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## DEMONETISATION: IMPACT ON INVESTMENTS AND ECONOMY –AN EVIDENCE FROM INDIAN ECONOMY

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### Abstract

*Demonetisation, as a concept that has been often used as a tool to reduce hyper inflationary pressure in the economy and also when the government wants to replace their old currency with the new one. According to the government, the current moves on demonetisation was targeted towards combating untaxed black money, corruption, terrorism and encourage cashless transactions. This move by the government is likely to have long term impact on the economy as well as on the investment scenario. This paper attempts to describe the short term and long term impact of such a move on various sectors of the economy and government finances. For this study various magazines and journals have been used as it is a conceptual paper. Thus, the focus is on to understand more about the concept and the impact on economy via other parameters. Therefore, qualitative and quantitative data have been used.*

**Keywords:** *Demonetisation, Gross Domestic Product (GDP), Remonetisation, Inflation, Interest Rate.*

### Introduction

The central government has influenced a major change in the economic environment by demonetizing the currency notes of Rs. 500 and Rs. 1000 which constituted nearly 86% of the whole money circulation in the country on November 8, 2016. Demonetization is a radical monetary step in which a currency unit's status as a legal tender is declared invalid. It is usually done whenever there is a change of national currency, replacing the old unit with a new one. Such a step, for example, was taken when the European Monetary Union nations decided to adopt Euro as their currency. The Government gave the option, either to deposit the scrapped currency notes in banks or exchange them against new currency.

The central government has taken this initiative with the intention of combating untaxed black money, curbing corruption and terrorism and also to encourage cashless transactions to bring more accountability in the informal sector of the economy. India's black money has been estimated by the World Bank in 2010 to be worth about one fifth of the Gross Domestic Product (GDP).

### Objectives of the Study

The paper has the following objectives:

1. To study the concept of demonetization.
2. To analyze and understand the socio economic impact of demonetization.
3. To find out how the demonetization will affect the various sectors of the economy.

### Methodology

An attempt has been made in this study to analyze the secondary data available in the field of study. For this study various magazines and journals have been used as it is a conceptual

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**Theoretical Framework and Review of Literature****History of Demonetisation**

Demonetization is not a new concept to the world, as there have been many instances of demonetization in the recent past. In 2015, the Zimbabwe government demonetized the Zimbabwean dollar to control the hyper inflation in the country. In 2002, the member nations of European Union adopted Euro as their currency. Governments fixed the rate of exchange for varied national currencies into Euros and demonetized the old currencies. In India, the government had demonetized high value currency notes of Rs. 5000 and Rs. 10,000 in 1946 and 1978 in the past.

**Demonetisation: The Current Picture**

An important economic decision move taken by the government to demonetise Rs.500 and Rs.1000 notes by replacing them with new Rs.500 and Rs.2000 notes has taken the country to tackle the menace of black money, corruption, terror funding and fake currency. From the marketing perspective, we may think that this is a very welcome move by the government and which has taken the black money hoarders with surprise. On the contrary, macro environmental factors like GDP, Inflation, Interest rate, investment, etc and important informal sectors like agriculture, real estate, fishing etc. have been affected by demonetization. However the experts say that it's a short term scenario and this move will give positive long term consequences. To recover the economy on track again, government has to promote cashless economy because scrapping of cash needs an alternative to cash.

According to a World Bank Report, bank account penetration in India in 2014 was just 53%, out of which only 15% users used their accounts to make or receive payments. In 2014, the NDA government announced Pradhan Mantri Jan Dhan Yojna to increase the financial inclusion of those who never had an account in a bank. Under this scheme, 250 million bank accounts have been opened in two years. As per RBI reports bank branches increased by 5% per year but Automated Teller Machines (ATM'S), debit cards and card swiping machines have doubled in four years and online transactions have grown 20 times in six years to 2016. All these data shows a gradual shift towards cashless economy. Demonetization has sped up this transition.

**Demonetization and its Impact**

The demonetization of the 500 rupee note and the 1,000 rupee will hit the economy as a whole hardly in the short term. In this series, we will look at the possible impact of the demonetization on the various sectors of the Indian economy. It will help us to analyze and understand what could transpire with our Indian investments in the short to medium term. Let's start by looking at the broad impact that the demonetization had on the Indian economy.

**DEMONETISATION: IMPACT ON INVESTMENTS AND ECONOMY –AN EVIDENCE FROM INDIAN ECONOMY****a) Impact of Demonetization on the Economy**

Within 7 days of demonetization announcement, **Paytm** registered over 25 million transactions worth over Rs. 150 Crore. Daily downloads of e-wallet Mobikwik increased 40%. Digitally focused sectors like online grocery business have started blooming. Now even some small street vendors have started accepting digital payments through mobile wallets and swipe machines. This is revolutionary and shows that even smaller traders can easily shift to a cashless system. All these changes indicate towards a more transparent and inclusive economy.

