DEMONETIZATION AND IT S IMPLEMENTATION IN FINANCIAL REFORMATION

Trisha Jolly
Research Scholar, Amity School of Economics
Dr. Kavita Indapurkar
Professor, Amity School of Economics

Abstract: India, in November 2016 observed a major reform in its financial sector called Demonetization which may be regarded as one of its kind the country has observed over the last couple of years. Experts define Demonetization as "the act of stripping a currency unit off its status as legal tender. The existing form or forms of currency is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country even opts to completely replace the old currency with the new one".[1] [1] In India this however came with a shock treatment with an intention to strip off the unaccounted and fake currency from circulation. The paper attempts to evaluate nature of this recent movement in India, its short-term impacts and the major lessons learnt in past one year.
In line with the above stated objective the paper goes on to investigate the reform pertaining to country in historical perspective along with its present form. It then moves on to bring out the immediate effect of Demonetization on growth of the economy. With the relevant data, the paper also aims to chart a roadmap for India's economic growth performance in the near future incorporating the aftermaths of Demonetization.

Keywords: Demonetization, Financial Reform, Fake Currency, Post-Demonetization, Unaccounted Currency.

Introduction: Demonetization is a far-reaching financial reform witnessed by Indian economy. It was announced quite dramatically maintaining the surprise element on 8th November 2016 at about 8.30 in the evening by the Prime Minister himself coming fore to speak to the public. Many measures were announced then and even later to help out those who might be having their hard-earned money in cash. Accordingly, about 86 per cent of the currency in circulation lost its status of legal tender except for use in some areas like hospitals and petrol pumps, for some days. The government argued of multifold objectives behind this: to curb corruption; counterfeiting; terrorist activity funding; tax imposition on unreported incomes; targeting black money and curbing fake notes in the system are to name a few.

Political gurus claim that with this bold step the government signaled a regime change on one hand and tried to prove that they are for the hard-working middle-class tax payers on the other, who actually voted them in power. This one act confirmed their determination to penalize illicit activities and the associated wealth. In effect, the tax on all illicit activities, as well as legal activities that were not disclosed to the tax authorities, was sought to be permanently and punitively increased.[2]

Experiences worldwide show introduction of Demonetization in various areas of world when countries faced any problems in their financial or real sector. However, India announced stripping the legal status of its 500 and 1000 rupee notes at an astounding turn when almost all its macroeconomic indicators were doing well.

Historical Perspectives; Demonetization, in its present form, in India is although termed as an unparalleled move; it has taken place twice in the modern Indian history, viz. 1946 and 1978. Although, the one that took place in 1970s also accounted for almost 86.6 per cent of the then existing money stock but is still considered to have a negligible impact on the economy.[3] This was probably because the higher denominations that were demonetized then, had little to do with the general public. This along with smaller middle income group, lesser impact and power of media and smaller number of tax payers together made it less connected to the people at large. It only remained a political "stunt". As far as demonetization in India is concerned, it has always been questioned to be used as a tool to contractionary monetary policy. It has rather been understood as a financial sector reform focused at certain objectives. In the wake of this transitional reform, the researchers will have to carry out a careful investigation to study its impact on GDP, both immediate and in the long run to evaluate its implications in future.

Short Term Implications: Growth rate in India was expected to come to a sudden halt with introduction of Demonetization. Statistics revealed by Central Statistical Office on Quarter wise estimates on GDP are also in line with these anticipations wherein only 1.2 percent of growth was observed to be enumerated in the current trough. This number went only as low as 3.3 percent in the previous four troughs observed in the growth performance.

Economic Survey, 2017-17 (Volume I)[2] elaborates the surprising reaction of Indian economy to the process of demonetization followed by slow re-monetization halting the growth in Gross Domestic Product in the country because of both demand and supply side factors.

