

KrayMan

Demystifying Complexities

Demonetization

India's biggest financial move till date..

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Background

'Demonetization' was not a very popular term until 8 November 2016. The very common visible impact for the last one month, are the long queues at banks & ATMs across the country. While the Government's move has been appreciated for its intentions, at the same time it has been alleged for mismanagement. Shortage of valid currency notes created a huge cash crunch which affected both rich and poor.

The Government has tried to ease the situation by bringing various relaxations. One of the notable schemes recently launched by the Government is Pradhan Mantri Garib Kalyan Yojna, 2016. Other is Taxation Laws (Second Amendment) Bill, 2016 (details explained later)

What is Demonetization?

Demonetization is withdrawal of legal status of a currency. In other words, it is a process of removing a currency from general usage. In a historic move, on 8th November, 2016, Prime Minister of India, announced to the nation that Rs. 500 and Rs. 1000 existing currency notes will not be a 'legal tender' from midnight. In his 40 minutes speech, the Prime Minister highlighted various reasons behind this surprise step and urged the support of people.

Why Demonetization in India?

Approximately 86% of total value of currency in India was in the denomination of Rs. 500 and Rs. 1000 currency notes. Then what was the need to suddenly scrape down such a large amount of notes?

This bold step of Demonetization aims to curb fake currency, tackle black money and corruption and provide facilities like better healthcare, higher education and real estate prices within the reach of common people.

How Demonetization will help?

‘India is an emerging economic power and has become one of the preferred destinations for investment. Efforts to root out black money will not only increase the credibility of India, but transparency in transactions will also prove good for the financial system.

- ❖ **Blow to hawala transactions:** Hawala transactions are the potential sources of black money. These transactions involve one of the most voluminous paperless money transactions. As per market sources, the sudden demonetization of Rs. 500 and Rs. 1000 notes is likely to render the huge amount of cash lying with the hawala brokers as useless. According to security agencies, most of the money routed through hawala is used for funding of criminals and terrorist outfits. As the demonetization has broken the back bone of hawala trade, it is expected that tax evasion and generation of black money will considerably reduce.
- ❖ **Digital India:** IT industry supported the move and termed this step as a ‘masterstroke’ - not only the issues like corruption and black money will be addressed, but also, this will help economy to become more digital. Digitalization will further check the corruption prevalent in various sectors of Indian economy. In addition, increased use of bank based payments and electronic mediums would help Government to keep a better track of transactions.
- ❖ **Encourage tax payment:** Though India has very low rates of tax compared to many other countries, the tax-to-GDP ratio (i.e. how much tax is raised as a proportion of the output of the economy) was just 17% in the year 2013. Tax evasion is a major source of black money generation in the country. Earlier efforts like tax amnesties, also could not prove much effective. After the demonetization, a large amount of black money is likely to be rendered useless. Hence, people may now refrain themselves from such practice.
- ❖ **Lower interest rate and inflation:** One of the very interesting effect of demonetization is the lowering of interest rates. SBI Chairman said, “All rates will fall”. This is because of huge inflow of deposits in banks and also, the demand for credit has slowed down. In turn, inflation will also reduce.
- ❖ **Boost foreign investment:** As the economic system of India will become free from corruption, hoarding and black money, the foreign investors will no longer be apprehensive to invest. In addition, digitalization will further facilitate the investors to set up business in India.

Impact on Foreign Trade

The European Union welcomed India's decision and said that ridding the financial system of "black component" and bringing transparency will strengthen Indian economy and spur growth. EU is one of India's leading trade partner and the flow of European investment is expected to increase manifolds in future.

Even International Monetary Fund (IMF) supported India's initiative to curb black money and corruption.

