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DEMONETIZATION IN INDIA AND ITS AFTERMATH

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ABSTRACT

Demonetization is the process by which a particular type or denomination of currency is removed by the government from economic circulation. It could happen when a country decides to change its currency for many reasons. The previous units of currency are eliminated, and a new unit of currency is introduced to be used that replaces the earlier. In India 1946 for the first time and again in 1978, the money was demonetized for different reasons. The Modi administration demonetized currency for the third time in November 2016. This was a daring move made by the government for the said benefit of the national economy. The goal of the current study is to analyze the idea of demonetisation and its consequences following its recent implementation in India.

Keywords: *Demonetization, currency, government*

1. INTRODUCTION

Demonetization refers to withdraw 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 8th November 2016 the currency was demonetized third time by the Modi government. This is the bold step taken by the govt. for the betterment of the economy and country.

Demonetization is a generations' memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. Demonetization affects the economy through the liquidity side. Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk of it. As a result of the withdrawal of Rs. 500 and Rs. 1000 notes, there occurred huge gap in the currency composition as after Rs. 100; Rs. 2000 is the only denomination.

Absence of intermediate denominations like Rs. 500 and Rs. 1000 will reduce the utility of Rs. 2000. Effectively, this will make Rs. 2000 less useful as a transaction currency though it can be a store value denomination.

Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce various short term or long term impacts on Indian economy.

2. REVIEW OF LITERATURE

Arpit Guru and Shruti Kahanijow (2010) researcher analysed the black money income and analysed that black money is spread everywhere in India up to a large extent which continuously stashed towards abroad in a very large amount. The researcher also identified how black money had caused menaces in our economy and in what ways it is used.

Sukanta Sarkar (2010) conducted a study on the parallel economy in India: Causes, impacts & government initiatives in which the researcher focused on the existence of causes and impacts of black money in India. According to the study, the main reason behind the generation of black money is the Indian Political System i.e. Indian govt. just focused on making committees rather than to implement it .The study concludes that laws should be implemented properly to control black money in our economy.

Tax Research Team (2016) in their working paper stated in favour of demonetization Its main objective is to analyze the impact of demonetization on Indian economy. This paper shows the impact of such a move on the availability of credit, spending, level of activity and government finances.

3. OBJECTIVES OF THE STUDY

- To describe the demonetization concept in India.
- To identify the impact of demonetization on Indian Economy.

4. ANALYSIS AND DISCUSSION

Before we start with the discussion of demonetization which took place on November 8th, 2016, we will look into history of birth of paper currency as how use of paper currency had been started in India.

Until the 18th century, people in India used to use silver and gold coins to carry out their day-to-day transactions. But then some European companies established their own banks in the region to carry out their business transactions, like the Bank of Hindustan in Calcutta. They introduced the very first versions of Indian paper notes which then boosted the further popularized the use of paper notes. The Bank of Bengal went on to release notes that featured a small image of a female figure meant to represent the idea of "commerce," as well as the bank's name and the denomination in three scripts: Urdu, Bengali, and Nagri.

However, it was only after the Paper Currency Act of 1861 that the British colonial government really got involved in producing money, establishing the paper currency as we know it today. Money was now to be issued by the state alone, not banks.

A. Demonetization in India before November 2016

The act of demonetization 2016 is not happening for the first time in India, but before it, has happened twice, first in the year of 1946 and then in the year of 1978. In January 1946, Rs. 1,000 and Rs. 10,000 banknotes were withdrawn but the same Rs. 1,000, Rs. 5,000 and Rs. 10,000 notes were reintroduced in 1954, and were again demonetized in January 1978.

The second demonetization has taken place in the year of 1978 by the Janata Party government. It had decided to withdraw Rs1,000, Rs5,000 and Rs10,000 notes by issuing an ordinance on the morning of 16 January that year. The objective behind the all the acts of demonetization happened in past and happened recently is common reduction of black money, corruption and removal of fake currency.

B. Demonetization- November 2016

On Tuesday, 8th of November, 2016 Prime Minister of India Narendra Modi announced the demonetization of Rs. 500 and Rs. 1000 notes with effect from midnight, making these notes invalid. The major reasons behind this move were controlling black money, controlling fake currency and controlling corruption.

5. REASONS OF DEMONETIZATION

According to The Reserve Bank of India, the most important reason for the demonetization of 500 and 1000 rupees note was the rise of fake currencies of the same notes, and also the higher occurrence of black money in the economy. "The fake notes are being used for illegal activities by anti-nationalists like terrorists and India being a nation of a cash-based economy, the circulation of fake currency continues to be a threat. But it has been taken care by Government that the public that a person who changed his higher value cash will get exactly the equal amount in lower denominations.

6. CONSEQUENCES OF THE DEMONETISATION

The following likely impacts on the economy can be observed if such a considerable percentage of currency notes in the form of cash are either reported or consumed in an economy.

