

Chapter 98

Demonetization and Movement Towards Digital Cashless Indian Economy: Its Macroeconomic Effects

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ABSTRACT

One of the greatest painful, un-stabilizing self-imposed macroeconomic blows on the Indian economy occurred in the absence of a short-term crisis when the government decided to announce a major change in the macroeconomic environment by demonetizing the high value currency notes – of Rs 500 and Rs 1000. These two denominations ceased to be legal tender from midnight of 8th of November 2016. The reasons offered for demonetization are two-fold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern; and second, to undermine or eliminate the “black economy.” It has also been a step forward towards a digital cashless economy. In this study an attempt is being made to present a discussion on both the short- and long-run effects of demonetization. It attempts to throw light on the impact of some macroeconomic variables—GDP, sectoral composition, industrial production, inflation, employment—using secondary time-series analysis. The empirical analysis clearly reveals that contraction of currency in circulation was one of the most important factors responsible for decrease in GDP in India after the period of demonetization. Apart from the issue of transition, confronted by the banking system, the government initiative was needed to neutralize the short-term, medium-term, and long-term effects particularly on regularization of cash flows, withdrawals, income, employment, inflation, consumption, and production. Moreover, cyber and other digital security measures were also essential to curb any kinds of frauds and encourage people towards a more digital cashless economy.

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INTRODUCTION

One of the greatest painful, un-stabilizing self-imposed macroeconomic blows on the Indian economy occurred in the absence of a short term crisis when the government decided to announce a major change in the macroeconomic environment by demonetizing the high value currency notes – of Rs 500 and Rs 1000. These notes ceased to be legal tender from the midnight of 8th of November 2016. Demonetization generally implies a systematic and independent process carried out to replace currencies generally of higher denominations with new currency units. Demonetization is one of the monetary measures adopted by a Government ideally to control demand pull inflationary pressures in the market. This is performed by imposing a restriction on currency notes to completely wipe them off the slate, thereby leading to lower circulation of cash in the economy.

The reasons offered for demonetization are two-fold: one, to control counterfeit notes that could be contributing to terrorism, in other words a national security concern and second, to undermine or eliminate the “black economy”. It has also been a step forward towards a digital cashless economy. For proper implementation and conduct of policies in the public domain curbing black money is very essential as it has an adverse impact on both economic and social front. Technically speaking demonetization is a liquidity shock; a sudden stop in terms of currency availability and so it created short term negative impact on the economy. Most middle and lower segments of the population who constitute the ‘base of the pyramid’ uses currency to meet their transactions. The daily wage earners, other labourers, small traders etc. who reside out of the formal economy lost income in the absence of liquid cash. Cash stringency compelled firms to reduce labour cost and thus reduces income to the poor working class. This, in turn, created a fall in the demand for mass consumption goods and the market suffered a short term recessionary situation. The information on demonetization was released suddenly and the worst affected was the common man. The social impact was also tremendous, particularly in case of serious patients undergoing emergency treatment or in case of some social gatherings or mishaps. Moreover, people who are not so much habituated in using digital platforms like old and retired people had to bear great hardships to maintain their regular expenditures.

Though the aim of the government was to unveil counterfeit currency from circulation, but surprisingly and contrary to the expectation almost 99 percent of demonetized currency notes were returned to the banking system. This was despite the fact that, in an effort to punish those with unaccounted cash, the Indian government introduced additional rules regarding the amount of discontinued currency that could be deposited into a bank account. But to get hold of the original amount, an accurate estimation was required of the amount of unaccounted cash in the country preceding demonetization.

Demonetization had immediate impact (short term) of wiping out of cash on both household and business transactions. In the medium term it has significant impact on the banking system and also a change mode of payment and tax system and in the long run it has its effect on some macroeconomic variables- GDP, sectoral composition, industrial production, inflation, employment.

LITERATURE SURVEY

Since the announcement of the demonetization in India, a huge body of literature has developed regarding its various aspects. Some of the important contributions in this field are discussed below. Agarwal et al (2018) conducted a comprehensive analysis of the impact of unexpected demonetization in India

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