

“A STUDY OF DEMONETIZATION IN INDIA”

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Abstract: Demonetization refers to discontinuing of current currency units and replacing those currency units with new currency units. It is a major decision and it impacts all the citizens of the country because overnight all the money you have become a piece of paper which has no value if you do not exchange it with new currency units or deposit it in the banks. This study attempts the concept demonetization and effect of demonetization on various economic variables of India. Demonetization of the 500 rupee note and 1,000 rupee note two highest currency denominations available in India will likely hit economy hard in the short term. The 500 rupee and 1,000 rupee currency notes formed 86.4% of the value. The government removed 86.4% of the currency in circulation by value. In terms of volume, the currency notes of these two denominations formed 24.4% of a total 90.27 billion pieces. The present study represent situation of demonetization in India.

Keywords: - Demonetization, India-GVA Growth Rate, Percentage Share of Demonetization in Circulation by Value, effect of demonetization

1. Introduction: There are multiple reasons why nations demonetize their local units of currency. Some reasons include combat inflation, to combat corruption, and discourage a cash system. The process of demonetization involves either introducing new notes or coins same currency or completely replacing old currency with new currency. The government has implemented a major change in economic environment by demonetizing high value currency notes – of Rs. 500 and Rs 1000 denomination. These ceased to be legal tender from the midnight of 8th of November 2016. People have been given up to December 30, 2016 exchange the notes held by them. The proposal by government involves elimination of these existing notes from circulation and gradual replacement with a new set of notes. In the short term, it is intended cash circulation would be substantially squeezed since there are limits placed on amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat. The reasons offered for demonetization are two-fold: one, to control counterfeit notes that could be contributing terrorism, in other words a national security concern and second, to undermine or eliminate “black economy”. The widespread use of cash in high denominations has led to an artificial increase in the cost of goods and services which was reflected in the government’s success in bringing out Rs 1.25 lakh crore of unaccounted money. A structural transformation agenda which drive against black money can bring about a modification in the medium term and political gains. Progressive shift to a cashless economy with a greater focus on electronic transactions is being envisaged. The removal of large bills will make several criminal and illegal activities more costly such as tax evasion, human trafficking, drugs, extortion and terrorism. Scaling back large bills will not end crime, but it will force the underground economy to employ riskier and less liquid payment methods.

2. Review of Literature: **Sunita R. (2014)**, he has studied demonetization of Indian rupee against US \$. The objectives of this study trend of Indian rupee and it exchange rate against US \$ historically and concept of demonetize. Researcher conclude that real implications of the depreciation rupee on Indian economy and long run Indian economy has more to lose and less to gain with weaker rupee. **Rajakumar and Shetty (2016)**, they have studied demonetization 1978, the present and the aftermath. The study shows that demonetization of 500 and 1000 notes the issuance of currency and its different denomination are traced over time while also tracking key macroeconomic features of India’s changing economy over the decades. **Sherline T. I (2016)**, he has studied on demonetization as a prelude to complete financial inclusion. The study focus on various initiatives taken by Government and RBI and also the latest attempt of demonetization and it’s expecting impact on various sectors. The main reason is majority of population lived in rural areas and they are not literate enough to understand the advantages of financial services. **Tax Research Team (2016)**, they have studied demonetization impact on the economy. The study shows that argument posited in favors of demonetization is that cash would be extinguished would be black money and hence should be rightfully extinguished to set right the perverse incentive structure in the economy. Researcher concludes that impact of such a move on the availability of credit, spending, level of activity, and government finances.

3. Objectives of the study:

1. To understand the concept of demonetization.
2. To examine effect of demonetization on various economic variables.
3. To give appropriate suggestions.

4. Research Methodology of the study: For accomplishing the objectives of the study secondary data were collected. Data published by various books, journals, articles, and governments reports are used for purpose of the present study.

5. Demonetization: Definitions: “Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit”.

- **History of Demonetization in India:**

➤ **First Denom — 12 Jan 1946 :** Following the action in several foreign countries, including France, Belgium and the U.K., the Government of India decided on demonetization of high denomination notes, in January 1946. It is interesting that as early as 7 April, 1945, suggested similar action in India as 'one more concrete example for the Indian Government to follow in its fight against black market money and tax evasions which have now assumed enormous proportions.

➤ **Second Denom — 16 Jan 1978** The higher denomination banknotes in Rs 1,000, Rs 5,000 and Rs 10,000 were reintroduced in the year 1954 and these banknotes were again demonetized in January 1978. Denominations of 1, 2, 3, 5, 10, 20 & 25 paise were in circulation till June 30, 2011 but were then withdrawn. While the 50 paise coins are still in circulation. They are called small coins while the other denominations are known as rupee coins. So the last time demonetization was done in India is almost 36 years ago.

➤ **Latest Demonetization 8th November 2016:** The demonetization of 500 and 1,000 banknotes was a policy enacted by the Government of India on 8th November 2016. All 500 and 1,000 banknotes of the Mahatma Gandhi series ceased to be legal tender in India from 9th November 2016. In the announcement, Modi declared that use of all 500 and 1,000 banknotes of the Mahatma Gandhi Series would be invalid from midnight of the sameday and announced the issuance of new 500 and 2,000 banknotes of the Mahatma Gandhi New series in exchange for the old banknotes. However, the banknote denominations of 100, 50, 20, 10 and 5 of the Mahatma Gandhi Series remained legal tender and were unaffected by the policy. The move by the government to demonetize Rs. 500 and Rs. 1000 notes by replacing them with new Rs. 500 and Rs. 2000 notes aims to tackle the menace of black money, corruption, terror funding and fake currency. The total value of old Rs. 500 and Rs. 1000 notes in the circulation is to the tune of Rs. 14.2 trillion, which is about 85% of the total value of currency in circulation.

