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IMPACT OF DEMONETIZATION IN INDIAN ECONOMY

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ABSTRACT

At the stroke of the hour on midnight of 9th November 2016, India lost 86% of its monetary base. The print, electronic and social media has been praising Prime Minister's masterstroke by which he has reportedly destroyed the base of corruption in India. In this single move, the Government has attempted to tackle all the three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing. There is no doubt that Prime Minister has pulled out a major coup and substantially enhanced his reputation as a strong leader.

KEYWORDS: Indian Economy, electronic and social media.

INTRODUCTION:

The demonetization effort being led by PM Modi in India is that idea that Rs 500 and Rs 1,000



notes should be declared no longer legal tender, to be replaced by other notes of different designs and in one case, denominations. The aim is to wash the stock of "black money" out of the economy and get it into the licit, banked and taxable, part of the economy. The micro-economic effects here seem, as I've said before, to be beneficial. There have long been concerns about terror financing through forged notes for example. There's quite obviously substantial tax revenue going uncollected. And perhaps the biggest effect is, as I've said, that large portions of the population feel

that the basic system is unfair. They're locked out of that easier world where matters are settled in large amounts of cash, where tax is not paid and where favours are bought.

Manufacturing
Since storming to power in 2014, Modi has tried hard to revive India's struggling manufacturing sector, which accounted for about 16% (pdf) of the GDP in 2015. Modi wants to increase this to about 25% by 2025, but demonetization may have thrown the sector into a tailspin.

In November, India's Purchasing Managers' Index (PMI) — a

economic indicator of the manufacturing sector that tracks new orders, inventory levels, production, supplier deliveries, and the employment environment—stood at 52.3. That's two points lower than the 22-month high of 54.4 recorded in October. A PMI of less than 50 indicates a contraction in the economy.

"PMI data for November showed that the sudden withdrawal of high-value banknotes in India caused problems for manufacturers, as a cash shortage hampered growth of new work, buying activity and production," said Pollyanna De Lima, an economist at IHS Markit, one of the compilers of the index.

Experts now believe that the impact of demonetization on the manufacturing sector will continue through December, too.

"In our view, the November PMI data may understate the near-term disruption in

activity. Sales have been hit hard, which will result in higher inventory (which, surprisingly, the PMI data do not show) and result in sharper production cuts in the months ahead. Thus, we expect the PMI to drop further in December," brokerage firm Nomura said in a report.

Despite the disruption, IHS Markit believes Indian manufacturing has done better than what many expected.

"...Whereas some may have anticipated an outright downturn, the sector held its ground and remained in expansion mode," Lima said.

SERVICES

Perhaps the worst hit by Modi's demonetization move has been India's services sector.

The sector comprises areas such as trade, hotels and restaurants, transport, communication, finance, insurance, and real estate, among others, and accounts for 60% of India's \$2 trillion GDP.

The Nikkei/Markit Services Purchasing Managers' Index—which measures sales, employment, inventories, and prices at service sector companies—sank to 46.7 in November, from 54.5 in October. This is the first time since June 2015 that the index has slipped below the 50 mark.

"New business declined for the first time since June 2015, leading to a solid reduction in activity," IHS Markit, the compiler of the index, said. "Correspondingly, backlogs of work rose, while employment increased only marginally." The decline of 7.8 points was also the biggest one-month drop since November 2008.

Yet, IHS believes that the sector will rebound quickly.

"The disruption is expected to be short-lived, however, with many panelists anticipating a pick-up in activity as these high-value banknotes are replaced and black-market firms end their operations," Lima said. "In fact, business confidence improved to a three-month high."

Consumer spending

Asia's third-largest economy has also been hit by poor consumer spending since demonetization. Private consumption expenditure contributes to around 60% of India's GDP.

"Interestingly, the consumer goods sector, which has reported solid growth so far, was the weakest performer this month. This suggests that consumption—the sole growth driver—has been hit rather sharply," Nomura said.

India's rural economy—which services 68% of the population and has seen sluggish demand for the past two years—could take months before it sees a recovery. This rural economy was the driver of India's consumption boom between 2007 and 2012.

"The sluggish rural consumption is staring at a further dip due to their higher dependency on cash transactions," market research firm Nielsen said in a report on Nov.15 (pdf). "Discretionary spends will see a bigger impact in this geography. Mandis may experience a shortfall of cash for the purchase of daily essentials including fruits and vegetables; leading to further problems for farmers and having a domino effect on their ability to purchase."

And it could take at least a few months before consumer spending is finally back on track.

