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Management

Demonetization in India: Who Will Pay the Price?

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ABSTRACT

“The black money parallel economy, for which no reliable size estimates are easily available, has become an increasingly serious problem over the years. But for the ordinary Indian, while there may be some discomfort during the transition, this will be fine in the longer term.” To break the grip of corruption and black money, we have decided that the currency notes presently in use will no longer be legal tender from midnight tonight.” Added Finance Minister Arun Jaitley: “The goal of this is to clean transactions, [to] clean money.” “This announcement appears to be the most significant change made by the Modi government to date,” says Girish Vanvari, partner and head (tax), KPMG in India. The point is that the retrograde practices that have emerged with the black economy force innocent, honest people into considering illegal actions, because that has become the norm over time.” There are many benefits that will come with the government’s move, Singh notes. “Its impact could be even bigger than GST (the Goods and Services Tax which is still running the gauntlet of politicians).” Adds a report by Crisil, a global S&P company: “Tuesday’s move could change the face of the Indian economy, improve the government’s fiscal position and tax compliance. The demonetization” move could change the face of the Indian economy.” –Crisil Report The need for the government to keep the move a secret — so that tax evaders wouldn’t be alerted before the demonetization took place — affected preparedness.

The 'demon' in demonetization is in the beginning. On November 8, Indian Prime Minister Narendra Modi announced in a broadcast to the nation that Rs500 and Rs. 1,000 currency notes would no longer be recognized legally as currency. “Great,” said Corporate India, economic commentators, foreign investors, international think tanks and global rating agencies. “Masterstroke,” echoed the Confederation of Indian Industry (CII).

The aim behind the government's action was to combat tax cheating, counterfeiting and corruption. Eliminating large denominations makes it harder to hide large amounts of cash. Modi noted that the move complements the country's swachh bharat abhiyan (Clean India campaign). “For years, this country has felt that corruption, black money and terrorism are festering sores, holding us back in the race towards development,” he said. “To break the grip of corruption and black money, we have decided that the currency notes presently in use will no longer be legal tender from midnight tonight.” Added Finance Minister Arun Jaitley: “The goal of this is to clean transactions, clean money.”

Adds a report by Crisil, a global S&P company: “Tuesday's move could change the face of the Indian economy, improve the government's fiscal position and tax compliance. The size of the cash economy will shrink, as will black money generation avenues, because of the better cash-flow trail.”

That was Tuesday. By Wednesday, the picture on the streets had begun changing somewhat: The demon started surfacing. India is a cash economy; almost everyone keeps a few Rs500 notes as a nest egg. Lines began forming in front of ATMs and banks which could exchange old notes for new. A mere exchange — a new Rs500 for an old Rs500 — was not enough; there was also a limit imposed on how much one could exchange or withdraw from their accounts. In some cases, there were altercations as people waited for hours. Gas pumps and hospitals (which were allowed to accept old notes) saw a boom in business. People also wanted smaller currency notes to serve their daily needs. A loaf of bread costs Rs25. No shopkeeper would give change for Rs500.

“The demonetization” move could change the face of the Indian economy.” –Crisil Report

The need for the government to keep the move a secret — so that tax evaders wouldn’t be alerted before the demonetization took place — affected preparedness. Jaitley admits it will take two-three weeks to reconfigure the ATMs to handle the newer and larger notes. An Rs2, 000 note has also been introduced. Modi has

suggested it will take 50 days (until the end of 2016) for people to adjust to the change.

A Bold Move

“Demonetization is a step which will make a positive difference, if the transition challenges get handled well by the administration,” says Jitendra V. Singh, Wharton emeritus professor of management. “We will need to be careful of potential attempts to derail this positive agenda.” The International Monetary Fund (IMF) echoes those sentiments. “We support the measures to fight corruption and illicit financial flows in India,” said a spokesperson. “Of course, given the large role of cash in everyday transactions in India's economy, the currency transition will have to be managed prudently to minimize possible disruption.”

The role of cash and high-value bank notes in the Indian economy cannot be understated. According to Reserve Bank of India (RBI) figures, as of March 2016 currency in circulation amounted to Rs16,415 billion. Of this, Rs500 notes accounted for 47.8% in value and Rs1,000 notes another 38.6%. Together, they were more than 86% of the value of the notes in circulation. That's a whopping amount to be frozen in one fell swoop.

Understandably, banks and ATMs can do only so much. There's a lot of tinkering to be done with limits and schedules of the exchange outlets and bodies authorized to take payments in old bills — state-owned electricity suppliers, for instance. To the credit of the government, this is being done on a continuous basis. But there are questions — especially from political parties — over their effectiveness.

Will It Work?