The reform did not allow the consumers to put forward their complete demand in the markets majorly because of lesser availability of cash in hand with the middle class who were occupied in depositing/withdrawing money from banks. The traders and retailers working on small scale, dealing with commodities of daily use like vegetables, fruits, etc. along with roadside vendors also suffered a setback due to their decreased number of transactions leaving them with barely any money to meet their ends and hence negatively affecting aggregate expenditure. Consumption expenditure on the other hand show an astounding increased consumption expenditure for this period. This may be explained by speedy response of urban educated who resorted to plastic money. However, the technical support came to them with some lag. The tier two and tier three cities followed the suit and this resulted in higher consumption expenditures of people in the formal sector with greater transactions through electronic wallets, debit cards, credit cards, internet banking among others.

There were certain sectors like marketing of agriculture and allied products, inputs used in primary sector, local clothing, street foods, entrepreneurial set ups working at small or marginal scale among the others who had to bear the burden to decreased circulation of cash in the economy. These comprised of the common man who against all odds that came across, looked supporting the move standing patiently in queues waiting for their turn to get/deposit cash from/in banks. The other sectors that showed setback were gems and jewelry and real estate. And it is an open secret that these are the sectors where unaccounted money is highly used.

Thus, the short term anticipated effect on GDP was a slow down due to reduced/postponed demand (due to cash crunch, private wealth), supply (rendered liquidity and working capital, and disrupted supply chains) and increased uncertainty.

As against the agencies like Nomura[21] that expected the Indian growth rate to rise from 7.3% in 2015 to 7.8 in 2016 and further 8% in 2017 primarily because of demand side factors, in the wake of Demonetization the economic survey anticipated the growth rate to fall by 0.25-0.5 per cent for the current year. Also, RBI in its Sixth Bi-monthly Monetary Policy statement released in February estimated GVA[22] growth in 2016-17 at 6.9%, lower than what it estimated the same in December.[4] The NCAER also cut down on its estimates on growth from 7.6% to 6.9% for 2016-17 in the same month.[5]

Giving a closer look at recent data released by Central Statistical Organisation in March 2017, the growth rate was recorded at 7% in the third quarter of 2016-17 (Statistics released by Central Statistical Office on Quarter wise estimates on GDP) which was 7.4% in the previous quarter. In the wake of demonetization this growth rate cannot be considered as abysmally low for third quarter. In line with this, Indian statisticians project the country to grow at 7.1% by the end of current financial year.[6] Such a performance of country on growth front has left economists across country surprised who expected the economy to slump because of lower consumption demands due to Demonetization. Such a performance may be attributed to faster transition and digitalization and unexpected better performance of both agriculture and manufacturing sectors making the move truly a pro-development one that held the economy growing with sustenance.

The immediate impact on certainty and stability in the macroeconomic framework was definitely shaken and the households, unaware of the future economic policies and behaviour postponed consumption for the situation to settle down. This pent up demand has led a foundation stone for the economy to have a more sustained economic growth in future.

Long Term Implications: The immediate impacts of demonetization provide a glimpse of how the economy changed in short term. This behavior also lays a blueprint for the changes in the economy in the longer run. Economists across the globe have projected actual impact to be felt only after a year of the change[23]. In the wake of demonetization, some early signs of alterations have been felt in varied areas of the country. One of the important behavioral changes that the economy has observed post demonetization is increased use of digital transactions. Other areas that were primarily dependent on cash transactions have also observed noteworthy changes. These include agriculture and allied activities, street food, activities in informal sector along with larger sectors like real estate, gems and jewelry and other. Each of these sectors demand a detailed investigation.

Digitalization: Statistics reveal dependence of Indian masses on cash transactions to be humongous. Indian masses have a history of chronic dependence on cash transactions for the wide-ranging benefits it offers. Cash transactions are more convenient and have wider acceptance due to large number of people using it as a medium of exchange. It also ensures anonymity which leaves a big room for tax evasion. The lower tax base is already a key constraint faced by Indian government. Also, cash transactions are hassle free and less costly since no surcharge has to be paid over and above the cost of goods or services being purchased.