"Consumer spending in at least the next two quarters will take a hit and could even cost India its designation as the fastest-growing major economy, even if the exact scale of economic disruption remains unclear," Jan Zaleski, senior risk analyst at UK-based Verisk Maplecroft, said.

But that could also mean that India's central bank could bring down key lending rates, since inflation has eased. A poll by Reuters on Dec.05 predicted a 25 basis point reduction in repo rates—the rates at which the Reserve Bank of India (RBI) lends to banks.

The agriculture sector

India's agriculture sector was widely expected to have a robust year.

The rainfall was good after two years of drought and the sector was pegged to grow by about 4% in the current fiscal. The agriculture sector constitutes about 15% of India's GDP but grew by a paltry 0.2% and 1.2% in

2014 and 2015, respectively.

Demonetisation means that the sector could once again take a hit. Agriculture is a cash-rich sector and most of the payments for the purchase of seeds, fertilizers, and tools, as well as for labourer salaries, are carried out in cash. It also doesn't help that the sale, transport and distribution of agricultural products take place at mandis which are almost entirely dependent on cash. In addition, the RBI has also banned the exchange of old notes at co-operative banks, which farmers visit more often.

India is currently in the midst of harvesting its Kharif (or monsoon) crops and is soon expected to prepare land for the Rabi crops, which are harvested during spring.

"The agriculture sector will bear the brunt of demonetisation," Dharmakirti Joshi, chief economist at credit rating agency Crisil said. "Farmers are finding it tough to sell their produce in the APMC (agricultural produce marketing committee) markets. Therefore, despite a good harvest, there is unlikely to be a commensurate improvement in rural demand."

Sensex and foreign inflows

Meanwhile, investors have also been jittery since the news of demonetisation and that hasn't helped Modi's cause.

Since Nov. 08, the Sensex has fallen by around 5% while foreign portfolio investors (FPIs) withdrew some Rs37,300 crore in November, the highest since June 2013. FPIs had withdrawn Rs12,140 crore in October.

"Foreign investors have pulled out funds from capital markets due to fears of (a) rate hike by the US Federal Reserve in December, uncertainty over US ties with emerging markets post (the) Donald Trump victory, and concerns over the the impact of demonetization and GST on economic growth & corporate earnings," the Centre for Monitoring Indian Economy (CMIE), a think tank which tracks business and economic data, said on Dec. 02.

Criticism

The Indian Supreme Court while hearing one among a slew of cases filed against the sudden demonetization decision in various courts,] observed that it "appears to be carpet bombing and not surgical strike" which government repeatedly claims it to be.

Nobel laureate Indian economist Amartya Sen, severely criticized the demonetization move calling it a "despotic action" among other things.

Former Senior Vice-President and Chief Economist of the World Bank, Kaushik Basu, called it a 'major mistake' and said that the 'damage' is likely to be much greater than any possible benefits.

Pronab Sen, former Chief Statistician and Planning Commission of India member, called it a "hollow move" since it did not really address any of the purported goals of tackling black money or fake currency.

Prabhat Patnaik, a former professor of economics at the Jawaharlal Nehru University, Delhi called the move 'witless' and 'anti-people'. He criticized the simple way in which black money was assumed as "a hoard of cash", saying that it would have little effect in eliminating "black activities" while "causing much hardship to common people."

Noted economist and journalist, T. N. Ninan wrote in the Business Standard that demonetization 'looks like a bad idea, badly executed on the basis of some half-baked notions'. Deepak Parekh (Chairman of HDFC) had initially appreciated the decision to ban the Rs. 500 and Rs. 1000 notes, but later said that the move had derailed the economy, and expressed skepticism about its outcome.

Chief Ministers of several Indian states like Mamata Banerjee, Arvind Kejriwal and Pinarayi Vijayan have criticized and led major protests against the decision in their states and in parliament. Initially, the move to demonetize and try to hinder black money was appreciated, but the manner in which it was carried out by causing hardships to common people was criticized. A Public Interest Litigation (PIL) was filed in Madras High Court by M Seeni Ahamed, General Secretary of the Indian National League, to scrap the decision. The High Court dismissed the PIL stating that it could not interfere in monetary policies of the government Similar PILs were also filed in the Supreme Court of India. Supreme Court of India is yet to decide on the matter. It is listed for hearing on

2 December 2016.

Several government ministers had declared before the demonetization that they were holding large amounts of cash, including Arun Jaitley, who had more than 65 lakh rupees in cash. This led to speculation about whether and when the ministers had deposited the cash they held.

CONCLUSION:

So far, it can be said that this is a historical step and should be supported by all. One should look at the bigger picture which will definitely fetch results in the long term. This is what the people have been asking for a long time which has finally happened.

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