There are also questions over whether the “masterstroke” is masterful enough. “Black money is not synonymous with corruption; it is rather one of several symptoms of corruption,” notes Rajesh Chakrabarti, professor and executive vice dean of the Jindal Global Business School at Jindal Global University. Pointing out that only a small percentage (by some estimates as low as less than 6%) of the unaccounted wealth is held in cash, Chakrabarti says: “This intervention is a one-time draining of this current stock of black money but unless the root causes of corruption are removed, corruption will continue. It is sort of like a dialysis, more of a short term cleaning up than a solution of the problem. It needs to be repeated periodically.”

“There are serious negative externalities that have been created over time,” says Wharton's Singh. “The black money parallel

economy, for which no reliable size estimates are easily available, has become an increasingly serious problem over the years. This poses not only all manner of macroeconomic management challenges, it creates distortions in the economy."

There are many benefits that will come with the government's move, Singh notes. "The size of the formal economy which the government can manage through its policy actions will increase, perhaps significantly. This step may have positive implications for tax revenues longer term. There may even be influences on the growth rate of GDP. However, for sectors like real estate, a notorious hotbed for black money transactions, there will likely be disinflationary pressures short term, with prices being pushed downward before they stabilize longer term." Real estate shares have plunged, in some cases by more than 30%.

But the stock market may be the wrong place to look for signs of how the demonetization move has been received, because it coincided with Donald Trump's victory in the U.S. presidential election. That was a global dampener. The Bombay Stock Exchange Sensitive Index (Sensex) fell 1,000 points on Wednesday morning before ending up just 250 points down. The next day saw a 500 point rally followed by a 700-point plunge. The first two trading days of the next week saw another 1,000-point fall.

While most people are short-term pessimists but pin their faith on the long term, there are those who are skeptical of that aspect, too. "The cancellation of high-denomination notes is not expected to curtail black money or the black economy in the long run," says Dev Kar, chief economist at Global Financial Integrity, a Washington-based think tank advocacy group. Kar is the author of a report titled "The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008." The report estimates India lost a total of \$213 billion due to illicit flows in that period. "The total value of illicit assets held abroad represents about 72% of the size of India's underground economy which has been estimated at 50% of India's GDP" says the report.

Finally, the fact that the government has already announced Rs2,000 notes is a tacit admission that people need higher denomination notes in the future due to inflation. Expected inflation is running high due to India's monetary and fiscal history. Small notes will rapidly lose further value so that essential goods cannot be purchased with a reasonable quantity. Governance needs to be improved in all its dimensions. Cosmetics will not cut it."

But, nonetheless, he sees the move as positive. "It is remarkable that PM Modi has taken this bold step. Clearly, there will be howls of protest from some. A simple analysis can be done by asking 'cui bono', which is Latin for 'who benefits' from the status quo. Just who has the stacks of Rs500 and Rs1,000 bills and cannot account for them? Those parties will not be happy with this step. But for the ordinary Indian, while there may be some discomfort during the transition, this will be fine in the longer term."

Meanwhile, a group of prominent citizens including social activist Aruna Roy, economist Jayati Ghosh and writer Nayantara Sahgal have called the decision to demonetize Rs500 and Rs1,000 notes as "misconceived" and have demanded for it to be rolled back or suspended if the inconvenience to the public is not resolved immediately. In a joint statement questioning various aspects of the demonetization move, they have said: "Black money is generated through evasion of taxes on income from lawful activities and money generated from illegal activities. In the absence of steps to curb the generation of black money, demonetization is a futile exercise, as it proved to be in 1978."

The Supreme Court of India, while refusing to stay the demonetization move, has asked the Modi government to file an affidavit detailing the steps being taken to ease the inconvenience to the general public.

For Modi, this is work in progress. In his speech to the nation, he outlined what his government has done so far. A law was passed in 2015 for disclosure of foreign black money. Agreements with many countries, including the U.S., have been made to add provisions for sharing banking information. A strict law has come into force from August 2016 to curb benami transactions, or the purchase of property and deals using fictitious names — a way of deploying black money earned through corruption. A scheme was introduced for declaring black money after paying a stiff penalty. And arching over it all was the Prime Minister's Jan Dhan Yojana, which aimed at financial inclusion for the whole country. Launched in August 2014, it has managed to add 250 million bank accounts through November 2016. Demonetization, then, was inevitable; the only surprise being when.

Conclusion:

From the above discussion we get an optimistic view on Demonetization. Actually it was purposeful act to stop the corruption. After Demonetization & note banned the growth rate might be reduced and overall industrial growth might be affected in economy. In small run economy might face slump but in long run the economy will flourish. The Indian government took a bold move in the favor of common men. From the current data our GDP for this quarter is 7% so it can be said that note was not affecting overall development of economy. Now Indian Economy will get full throttle speed towards development.