
- To workout the probable consequences of the demonetization.

III. Research Methodology

The paper is based on secondary data. The data has been collected from internet.

Objectives of Demonetization:

The main objectives of demonetization are:

1. To eradicate black money
2. To remove counterfeit currency
3. To fight against terrorism
4. To stop money laundering activities
5. To mitigate corruption and so on

Procedure for Exchange Old notes

The Reserve Bank of India laid down a detailed procedure for the exchange of the demonetized banknotes with new Rs.500 and Rs.2000 banknotes of the Mahatma Gandhi New Series and Rs.100 banknotes of the preceding Mahatma Gandhi Series. Following are the key points:

- Citizens will have until 30 December 2016 to tender their old banknotes at any office of the RBI or any bank branch and credit the value into their respective bank accounts.
- Cash withdrawals from bank accounts will be restricted to Rs.10, 000 per day and Rs.20,000 per week from 9 November 2016 till 24 November 2016.
- For immediate cash needs, the old banknotes of value up to Rs.4000 per person can be exchanged for the new Rs.500 and Rs.2000 banknotes as well as Rs.100 banknotes over the counter of bank branches from 10 November 2016 by filling up a requisition form along with a valid ID proof.
- All ATMs will dispense bank notes of only 50 and 100 rupee denominations.

History in India

India had an experience of demonetization of its currency twice before. The first was when Rs. 1000, Rs. 5000 and Rs 10000 notes were taken out of circulation on 12th January 1946, a 1 ½ year before the Independence. The highest denomination note ever printed by RBI in India was Rs. 10000 note introduced for the first time in the year 1938. However all three of Rs. 1000, Rs 5000 and Rs. 10000 notes were again reintroduced in 1954. The second phase of demonetization was done on 16th January 1978 when an ordinance was promulgated to phase out notes with denomination of Rs. 1000, Rs 5000 and Rs. 10000.

On 12th January 1946 demonetization was resorted to but the Direct Tax Enquiry Committee in its interim report observed, “Demonetization was not successful then, because only a very small proportion of total notes in circulation were demonetized in 1946 and its worth was Rs. 1,235.93 crores”. On 16th January 1978, demonetization of high denomination notes was introduced. The high demonetization notes as on that day amounted to Rs. 146 crore and total notes tendered to RBI amounted to Rs. 125 crore as per data available till August 1981.

Russia:

On its last legs, the country under Mikhail Gorbachev in January 1991 withdrew large-ruble bills from circulation in a move to take on the black economy. The reform failed to halt inflation, and instead served mainly to accelerate a slide in public confidence in the government. As political infighting combined with economic collapse, Gorbachev faced a coup attempt that August which destroyed his authority and led to the Soviet break-up the following year. Learning lessons, Russia's 1998 redenomination of the ruble, when it removed three zeroes, went altogether more smoothly.

North Korea:

In 2010, the regime of then-dictator Kim Jong-Il mounted a reform that knocked off two zeros from the face value of the old currency in an effort to tighten control of the economy and close black markets. Combined with a poor harvest, the measure left the country with severe food shortages, according to reports at the time. Surging rice prices stoked unrest that prompted an unusual apology from Kim, and -- reports suggested -- the execution of the ruling party's head of finance.

Zaire:

Dictator Mobutu Sese Seko faced increasing economic disruptions in the early 1990s, when his administration mounted successive banknote reforms. A plan to withdraw obsolescent currency from the system in 1993 saw a surge in inflation and a collapse in the exchange rate against the dollar. After a civil war, Mobutu was ousted in 1997

Myanmar:

In 1987, the country's military junta invalidated as much as 80 per cent of the value of money in circulation, according to reports at the time -- as in other such initiatives, it was directed at curbing the black market. One result was the first student demonstrations in years. Deepening economic unease helped trigger mass protests across the nation the following year that led to a government crackdown that killed thousands of people.

IV. Principles of Tackling Black Money

The first principle is that remove the systemic pain that leads to creation of black money in the first place. Blame lies with the tax department. Black money is nothing but money generated in legitimate transactions which are hidden from government so as to avoid paying the transaction cost (usually tax) in the legitimate economy his is usually done by using physical cash. This cash thereafter must be processed to convert into consumption or investment. Black economy refers to various activities, transactions etc. that help process this physical cash, create returns on this cash, facilitate consumption using this cash etc.

The second principle has two parts. First, not all cash transactions are necessarily black money transaction. They become black money transactions only if they are hidden from the legitimate economy. Thus, a shopkeeper who does not give receipt but declares the sale (it’s only hypothetical) does not create black money. Conversely, a shopkeeper who gives a receipt but discloses other receipt book to the tax authorities (happens all the time) creates black money transaction. Second, the black money must at some time or other be plugged into legitimate economy. Thus, it cannot be done using user created currency that cannot be exchanged with local currency. So it depends on legal tender. It means somewhere down the chain there must exist a person for whom part of this black money is legal cash income which he can use for his own consumption in legitimate channels. Usually, this is the construction worker, or other poorest of the poor who will give certain services and his income will remain under the government radar. It can also be illegal traders in gold or diamonds etc. who can convert this into precious items that have quasi legal tender status.