There is enough empirical evidence to support the dependence of Indian masses on cash as a medium of transaction. Watal Committee in its report in December 2016 illustrate 78% per cent of the country's dealings to be carried out completely on cash basis.[7] Princewaterhouse Coopers (2015) also provide enough evidence to show cash based transactions in the country to range up to 68 per cent of the total and around 98 per cent by volume.[8] The similar numbers for China are 45 per cent and 90 per cent respectively and are as low as 11 per cent and 48 per cent in developed countries like United Kingdom and United States.

Digital transactions, on the other hand offer significant benefits to the economy by connecting all the sectors and leaving lesser room for people to evade taxes and hence expanding the tax base. This may be clearly brought out by the way informal sector in the country makes use of indicators borrowed from the transactions in formal sector to anticipate the expenditure incurred by people in it. In such a phase of high dependence of people on cash transactions, the country needs to take more cohesive steps along with creating awareness about benefits digital means offer to carry out transactions. All this seems to be a far reaching dream and requires a well-equipped and seam less financial eco-system[24].

One of the stated objectives to introduce demonetization in the country was to propose a more unified system in order to have increased cashless transactions. This would simply mean lesser cash transactions and increased electronic or digital transactions which are recorded in the formal sector and are accounted for while calculating national expenditure/income. The move is also expected to boost the formal sector savings and will hence contribute in the growth process if accompanied by tax compliances via expanding the tax base of the country.

Indian masses may be divided into three distinct segments in order to extend means of digitalization viz. the poor, the less well-heeled and the prosperous ones. The first out of these are left outside the net of the term called digitalization due to their lower level of literacy and negligible knowledge of digital transactions. The second category is the one who are being slowly included in digital bracket for them being covered under Jan Dhan accounts and RuPay cards. However, the third of these is the one already being digitally integrated via plastic and electronic money. In order to quantify these categories numbers show, out of the 1250 million people living in the country approximately 350 million are digitally excluded (without cellphones), 350 million own featured phones and the rest 250 million possess smart phones.

However, the increasing rate of mobile penetration and internet penetration in India provides a big room for the former category to be included under the digital net. As per the data release by ministry of telecommunication in India, the penetration rate of sim connection in 2015 was 76% which is projected to increase to as high as 101% by 2020. The statistics also bring out the country to have the second largest number of mobile users in the world. Also, the data on mobile broadband connections seem to follow the same pattern. The penetration rate for the head is expected to go up to 48% by 2020 from 15% in 2015.

Hence, the government has to intervene dramatically to equip the nation with social overhead capital and create awareness about digital transactions along with introducing schemes that involve larger group of people. In the rouse of cashless economy, the role played by government deserves applause. With launch of BHIM application for smart phones making use of Unified Payment Interface, about 1 million transactions have been catered followed by approximately 10 million downloads. Not only has this BHIM USSD 2.0 allowed around 350 million featured phone possessors to have digital transfers. The government has also tried to include the 350 million people without mobile phones by launching the Aadhar Merchant Pay which makes the use of Aadhar card and biometric identification for transactions. As per the data released by National Payments Corporation of India in January 2017[9], a theatrical move has been experienced by the country. The National Automated Clearing House show the value of transactions to increase from 1196.97 billion in 2014-15 to 3715.09 billion in 2015-16 and to 5787.17 billion from April'16 to January'17. Also the Aadhar Mapper Enables Services show an increase in volume from 118.11 million in 2015-16 to 175.50 million in the first three quarters of the current fiscal. RBI survey data indicates that during December 2016 digital wallets accounted for just Rs 95 billion in transactions and UPI only Rs 7 billion, compared to Rs 314 billion for debit (excluding RuPay and ATM transactions) and Rs 270 billion for credit cards. Still they are growing rapidly.

In the wake of Demonetization, steps taken by government and its responses from masses clearly indicate a move towards a more digital, transparent and corruption free economy reflecting better performance on growth trajectory.

Real Estate: Real estate in India is one sector that easily absorbs peoples' unaccounted cash by providing a medium to evade taxes on property sales. This is an open secret for masses that it is one sector which is used to convert people's black money into white. This unlawful practice followed by a section of society has adverse impacts on genuine buyers. Businessmen, investors, property dealers and builders increase the demand in the sector resulting in sky touching prices and hence making it unaffordable for legitimate buyers.

