

## **Impacts of Demonetization: Organised and Unorganised Sectors**

**Dr. P. AYYAPPAN**

*HOD, Department of Management Studies, Nandha Arts And Science College*

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**Abstract:** *Demonetization refers to Withdrawal of a particular form of currency from circulation. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be removed and substituted with a new currency unit. The currency was demonetized first time in 1946 and second time in 1978. On Nov. 2016 the currency is demonetized third time by the present Modi government. This is the bold step taken by the govt. for the betterment of the economy and country. In this paper I want to discuss the impact of recent demonetization on the Indian system.*

**Keywords:** *Demonetization, Black Money, Counterfeit Currency, Corruption*

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### **I. Introduction**

PM Modi has announced a war against black money and corruption. In an emboldened move, he declared that the 500 and 1000 Rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI will issue new chip based Rs. 500 and Rs. 2,000 notes which will be placed in circulation from 10th November 2016. Notes of 100, 50, 20, 10, 5, 2 and 1 Rupee will remain legal tender and will remain unfazed by this decision. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money, terrorism and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money at the same time. One of the reasons that prompted the Government to demonetize Rs. 500 and Rs. 1000 notes is that their circulation was not in line with the Economic Growth. As per the Finance Ministry, during 2011-2016 periods, the circulation of all notes grew 40% but the circulation of Rs. 500 and Rs. 1000 notes went up by 76% and 109% respectively. Relatively speaking, the economy has grown only by 30% which is way below the money circulation.

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

#### **Effect on parallel economy: Cash Economy to Witness Contraction**

The currency of the aforementioned denominations constitutes around 86% of the total value of the currency in circulation. It is expected to remove black money from the economy as they will be blocked considering the holders will not be in a position to deposit the same in the banks, temporarily halt the circulation of large volumes of counterfeit currency and curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

#### **Effect on GDP: Downward Bias to GDP Growth**

The sudden decline in money supply and simultaneous increase in bank deposits is going to adversely impact consumption demand in the economy in the short term. This coupled with the adverse impact on real estate and informal sectors may lead to lowering of GDP growth.

The GDP formation could be impacted by this measure, with a reduction in the consumption demand. However, with the recent rise in festivals, demand is expected to offset this fall in an overall impact. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and will re-enter the stream once the cash situation becomes normal.

#### **Lower Money Supply has a Deflationary Effect:**

With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to be reduced in the short run. 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. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money, and eventually, money supply will decrease permanently. However, gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up speed.

**Impact on Bond Markets:**

Surge in deposits will create more demand for government bonds and other high rated bonds in a situation of tepid demands for credit, leading to lower bond yields especially in the shorter end of the curve. At the same time, a reduction in leakages in systemic liquidity will reduce the scope for open market operation purchases in the coming days. We believe that the RBI will continue to sterilize excess liquidity from the banking system to keep the short term rates aligned with the policy rate.

**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.

**Effect on Banks**

As directed by the Government, the 500 and 1000 Rupee notes, which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Accounts of commercial banks. This, in turn, will enhance the liquidity position of the banks, which will be later utilized further for lending purposes. 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.

**Effect on 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.

**Bank Deposit Rates to Soften:**

We can expect 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 to Benefit:**

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'.

**Investment in Financial Products:**

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.

**Impact on Consumption Sectors**

**Agreement Cost of Real Estate May Rise:**

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 rumored 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).

**Used car Sales May Fall:**

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.

**Slowdown in Discretionary Spending to Hurt Consumer Durable Sales:**

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.

**Demand for Gems and Jewellery to Decline:**

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 unorganised 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 unorganised 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 organised market and sales are against invoices.

**High End Retail Demand to fall:**

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.

**Private 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.

**Medical Institutions (Both Hospitals & Medical Colleges):**

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.

**Political Parties:**

Elections & Political Parties are major sources of Black Money transactions. Most of the funding of National Political Parties is in Cash which is 40% to 50%, and when it comes to Regional Parties it goes upto 50% to 60%. The sources of more than 90% of such funds are never disclosed. Candidates as well as their donors even the Political Parties will feel cash strapped. An assembly seat candidate spent on an average Rs. 4-5 Crores on Campaigning that is likely to go down drastically.

This is going to cause huge craters on their funding and will reduce their funds drastically. It is going to deal a major blow to political parties fattening their coffers with cash contributions in anticipation of high stakes electoral battles in UP, Punjab, Uttarakhand, Goa and Manipur. This stroke is bound to leave big players hamstrung and suddenly resource-poor.

**Effect on various 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**

So far, it can be said that this is a historical step by the Modi Govt. and should be supported by all. This decision of govt. will definitely fetch results in the long term. From an equity market perspective, this move would be positive for sectors like Banking and Infrastructure in the medium to long term. This could be negative for sectors like Consumer Durables, Luxury items, Gems and Jewellery, Real Estate and allied sectors, in the near to medium term. This move can lead to improved tax compliance, better fiscal balance, lower inflation, lower corruption, complete elimination of fake currency and another stepping stone for sustained economic growth in the longer term.