The third insight is that black economy is continuously fed by parts of white economy that go underground. Quite a few people who do not want to promote black money contribute to it. They are either coerced say developer forcing buyer to pay him in cash or government officer seeking bribes in cash. Therefore, preventing white money from becoming black the starting point. The recommendations of Report titled Measures to tackle Black Money in India and Black economy depends on black money financiers. These are money lenders earning like 2% per month on their investments for financing the activities in black money friendly sectors. Film financing, construction financing, retailers, dance bars, alcohol, etc. These financiers also need enforcement mechanism to ensure their money is safe. Naturally they ally with criminal elements. Al Capone, the famous Chicago mobster, was previously an enforcer but later a financier.

V. Other Black Money Creators

There are other critical elements in black money chain or black economy. These elements represent turning smaller amount of white money into black by aggregation and misrepresentation.

For example, take NGOs. Some of the NGOs existing only on paper. Their model is thus. These NGOs collect legitimate amounts from citizens and push it into causes like animal shelters, girl child, medical aid to needy etc. The main problem is that the costs of these NGOs is unreasonably high. They also commit fraud by misrepresenting number of animals and kind of facilities etc. creating a source of black money for the promoters who get salary and or benefits like cars and drivers from the NGOs.

Cooperative banks are another piece of the puzzle. These accept smaller deposits from individuals and loan to founders and directors. The process is illegal and escapes the law only because it is not regulated by the RBI but by Politicians who are themselves directors in such institutes.

Government aided/recognized schools, colleges and institutions which look innocuous and have no actual teachers, students or infrastructure but simply using approvals from complicit education officers create a chain wherein legitimate money turns into black money. Others institutes have proper systems but use management quota to pool students' money into black money pools for the founders. Some use both mechanisms.

Such entities are inherently different from SMEs which exist to service the needs of a wealthy black money holder or create black money through banks. These elements will be hit substantially by the demonetization and their promoters will be forced to declare these amounts or destroy them. However, the issue is that they can continue to create black money sources since their model has not been dismantled.

VI. Role of Religious And Other Public Trusts

The model of trusts is a little different but they are as important elements in processing black money as SMEs and others listed above. The trusts are both receptacles and users of black money. They are not creators.

Some allow devotees to make small but numerous donations while spending substantial amounts on expenditures related to their promoters. Others are created out of anonymous black money donations with specific beneficiaries. Their nature makes them a hot-potato issue where they seem to be untouchable by any government, religious entities being protected by constitution.

So Will Demonetisation Eliminate Black Money?

Not by itself. It is just one move of one piece in the chess board of black money. To check-mate the black money king, you have to win the board. There are various steps required as detailed above. Government can play all these moves and still fail if they play improperly. All we can say is that Government is playing well. But will it succeed? The efforts will bring massive amounts of cash into the banking system – a benefit in itself. Once the money is in the legitimate channels, it should be better utilized and revenue will be generated from its use. If that is success enough then yes.

Strategies for tackling Black money

The distillation of various approaches can be summarised as under:

- Establish identity of persons (through PAN Card, Aadhar Card etc.) operating in the country citizens and foreigners.
- Enable low the cost direct bank transfers (Implementation of NEFT/IMPS/RTGS and other formats) including direct transfers of subsidies to the beneficiaries under the Aadhar scheme.
- Enable electronic register of assets (Underway through electronic land records, digitisation of revenue records)
- Reform tax system so that cost of compliance is lower than cost of tax evasion. (through initiatives such as Saral forms, e-filing, self declaration etc.) Indirect tax system through simplification (GST).
- Widen the net for disclosure by filing Income Tax return. (auto processing returns for tax refunds)
- Regulations that increase costs for black money creating activities. (Prevention of Corruption Act etc.)
- Create attribution chain for funds entering and exiting the country (such as through P-Notes, FDI, Prevention of Money Laundering Act etc.)
- Create e-trails of both incomes and expenditure.
- Control on holding of cash and physical money including Indian and foreign money. (FEMA, recent demonetisation)

Semantics of the current Demonetisation

Demonetisation is the mechanism by which the government states to withdraw the money which is current legal tender. The government being sovereign can take such decision. The effect of this announcement is that the currency notes in circulation will now cease to be valid tender and can only be exchanged at the banks. Demonetisation of higher denomination notes as an idea has been around.There are two important issues with respect to the present demonetization. Government aided/recognized schools, colleges and institutions which look innocuous and have no actual teachers, students or infrastructure but simply using approvals from complicit education officers create a chain wherein legitimate money turns into black money. Others institutes have proper systems but use management quota to pool students' money into black money pools for the founders. Some use both mechanisms.

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VII. Conclusion

Central government's recent decision to demonetise the high value currency is one of the major step towards the eradication of black money in India. The demonetization drive will affect some extent to the general public, but for larger interest of the country such decisions are inevitable. Also it may not curb black money fully, but definitely it has major impact in curbing black money to large extent.

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