Indian government, realizing importance of housing in the country took various steps to make it available at affordable prices. Steps taken by government in this direction have been able to cater to the problem to some extent. Amendment of the Benami Property (Prohibition) Act in the year 2016 was one striking move. The Gazzette[20] of India defines "benami property as the subject matter of a benami transaction and also includes the proceeds from such property". It also identifies "benami transactions as (A) a transaction or an arrangement— (a) where a property is transferred to, or is held by, a person, and the consideration for such property has been provided, or paid by, another person; and (b) the property is held for the immediate or future benefit, direct or indirect, of the person who has provided the consideration, except when the property is held by— (i) a Karta, or a member of a Hindu undivided family, as the case may be, and the property is held for his benefit or benefit of other members in the family and the consideration for such property has been provided or paid out of the known sources of the Hindu undivided family; (ii) a person standing in a fiduciary capacity for the benefit of another person towards whom he stands in such capacity and includes a trustee, executor, partner, director of a company, a depository or a participant as an agent of a depository under the Depositories Act, 1996 and any other person as may be notified by the Central Government for this purpose; (iii) any person being an individual in the name of his spouse or in the name of any child of such individual and the consideration for such property has been provided or paid out of the known sources of the individual; (iv) any person in the name of his brother or sister or lineal ascendant or descendant, where the names of brother or sister or lineal ascendant or descendant and the individual appear as joint-owners in any document, and the consideration for such property has been provided or paid out of the known sources of the individual; or (B) a transaction or an arrangement in respect of a property carried out or made in a fictitious name; or (C) a transaction or an arrangement in respect of a property where the owner of the property is not aware of, or, denies knowledge of, such ownership; (D) a transaction or an arrangement in respect of a property where the person providing the consideration is not traceable or is fictitious". With proper implementation of these amendments, the supply side constraints for the sector are expected to be tackled to some extent.

Another important step taken by the government to revitalize the sector is in direction of circle rates. Circle rates in property for a naïve may be understood as "the minimum value at which the sale or transfer of a plot, built-up house, apartment or a commercial property can take place. Such rates or minimum rates of property are generally notified by local state revenue department or local development authorities. It is the minimum value at which the sale or transfer of a plot, built-up house, apartment or a commercial property can take place." Real estate sector for long has observed an increasing trend in these rates over last two decades. The authorities did not make any change in them for the fiscal years 2014-15 and 2015-16. However, fiscal year 2016-17 laid special importance to these minimum rates at which transactions in the real estate sector can take place. It was first time ever in post reform era that the circle rates were slashed down by 5% in major cities of the country. Some areas saw this cut down by as high as 15 to 18%. This significant move of the government to provide housing to larger set of masses has undoubtedly delivered results by reducing the prices of property in the country. Alongside, Indian government has tried to enhance demand side of the sector by introducing pradhan mantra awas yojna which is proposed to extend housing loans to rural poor, urban poor and middle class of the country at subsidised rate to make it affordable for them to purchase their own houses.

In the wake of these major movements to reconstruct the sector, demonetization was another vital step of the government. With Demonetization in place, followed by lesser cash based transactions and more electronic or digital transactions, the capacity of people active in the sector with an objective to invest their unaccounted incomes will certainly be contained. Also, Demonetization is expected to expand the tax base of the country by checking tax evasion via increased use of white money.

All these steps taken by the government together have been able to make a visible change in the sector. These anticipations have been supported by estimates of Knight Frank and Survey[10] calculations stating that the real estate prices have been continuously dropping since fourth quarter of 2015 and also plumped to become negative in third quarter of fiscal year ending 2017. Such a deceleration in property prices is considered to be a sign of prosperity in the country since it clearly increases affordability of the middle class and facilitates labor mobility across the country.

