

Demonetization and Its Impacts in India

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Abstract:

Demonetization refers to Withdrawal of 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 Nov. 2016 the currency is demonetized third time by the present Modi government. This is the bold step taken by the govt. for the betterment of the economy and country. In this paper I want to discuss the impact of recent demonetization on the Indian system.

Keywords: Demonetization, Black Money, Counterfeit Currency, Corruption

Objectives

The main objective of this paper is to study the impact of demonetization on 8th Nov. 2016 by the present government on Indian economy and system.

Methodology

The paper is based on the secondary data. The secondary data was collected from various published sources like reports, magazines, journals, newspapers and the like etc.

Introduction:

Process of removing a currency from general usage, or circulation is known as demonetization. For example, gold was demonetized in this way when it ceased to be

used as an everyday currency. The Indian rupee (INR) is the official currency of India. The recent sudden move to demonetize Rs 500 and Rs 1,000 currency notes is not new. Rs 1,000 and higher denomination notes were first demonetized in January 1946 and again in 1978. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data.

To check undisclosed black money, corruption and fake currency the Government of India on the 8 November 2016 announced demonetization of high denomination currency notes Rs 500 and Rs1000. A new redesigned series of Rs 500 and Rs 2000 banknote is in circulation since 10 November 2016.

History and background

The sudden move to demonetize Rs 500 and Rs 1,000 currency notes is not new. Rs 1,000 and higher denomination notes were first demonetized in January 1946 and again in 1978. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data. Rs 1,000 and Rs 10,000 bank notes were in circulation prior to January 1946. Higher denomination banknotes of Rs 1,000, Rs 5,000 and Rs 10,000 were reintroduced in 1954 and all of them were demonetized in January 1978.

The Rs 1,000 note made a comeback in November 2000. Rs 500 note came into circulation in October 1987. The move was then justified as attempt to contain the volume of banknotes in circulation due to inflation. However, this is the first time that Rs 2,000 currency note is being introduced. While announcing currently circulated Rs 500 and Rs 1,000 notes as invalid from midnight 8 Nov, Prime Minister Narendra Modi said new Rs 500 note and a Rs. 2,000 denomination banknote will be introduced from November 10.

Bank notes in Ashoka Pillar watermark series in Rs 10 denomination were issued between 1967 and 1992, Rs 20 in 1972 and 1975, Rs 50 in 1975 and 1981 and Rs 100 between 1967-1979. The banknotes issued during this period contained the symbols representing science and technology, progress and orientation to Indian art forms. In the year 1980, the legend

Satyameva Jayate — ‘truth alone shall prevail’ — was incorporated under the national emblem for the first time.

In October 1987, Rs 500 banknote was introduced with the portrait of Mahatma Gandhi and Ashoka Pillar watermark. Mahatma Gandhi (MG) series banknotes – 1996 were issued in the denominations of Rs 5, (introduced in November 2001), Rs 10 (June 1996), Rs 20 (August 2001), Rs 50 (March 1997), Rs 100 (June 1996), Rs 500 (October 1997) and Rs 1,000 (November 2000).

The Mahatma Gandhi Series – 2005 bank notes were issued in the denomination of Rs 10, Rs 20, Rs 50, Rs 100, Rs 500 and Rs 1,000 and contained some additional/new security features as compared to the 1996 MG series. The Rs 50 and Rs 100 banknotes were issued in August 2005, followed by Rs 500 and Rs 1,000 denominations in October 2005 and Rs 10 and Rs 20 in April 2006 and August 2006, respectively.

Impact of Demonetization

1) Black Money and Corruption

By demonetization, Black money will be taken out of Indian system. As predicted by ICICI Securities Primary Dealership the government's plan to remove INR 500 and INR 1,000 notes from circulation will disclose up to INR 4.6 lakh crore in black money. Corruption will also be automatically reduced by removing black money from economy.

Arithmetic of Demonetization of High-Denomination

Notes in circulation (value in INR billion)	7854	6326	14180
Notes with banks together with other govt. agencies @ 30%	2356	1898	4254
Notes with public @70%	5498	4428	9926
Conversion by public for new notes with old (%)	60	40	-
Total value of converted by public (INR billion)	3299	1771	5070
Scenario 1: Total value not converted by public @50%(INR billion)	2199	2657	4856
Scenario 2: Total value not covered by public @50% of 20% of black money(INR billion)			4520
Scenario 3: Replicating 1978, with 25% not coming back	1374	1107	2482

Source: SBI Research, RBI

The table depicts the public holding of high denomination notes worth Rs. 9926 billion as on march 2016. There are 3 scenario in table. In scenario 1 and 2 it is assumed that 50% of the notes of higher denomination do not return to the system. It is also reasonable to expect that 60% of Rs. 500 notes and 40% of Rs. 1000 notes would be exchanged at banks/ post offices and RBI before march 31,2017. Based on such estimates, roughly round Rs. 4.5 lakh crore of money could disappear from the system.

2) Funding

Funding for smuggling and terrorism will take a blow since all the money will get back to bank and from there it is easy to identify the fake currency. Demonetization thus affects the funding of terror networks in Jammu and Kashmir, North-eastern states and the other areas.

3) Real estate

Another impact of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable. In the short term, prices of real estate would come down for the same reason above. There will be fewer suitcases moving.

4) Elections

Demonetization has shocked political parties. Many states like Punjab and Uttar Pradesh,

cash donations are a huge part of "election management". Political parties will find themselves helpless as cash hoards are often undeclared money. So upcoming elections 2017 will be transparent to the some extent.

5) Gold/Silver and Jewellery

After demonetization the demand for gold and other precious metals rise greatly. Because people are trying to invest their black money in gold to make it white in short period. But demand for gems and jewellery to decline in the next two to three quarters.

6) Digital payments

People adopting online payments system such as Paytm etc. after ban for high denomination currency in India. 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 increases in demand. This behavioural change could be a game changer for India in the near future.

7) Fake Currency

The impact on the fake currency would be more significant. Many dealers with the existing counterfeit notes would be trapped as they would have to take the notes to the bank and have better chances of getting their racket exposed. Thus, they have only option to destroy their notes and incur losses.

8) GDP

The sudden decline in money supply and increase in bank deposits is going to adversely impact consumption demand in the economy in the short term. This, coupled with the adverse

impact on real estate and informal sectors may lead to lowering of GDP growth.

9) Markets

There will be positive move in markets in long run that could bring confidence of overseas investors in Indian stock markets. Market goes a bit down in the short and medium term. India is still a very attractive destination on a long-term basis. It is not the best market in the next three months.

10) Decease in Interest Rates

We will see a lowering interest rates for education loans, home loans and medical loans very soon. It will make higher education and medical facilities more accessible. This change is hard to undo because if any subsequent government increases loan it will suffer huge backlash.

11) Lower Inflation

As the black money goes out of the system the money supply will shrink to some degree. This will reduce inflation rate in the absence of any open market interventions by the Reserve Bank of India.

Conclusion

So far, it can be said that this is a historical step by the Modi Govt. and should be supported by all. This decision of gov. will definitely fetch results in the long term. From an equity market perspective, this move would be positive for sectors like Banking and Infrastructure in the medium to long term. This could be negative for sectors like Consumer Durables, Luxury items, Gems and Jewellery, Real Estate and allied

sectors, in the near to medium term. This move can lead to improved tax compliance, better fiscal balance, lower inflation, lower corruption, complete elimination of fake currency and another stepping stone for sustained economic growth in the longer term.

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