Table 1 India-GVA Growth Rate (At Basic Prices)

Period	Percentage changes from year ago
April-June 2015	7.18
July-Sept 2015	7.32
Oct-Dec 2015	6.87
Jan-Mar 2016	7.42
April-June 2016	7.33

Source: Central Statistics Reports

Table 1 shows that demonetization of the 500 rupee note and 1,000 rupee note two highest currency denominations available in India—will likely hit economy hard in the short term. The surprise move is expected to grind the consumption activity in Indian economy to a virtual halt. The service sector, which dominates economic activity and involves a sizable chunk of cash transactions, will likely be hit hardest. Growth in the Indian economy remained solid in quarter from April to June 2016. In India, a financial year begins in April and ends in March of the following year. The previously mentioned quarter is the first quarter of fiscal 2016–2017. During that period, the GDP (gross domestic product) rose 7.1%, while the GVA (gross value added) rose 7.3%. The relationship between the GDP and GVA is:

$GDP = GVA + \text{taxes on products} - \text{subsidies on products}$

The base year for calculating the GVA is 2011–2012.

Figure 1

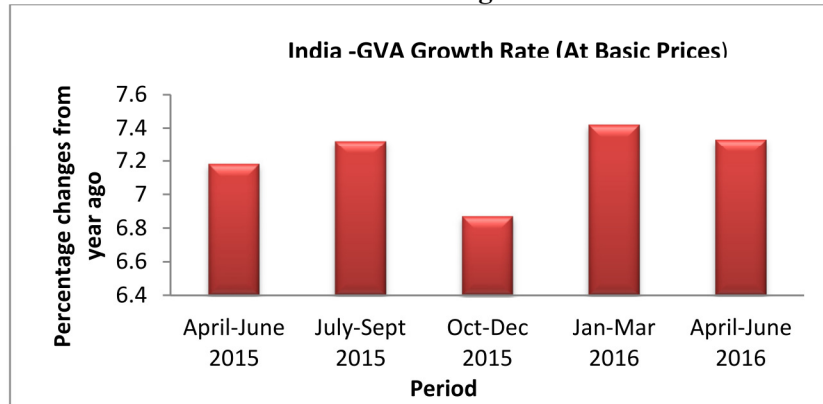


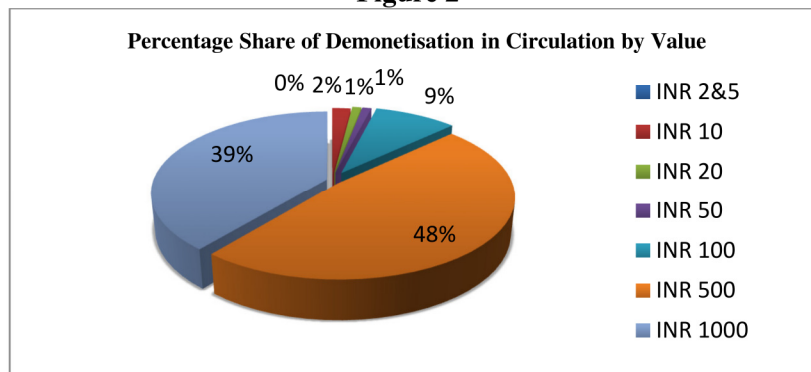
Table 2 Percentage Share of Demonetization in Circulation by Value

Notes	Percentage
INR 2&5	0
INR 10	2
INR 20	1
INR 50	1
INR 100	9
INR 500	48
INR 1000	39

Source: Reserve Bank of India

Table 2 indicates that Percentage Share of Demonetization in Circulation by Value. The RBI's (Reserve Bank of India) Annual Report for April 2015 to March 2016, the value of the currency notes at the end of March 2016 was 16.42 trillion Indian rupees. The 500 rupee and 1,000 rupee currency notes formed 86.4% of the value. In one stroke, the government removed 86.4% of the currency in circulation by value. In terms of volume, the currency notes of these two denominations formed 24.4% of a total 90.27 billion pieces.

Figure 2



6. Effect of demonetization on various economic variables:

a. 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.

b. 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.

c. Effect on Demand:The overall demand is expected to be affected to an extent. The demand in following areas is to be impacted particularly:

- 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.

d. 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.

e. 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

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.

f. 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.

g. 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.

h. 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: Demonetization is a generation's memorable experience and is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. India has done this before. In 1946, all 1,000 and 10,000 rupee notes were recalled. In 1978, 1,000, 5,000, and 10,000 rupee notes were demonetized. The impact of the demonetization measures would certainly be slower economic growth. Several businesses transact in cash and with demonetization they may become cash-strapped, hurting business—and consequently revenue, employment, consumption and investment. The informal sector in India employs more than a majority of the workers and most transactions are in cash. Demonetization affects the economy through the liquidity side. 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. However, such a sudden and drastic step by the government might dissuade some, if not all sections of the society

from creating new black money reserves. 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. It is also deliberation that Modi's demonetization drive will wipe out a measure of corruption and tax evasion in India's real estate market.

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