Lessons Learnt So Far: Demonetization, possibly the largest financial reform India experienced in last couple of years could not prove out to be an efficient tool for monetary policy in the country. The last year has observed dualistic state in terms of peoples' faith on banking sector or the country. It shook confidence of some as an institution to regulate the currency in circulation in line with the country's needs. However, it also expanded net of people making use of banking sector in their day to day transactions. Experts across the world have given mixed reviews about this move of the government with unanimous decision on its behaviour as a monetary policy tool and have claimed it to be completely ineffective.

One of the important reports on Demonetization is released by the central bank of the country on August 30th, 2017. The report clearly mentions return of about 99 per cent of old currency to banking system as against the expectations while implementing it. Return of such a high proportion of currency which lost its legal status on November 8th, 2016 raises questions on the amount of black money held by people in cash and the route taken by them to fit in the banking system. The Government chalked out a very ambitious plan of checking this black money in the economy by flushing it out of the system and using the fresh currency for expansion purpose with minimal cost. However, reality hit the banking sector hard with increased burden on RBI of printing new currency, repo rate transactions along with unnecessarily increased burden of banks on saving deposits of the people.

Impacts of Demonetization on the economy has been evaluated to be multi-faceted. The worst affected are the most innocent ones, consumers of the country who had to trade-off between standing in queues to deposit cash in banks and going to work to earn their livelihood. The burden distribution was also highly regressive in nature spread evenly across the country.

The digital sector on the other hand did soar as per revealed by statistics. However, this achievement may not sustain in the longer run since it is based on a very low base, As per Master card Study, 2013 India belongs to inception category of cashless transactions that has a long way to go for switching completely on plastic or electronic money. The country also faces structural constraints on three accounts. The first and the foremost is dependence of country on cash based transactions which is significantly high even as per developing country's standards. This is also supported by reports on Digital Evolution Index which brings out as much as 51 percent of India's financial holding in demand deposits and saving accounts which is petty high if compared to other countries. Also, the value of currency in circulation as a proportion of GDP is also as high as 12 per cent which is under 4 percent for all the other developing economies.

In this backdrop RBI chose to put banking sector in forefront to have financial inclusion. This astonishing move was against the trend of focusing on telecom sector for the purpose expanding their digital net. In line with such movements, the telecom sector is left with no option but to approach banks for partnering in expanding such digital network. This bank led digital expansion constrained the evolution of required magnitude of digital infrastructure and awareness among the consumer on its use leading to a state where many were left to fight their own battles on how to use these electronic media for optimisation. With such a pattern of market space, it was the private mobile wallet companies like Paytm, Mobiquick, Freecharge among the others who observed a sudden surge in the volume of transactions done via them. Although this increased business of mobile wallet companies may be explained by 108 percent subscription to mobile phones in India of which as high as 17 percent of the population uses smart phones.

The government also banged on such high subscription of mobile users in the country by introducing various applications and measures to connect simple, non-internet enabled mobile phones also to their bank account and carry out transactions by making use of only their 16 digits Aadhaar ID and bank account number. This was indeed a successful move of the government to provide for a more inclusive financial environment. Alongside various other measures have also been taken up by the government to promote electronic or cashless transactions, like providing a more consumer friendly set to use mobile wallets and debit cards at market places along with fuel pumps, waiver of taxes like service tax, GST etc. on online bookings. All these policy initiatives have together taken the country ahead towards its unexpected dream of cashless Indian economy.

Not only the consumers have been negatively affected by squeezing out the money from circulation, the supply side has also witnessed commotions in their own way especially in the sectors which are highly dependent on cash based transactions. Although these problems were served in a short while against the anticipations of some of the economists who proposed a complete collapse of monetary base with currency being sucked from circulation followed by slow re-monetisation. This might be simply explained via its inability to affect the broad money drastically majorly due to increased inflow of funds in the formal financial sector. Also, the close integration of Indian society also provided for temporary informal arrangements between traders and suppliers which kept the day to day transactions going on credit basis.