**i) Long term gain on the economy**

- **Clean and more transparent business transactions and money transfers:**
- **Increase in taxation base**

India's informal economy contributes 45% in GDP and 80% in employment. It means transactions of millions remain unaccounted and untaxed. Currently only 1% of India's population pays income tax as per Income Tax Department. In the long run, with this system most of this sector will be compelled to function in a formal framework.

- **Helps to reduce the instances of tax avoidance.**
- **Demonetisation will curb the parallel shadow economy** (black economy) which runs majorly on cash basis.
- **Efficiency in welfare programs:**

Since the money can be easily transferred to the accounts of the recipients, the role of intermediaries who used to usurp the share of welfare money spent on people will be eliminated. As the cashless regime represents transparency and accountable, people will get all the benefits directly in their account without paying any bribe to anyone.

- **Improved financial inclusion and credit access** through the linkage of all welfare activities with bank accounts. It will not only increase welfare for the people but would assist in creating a sense of belonging and faith in the banking system
- **Reduced money laundering** due to transparency and traceability of transactions.
- **Improved climate** for foreign investments.
- **Helps to eliminate counterfeit currencies**
- **Good Governance**
- In the year 2015, RBI spent Rs. 27 billion on currency issuance and management.  
**Cashless economy will reduce such costs.**

**ii) Short term pain on the economy:**

- **Decrease in demand**

The surprise move is expected to grind the consumption activity in the Indian economy to a virtual halt due to sizable chunk of cash transactions.

- **Adverse impact on informal sector**

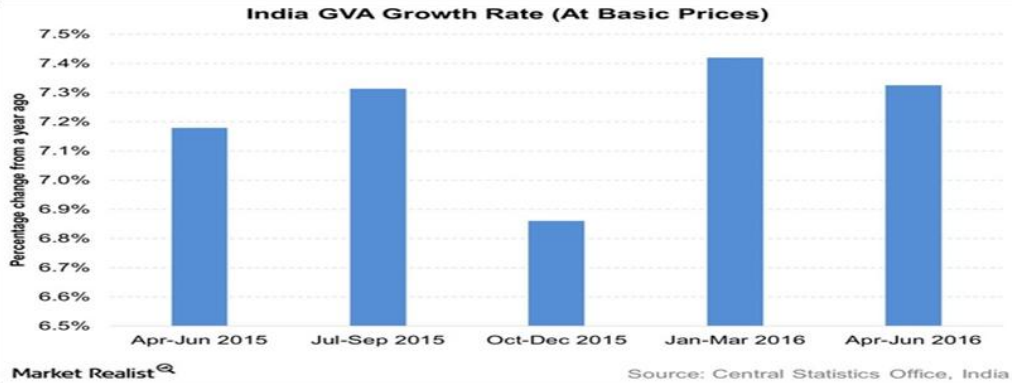
Important informal sectors like agriculture, real estate, fishing etc have been facing tough time due to this Demonetization scheme as they mainly deals in cash only. Sudden removal of cash from market put their business in an inactive phase.

- **Plight of Primary Producers**

Lack of liquidity would result in distress to primary producers who don't have much money, so that they could hold their product for long and on the other side due to lack of currency in flow they are offered very less by the buyers in the market.

**DEMONEITISATION: IMPACT ON INVESTMENTS AND ECONOMY –AN EVIDENCE FROM INDIAN ECONOMY****b) Impact of Demonetization on Economic Growth:**

Growth in the Indian economy remained solid in the quarter from April to June 2016. During that period, the GDP (gross domestic product) rose 7.1%, while the GVA (gross value added) rose 7.3%.



The relationship between the GDP and GVA is:

$$\text{GDP} = \text{GVA} + \text{taxes on products} - \text{subsidies on products}$$

The base year for calculating the GVA is 2011–2012.

RBI in its statement on 13 December has estimated 0.5% downward trend in GDP from 7.6 % to 7.1%. Our GDP is Rs. 125 lakh crore. The fall in economic activity due to demonetization could last from two to three quarters. As a result, GDP and GVA growth in the quarters from September to December 2016 and January to March 2017 could be significantly lower than previous years. Some bounce back should be seen in the first quarter of fiscal 2017–2018. In the medium term, the Indian economy can grow considerably after curbing the debilitation caused by counterfeit money and an increase in economic activity. A fall in discretionary consumption will hurt companies operating in this space. However, a rise in tax flow and lower interest rates, are expected to help the Indian economy grow stronger.

The cash squeeze, following the Demonetisation of Rs 500/1000 on November 8, 2016 will shave off the economic growth for the current fiscal by 0.25 per cent to 0.50 per cent compared to the baseline of 7 percent though it will have long-term benefits for the economy by reducing interest rates and eliminating corruption, besides bringing in more activities in the formal sector.

