



Demonetization in India

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Abstract

Demonetization of currency is a radical monetary step in which a currency unit's status as a legal tender is declared invalid. This is usually done whenever there is a change of national currency, replacing the old unit with a new one. The present study is an attempt to know about the Demonization in India and its objectives and effects. The purpose of the present study also elucidates the impact of such a move on black money.

Keywords: demonetization, objectives, effects, impact, black money

Introduction

When a currency note of a particular denomination ceases to be a legal tender, it is termed as Demonetization. It occurs whenever there is a change of national currency. The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins and sometimes a country completely replaces the old currency with new currency. Such a step for example was taken when the European Monetary Union Nations in 2002 decided to adopt euro as their currency. However the old currencies were allowed to convert into Euros for a period of time in order to ensure a smooth transition through demonetization. In 2015 the Zimbabwean government demonetized its dollar as a way to combat the country's hyperinflation, which was recorded at 231,000,000%. The three month process involved expunging the Zimbabwean dollar from the country's financial system and solidifying the U.S dollar, the Botswana pula and the South African rand as the country's legal tender in a bid to stabilize the economy. Fiji, Singapore and Philippines were other countries to have opted for currency demonetization.

Review of literature

Rahul Prakash Deodhar (2016) "Black Money and Demonetization" The Government of India announced that the Rs 500 and Rs. 1000 denominated currency notes will cease to be legal tender. The move was targeted towards tackling black money, corruption and terrorism. After initial euphoria, questions began to emerge. What are the costs of this demonetization? Will it be effective if people can still create new black money thereafter? The author concluded that it is just one move of one piece in the chess board of black money. To check-mate the black money king, you have to win the board. There are various steps required as detailed above. Government can play all these moves and still fail if they play improperly. All we can say is that Government is playing well. But will it succeed? The efforts will bring massive amounts of cash into the banking system – a benefit in itself. Once the money is in the legitimate channels, it should be better utilized and revenue will be generated from its use. If that is success enough then yes.

Dr Pratap Singh & Virender Singh (2016) "Impact of Demonetization on Indian Economy" India has amongst the highest level of currencies in circulation at 12.1% of GDP. Cash on hand is an estimated at around 3.2% of household assets, higher than investment in equities, or roughly around \$ 220 billion. Of this cash, 87% is in the form of Rs 500 and Rs 1,000 notes or roughly Rs 14 lakh crore (\$190 billion). A significant portion of the household cash on hand is generated by economic transactions that are not reported to tax authorities or generated through corruption. Scrapping the higher denomination money would either result in these being brought into the system or the money just disappearing. The study highlights the probable consequences of this decision on various economic variables and entities. The author concluded that if the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries shows that the move was one of the series that failed to fix a debt-burdened and inflation-ridden economy.

Objectives of the study

- To study the Demonetization Policy in Indian economy.
- To study the various objectives and effects of the Demonetization in India.

Research Methodology

Keeping in view of the objectives, in the present study secondary data has been used. Data has been collected from various research papers, magazines and articles. In addition to this study, data have also been collected from various journals, economic and political weekly and the research is also based on the referred sources- published, unpublished and electronic.

Demonetization in India

Demonetization for us means that Reserve Bank of India has withdrawn the old Rs 500 and Rs 1000 notes as an official mode of payment. Demonetization is the act of stripping a currency unit of its status as legal tender. In India's case, the

move has been taken to curb the menace of the black money and fake notes by reducing the amount of cash available in the system. It is also interesting to note that this was not the first time the government of India has gone for the demonization of high value currency. I was first time implemented in 1946 when the Reserve Bank of India demonetized the then circulated Rs 1,000 and Rs 10,000 notes, The government then introduced higher demonetization bank notes Rs 1000, Rs 5000 and Rs 10000 in a fresh avatar eight years later in 1954 before the Morarji Desai government demonetized these notes in 1978. The governments move to demonetize, even then, was to tackle the issue of black money economy, which was quite substantial t that point of time. The move was enacted under the High Demonetization Bank Note (Demonetization) Act, 1978. Under the law all 'high denomination bank notes' ceased to be legal tender after January 16, 1978. People who possessed these notes were given till January 24 the same year a week's time to exchange any high denomination bank notes.