Surprising remarks have been made in Economic Survey for the growth figures of the country that reveals growth rate to be 7 percent for the quarter ending in December, 2016 which is exactly what was estimated by the agencies before demonetization. This raises brows on the authenticity of data estimation procedures where the growth figures of country remain unaffected by 86 percent of the currency being demonetized, hue and cry about people compromising on their wages and some retailers being left jobless with clear sweeping on businesses and small set ups with undeclared incomes along with many projects being postposed in the formal set up. One of the widely identified problems with Indian statistics is the lag between its time of estimation and actual figures are released. Estimation is generally done based on the trend being followed which tends to become ineffective when a major financial reform like demonetization is placed. Also, the estimates do not have fair representation of informal sector in the country with provides avenues for large masses to earn their livelihood and it worst affected by reforms like Demonetization which squeezes on the availability of cash on which majority of their transactions are based.

Also the country does not account for data on consumers' spending behaviour capturing both formal and informal sectors. The approximation on consumers' spending is done via production figures and sale figures of the organised sector which constitutes a very small proportion of the total spending in an economy like India. Some of the organised sector sales show a slump in their sales. Hence the estimates revealed by statistical agencies in India may not be considered as complete and reliable one.

Any policy change is introduced with a set target and keeps prepared for its consequences alongside. Demonetization is one of those policies that has faced criticisms in the short run but is expected to deliver positive results in the longer run with increased tax base, transactions in vicinity of banking sector and increased number of transactions via digital means. With this backdrop one may assess that the economy is now prepared for a second round of similar financial reform that not only will turn out to be a successful monetary policy tool with increased financial inclusion but will also be able to efficaciously curb the black money out of the economy with direct impact on the state of corruption in the economy.

Conclusion: On deep investigation of the term called Demonetization and its recent implementation in India, one can easily conclude that the country's performance turned out to be surprising augmenting the early anticipations of slowdown in the country. These early signs of growth do not seem to be restricted here but rather offers wide scope of further improvement on growth numbers ahead. Growth numbers in the country are anticipated to nurture even further by including pent up demand and tax reforms in the country. Such growth figures are expected to be more sustained and consistent one.

Demonetization followed by larger cashless transactions, increasing the accounted income and tax base of the country will allow Indian government to have increased source of revenue thereby enhancing its capacity to introduce welfare programmes for people. Also a positive impact on income disparity and regional inequality is bound to follow. This may clearly be seen in various macroeconomic indicators.

The monetary sector of the economy has witnessed sharp increase in cash holdings of people followed by increased bank holdings. The central bank in its accordance decreased the interest rates on deposits, loans and government securities. However in the longer run the cash availability to people will settle down with relatively lower bank balances. This would further ease the credit availability in the country. Also the financial savings of the country in formal sector saw a pointed increase which would further increase in the long run to the extent of decreased cash to deposit ratio.

Nevertheless impact on corruption could not been seen immediately but is expected to decrease if incentives for observance improve. A spectacular impact has been observed on the stock of unaccounted income or black money in the economy that fell obliquely for increased tax net and is further anticipated to fall with the formalization of transactions.

Public sector wealth did not see any impact of Demonetization in the short run but is expected to increase certainly in the longer run with reduced liabilities of the central bank and increased revenue resources for the government. Although the impact on private sector is complete opposite. It decreased in the short run and would further decrease if accompanied by real estate sector observing a downward trend. The country has witnessed a significant increase in the number of digital transactions with cash squeeze which should further increase manifold times with people adjusting to the new system of payments.

It is only on the certainty and reliability parameter, the financial move did not perform very well. People's belief in the financial system shook considerable which is expected to settle but only after a considerable period of settlement.

Demonetization, in its current avatar has certainly affected different facets of the economy ranging from major reconstruction in the huge sector like real estate to affect people's small holdings at micro level. The country is expected to follow a more sustained and consistent growth trajectory in future.

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21. Nomura Research Institute is a research institution hailing from Japan which undertakes the market research to discover and create new social paradigms in order to contribute to the growth and development of Japan, Asia and the world.
22. As per NCAER Quarterly Review of Economy, February 2017, http://www.ncaer.org/uploads/photogallery/files/1488281969Press%20release%20QRE%20Feb%202017.pdf
23. A sound financial eco system would imply financially literate masses making informed choices to their access to well functioning financial system offering a wide range of financial instruments and services.