**c) Impact of Demonetization on Inflation**

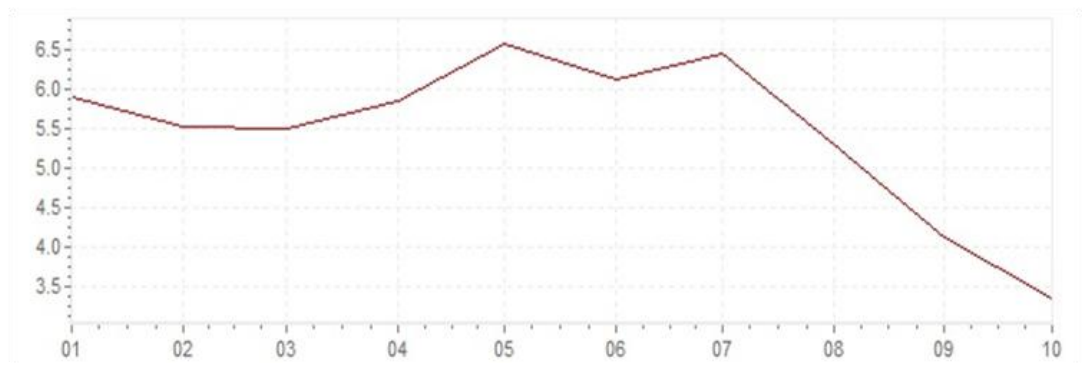
The RBI considers the CPI (consumer price index) as its primary gauge of measuring inflation. By January 2016, it was supposed to keep inflation below a target of 6%, which it was able to do. Its next target is to keep inflation at or below the 5% mark by March 2017.

The demonetization that has been in effect since November 9 is expected to have a negative impact on inflation due to low consumer spending activity. Consumers are refraining from making any purchases except essential items from the consumer staples, healthcare, and energy segments. Activity in the real estate sector, which includes a lot of cash and undocumented transactions, slowed down significantly, Metropolitan and Tier 1 cities reported up to a 30% fall in house prices.

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Food item inflation accounts for 47.3% of the overall CPI due to 86.4% of the value of the currency notes in circulation moving out of the financial system and re-monetization being slow, the supply and demand of food items fell. It will exert more downward pressure on inflation as shown below.

<b>Inflation(Monthly Basis)</b>	<b>Inflation</b>	<b>Inflation</b>
September 2016- August 2016	-0.36%	4.14%
October 2016 –September 2016	0.36%	3.35%
November 2016 – October 2016	-0.36%	2.59%
December 2016 - November 2016	-0.72%	2.23%

**d) Impact of Demonetization on Repo Rate Cut**

In its last meeting, the RBI's Monetary Policy Committee reduced the country's repo rate by 25 basis points on October 4, 2016. The rate reduced 6.3% from the said date. With the announcement of demonetization and the subsequent impact on cash transactions and consumption, inflation will likely fall. Due to the expected fall in inflation, the RBI will likely undertake more cuts in the repo rate to increase the consumption pattern. A change in the repo rate will impact interest rate-sensitive sectors and industries like financials and automobiles, among other sectors like the tech sector.

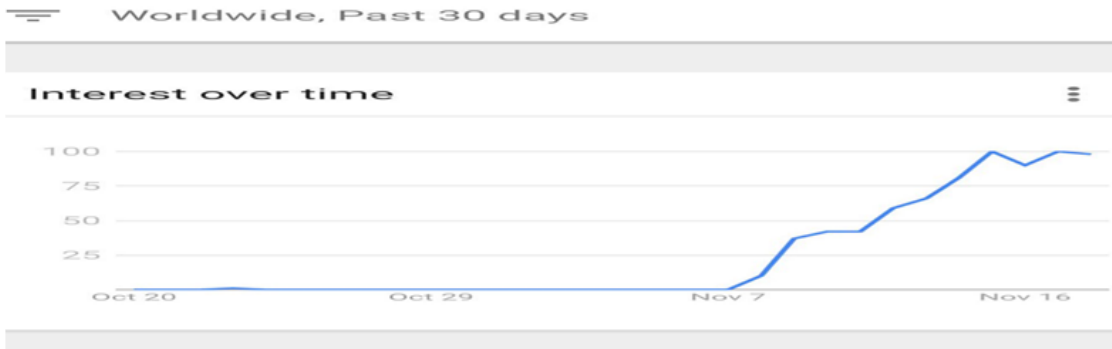
Banks already started reducing their deposit rates and Lending rates in order to get back the temporarily derailed economic growth on track. A cut in interest rates boosts economic activity and raises hopes that after a lull for two to three quarters, economic growth will rise.