On 28 October 2016, the total currency in circulation in India was Rs. 17.77 lakh crore (US\$260 billion). In terms of value, the annual report of Reserve Bank of India of 31 March 2016 stated that total bank notes in circulation valued to Rs. 16.42 lakh crore (US\$240 billion) of which nearly 86% (i.e. Rs. 14.18 lakh crore (US\$210 billion)) was 500 and 1000 rupee notes. In terms of volume, the report stated that 24% (i.e. 2,203 crore) of the total 9,026.6 crore banknotes were in circulation. In an important move, the Prime Minister of India Mr. Narendra Modi hit hard on corrupt bureaucrats, politicians, and business class, terrorist groups, smugglers, drug traffickers, black marketers and many others engaged in unlawful activities declared that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The people were given a chance either to exchange the old currency with new one through banks, post offices or deposit the same in their accounts upon December 30, 2016. According to the government of India, the RBI will issue Two thousand rupee notes and new notes of Five hundred rupees which will be placed in circulation from 10th November 2016. Notes of one hundred, fifty, twenty, ten, five, two and one rupee will remain legal tender and will remain unaffected by this decision. The main difference between previous drives of demonetization and the current one is that currency of higher denomination was barely in circulation in 1948 or 1978, unlike the Rs 500 and 1000 notes in 2016.

Objectives of demonetization in India

- To track fake currency.
- To cutoff the supply line money, arms and immunizations to terror funding.
- To transform Indian economy into cashless economy.
- To bring tax evasion to halt.
- To unearth and curb the black money.
- To curb illegal and unethical business activities such as, the black marketing, food adulteration, marketing of spurious goods, human trafficking, smuggling of gold and drugs.

Effects of demonetization in India

In an important move, the Government of India declared that

the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The RBI has issued Two thousand rupee notes and new notes of Five hundred rupees which have been placed in circulation from 10th November 2016. This measure has been taken by the PM in an attempt to address the resolve against corruption, black money and counterfeit notes. This move is expected to cleanse the formal economic system and discard black money from the same. The present study highlighted the probable consequences of this decision on various economic variables and entities.

1. Effect on parallel economy

The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 Rupee Notes is expected to:

- Remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks,
- Temporarily stall the circulation of large volume of counterfeit currency and
- Curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

2. Effect on money supply

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 reduce in the short run. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money and hence 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.

3. Effect on demand

The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly; the nature, frequency and amounts of the commercial transactions involved with these sections of the economy necessitate cash transactions on 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.

- Consumer goods
- Real Estate and Property
- Gold and luxury goods
- Automobiles (only to a certain limit)

All these mentioned sectors are expected to face certain moderation in demand from the consumer side, owing to the significant amount of cash transactions involved in these sectors.

4. Effect on Prices

Price level is expected to be lowered due to moderation from demand side. This demand driven fall in prices could be understood as follows:

- Consumer goods: Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
- Real Estate and Property: Prices in this sector are largely

expected to fall, especially for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheque transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices (probably charging more on cheque payment).

5. Effect on various economic entities

With cash transaction lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- Agriculture and related sector
- Small traders
- SME
- Services Sector
- Households
- Political Parties
- Professionals like doctor, carpenter, utility service providers, etc.
- Retail outlets

6. Effect on GDP

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

7. 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 Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there would be withdrawals at the second stage.

8. 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 increase in demand. This should eventually lead to strengthening of such systems and the infrastructure required.

Conclusion

The Demonetization undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be

“black money” and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility.

In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetization on the economy and its agents. It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

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