Tax: It has been claimed that the government will closely monitor cash deposits over Rs 2 lakh after closing the voluntary disclosure window for undeclared funds. more tax net, more tax collection, and an improved tax to GDP ratio would result from this. According to a research by Philips Capital, the parallel economy's size has increased from 23.2% of GDP to anywhere between 25 and 30% of GDP. The government might be tempted to lower tax rates in the future when the money is accounted for and more taxes are collected.

Interest rates: High value transactions, particularly those involving land and gold, will be one of the biggest effects of demonetisation. Lower inflation as a result would tempt the central bank to cut interest rates. However, the increased liquidity that banks would get will have a greater influence on interest rates. According to CLSA, banks would gain from higher CASA (current account savings account) growth if they received some of the $ 190 billion cash hoard as deposits. Lending rates could be lowered and investment activity could increase if deposit growth is higher and credit growth remains poor.

Liquidity: Money and goods movement will be hampered in the short term. According to a Bank of America Merrill Lynch study, the wholesale channel accounts for more than 40% of revenues for Indian consumer companies. Liquidity issues are anticipated to affect this channel, which mostly deals with cash transactions, in the near future. This can affect the December quarter's growth and upset the supply chain. The research also states that consumer companies generally give distributors short credit periods (under seven days), who then give credit directly to wholesalers and retail stores. Consumer companies would soon be forced to give distributors looser credit terms due to the overall tightening of cash-liquidity in the supply chain. We anticipate a rise in their receivables in the quarter ending in December as a result.

GST: With the introduction of GST, the country will transition to a new tax system at a crucial time. Demonetization would broaden the tax base and, when combined with GST, would reduce the production of black money. According to CLSA, demonetization will increase the tax/GDP ratio along with GST.

Financial Assets: As idle capital enters the main economy, it will gravitate to more liquid and high-yielding assets. Money is anticipated to shift from gold, precious metals, real estate, and basic cash to financial assets. According to the majority of broker reports and expert opinions, the move will be advantageous in the long run even though stocks may temporarily reflect the economy's worry.

Effect on parallel economy: The removal of these 500 and 1000 rupee notes and their replacement with new 500 and 2000 rupee notes is anticipated to: - Remove black money from the economy because owners won't be able to deposit them in banks; - Temporarily stall the circulation of large amounts of counterfeit currency; and - Reduce funding for anti-social elements like smuggling, terrorism, espionage, etc.

Effect on Money Supply: Money supply is anticipated to decrease in the short term as a result of the scrapping of the older notes of Rs. 500 and Rs. 1000 and up until the new currency notes of Rs. 500 and Rs. 2000 Rupee are widely used in the market. Reserved money and thus the money supply will continuously decline to the extent that black money (which is not counterfeit) does not re-enter the system. Money supply will increase, albeit gradually, when new notes are distributed on the market and the discrepancy is fixed.

Effect on Prices: The 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). The Indian real estate market which is largely fragmented and unorganized has had a reputation of being a safe haven for black money and therefore we expect to see impact on the sector. The impact is likely to be seen in secondary markets thereby making real estate more "illiquid" for a period of time till the market adjusts to a new normal. It will not have any impact on the primary residential segment as the buyers in this sector are driven by mortgage. The impact will be felt in the secondary market and the unorganized developers' community where there were still cash dealing. Prices coming down to more reasonable levels in the housing market cannot be ruled out. In the immediate future, the sector will be under serious pressure with volume and number of transactions in residential and land markets seeing a substantial downward trend. This decision along with real estate regulatory law, GST and Real Estate Investment Trusts would further improve transparency and increase investor confidence in the real estate market.

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.
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.

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.

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.

7. CONCLUSION

Demonetization though it has created some positive and some negative impacts on different sectors but in long run it definitely will have positive impact in controlling black money and fake money

The Short-term Impacts: There will be a disruption in the current liquidity situation as households are likely to get affected by the note exchange terms laid by the government. Though clarity is unfolding on this, commodity transactions and general cash market transactions are likely to feel an immediate impact. Unorganized sector proceedings, including small trade market activities, will remain volatile in the short-term. Roadside vendors, cab drivers, *kirana* stores, etc., have already stopped accepting Rs 500 and Rs 1,000 notes. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which is likely to be affected by immediate liquidity issues. Overall, negative impact on disposable income is expected along with likely disruption in the consumption patterns of the general populace. It is estimated that there will be a negative GDP impact in the current quarter as consumption gets a shock in the immediate term. However, quantum and degree of this impact cannot be ascertained at this time.

The Longer-term Implications: This essentially represents a change in regime for the real and financial economy. Domestically, there could be some turmoil as the effect will be disproportionately felt by the lower and upper income classes. Internationally, the government is likely to get thumbs up for the move and more countries could potentially see this as a viable option to curb black money and stem illegal financial activity.

Last, though this move by the government may not be a first, having being tried by earlier governments as a tool to fight corruption. Such an action achieves larger significance for a globally connected India as it shows boldness in tackling an issue which has remained a thorn in the growth success story of this generation.

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