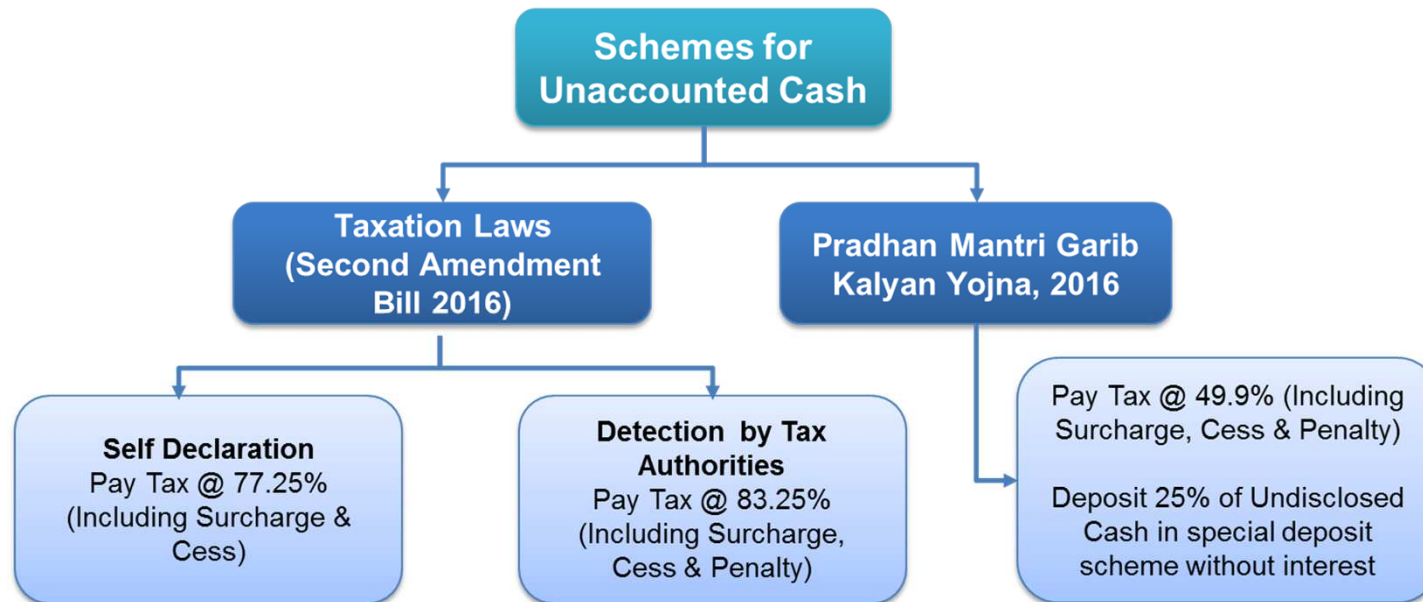
Recent Demonetization in India is being viewed as perhaps the most significant step to curtail the parallel market. It will result in sharp boost of cashless digital economy, which might facilitate the foreign investors to a great extent. Also, India's image on transparency and corruption is expected to improve dramatically on global platform.

In addition, deposits in bank is increased and thus, loans will become cheaper. Foreign companies desirous of entering into Indian markets may find it easier to afford loans for starting its operations in India. Prices in real estate may fall which will attract foreign companies to invest in this sector as well.

India after Demonetization

Long queues were seen at banks, ATMs and even after petrol pumps across the country, the very next day after Prime Minister of India announced the scrapping down of Rs. 500 and Rs. 1000 currency notes. While the Government was appreciated for its intentions, at the same time it was alleged for mismanagement. Shortage of valid currency notes created a huge cash crunch which affected rich and poor equally.

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Taxation Laws (Second Amendment) Bill, 2016 has been passed in Lok Sabha. In addition, the targeted date for roll out plan of GST (Goods and Services Tax) is in April 2017, which is expected to bring more transparency in the tax regime of the country. The Government has once again made its intentions clear that it will take every possible measure to curb black money. It is likely that the situation will stabilize in few months.

Short term pain, long term gain

In a nutshell, one can say that despite of temporary hardships being faced by people, Demonetization is likely to prove beneficial for the Indian economy. It is indeed a significant step in the interest of whole nation.

The Indian Government must handle the situation prudently so as to achieve the desired outcomes of Demonetization. The Government has been committed to provide a safe and friendly environment for foreign investors and demonetization is likely to help the country to achieve this objective. However, the impact of this massive step is yet to be seen.

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