**e) Demonetization Impact on Deposit Rate and Interest Rate**

With the announcement of demonetization on November 8, Indian banks saw a rise in deposits. According to data released by RBI on November 21, deposits crossed the 5 trillion rupee mark from November 10 until November 18. At 68.2 rupees to one US dollar, it translates to \$75 billion in deposits in just eight banking days. Banks also saw a rise in term deposit accounts since the demonetization. Due to these factors, commercial banks like State Bank of India, ICICI Bank, HDFC Bank, and Punjab National Bank sharply reduced their deposit rates.

**DEMONETISATION: IMPACT ON INVESTMENTS AND ECONOMY –AN EVIDENCE FROM INDIAN ECONOMY****Loan Burden will also Fall**

Apart from cutting deposit rates, banks also reduced their lending rates as well. In India, loans sanctioned from April 1 are with reference to the MCLR (Marginal Cost of funds-based Lending Rate), instead of the Base Rate, which was used earlier. It will translate into lower interest rates on existing floating rate loans and new loans. The reduction in lending rates is expected to influence lending by tempting consumers to take out loans for purchasing expensive consumer discretionary items like vehicles and houses.

**Demonetization can help Monetary Transmission**

Monetary policy transmission is the translation of monetary policy actions into the financial system through banking and trading channels. From January 2015, the RBI has been reducing the repo rate from 8% to the current level of 6.3% includes six rate cuts totaling 175 basis points. However, banks have been slow in transmitting the benefit to consumers.

After being flush with deposits, it's expected that banks will reduce their lending rates sizably, improve monetary transmission, and benefit consumers—both corporate and individual. Any increase in economic activity due to more consumption on account of lower rates can be beneficial to India-focused funds as well.

**f) Demonetization Impact on Financial Market****Equities fall, but prospects are better**

Indian equity markets have been on a near secular falling trend since the government demonetized the 500 rupee and 1,000 rupee currency notes after midnight on November 8, 2016. The two benchmark equity indices—the Nifty 50 and the S&P BSE Sensex—fell on each trading day since the demonetization except for November 10 and November 22. While the Nifty 50 fell 6.3% from November 8 until November 22, the S&P BSE Sensex fell 5.9% during the same period. Due to the rise in the US dollar, the dollar equivalents of the Sensex and the Nifty fell more than 8% each.

The S&P BSE 100 Index, which is comprised of 100 stocks compared to the Sensex's 30, fell 6.6% during this period. Mid and small-cap indices have been hit much harder than broader market indices. Even after a rise on November 22, the S&P BSE MidCap and the S&P BSE SmallCap indices fell 8.2% and 10.9%, respectively, in the previously mentioned period.

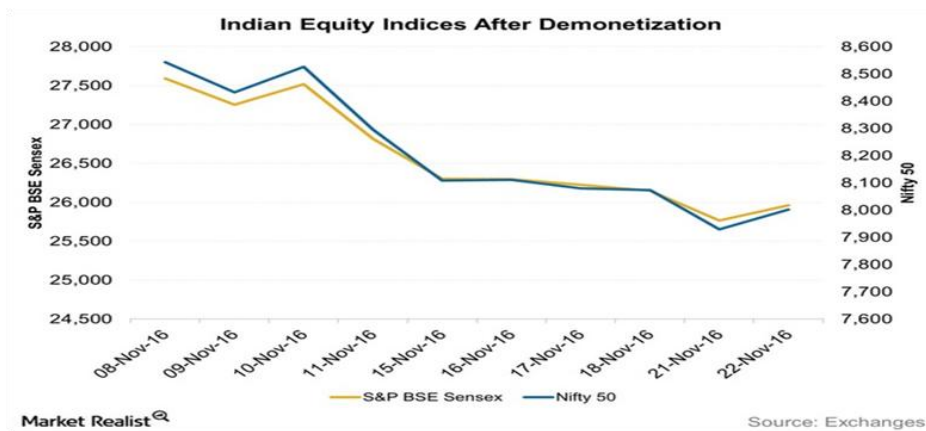
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However, once the short-term impact of demonetization is over, Indian equities will likely bounce back sharply. A rate cut from the Reserve Bank of India would be helpful and easy monetary conditions are generally beneficial for equities.

**Indian Rupee Fell**

The Indian rupee fell against the US dollar. It mainly fell due to Donald Trump's victory in the US presidential election. Given the pressure on the local unit and its relative stability, it seems like the Reserve Bank of India has been working hard to keep the currency stable.

India's tech companies saw a sharp correction since the demonetization was announced. However, the rupee's weakness can benefit these stocks. For now, Donald Trump's trade philosophy will be the main driver of the Indian unit.

**Conclusion**

Demonetisation is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. However, with the latest round of demonetisation, the common public and bankers are undoubtedly facing hardship since more than 85 percent of currency in circulation has been rendered illegal in one single stroke.

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