Demonetization in India and its Effect on Indian Economy

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Abstract:
In this paper, in an important move, the Government of India declared, 8th November 2016 that the five hundred and one thousand rupee notes will no longer be legal tender from midnight. 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. 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 ratio of currency to GDP (gross domestic product) in India, which averaged 8.4% during 1975-2000, crossed 10% for the first time in 2002-03 and has remained above this level since then. This ratio has averaged 10.8% in the last decade. There has not only been a relatively sharp increase in the ratio of currency to GDP during 2015-16 (table 1) but a reversal of the negative trend witnessed in the previous three years. The increase in this ratio could have persisted through the current year as well before the demonetisation of higher denomination notes announced on 8 November.

Keywords: Government of India, Demonetization, Economic system, Black money.

I. INTRODUCTION

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 following short term/long term, consumption/investment, welfare /growth impacts on Indian economy. The intensity of demonetization effects clearly depends upon the duration of the liquidity shocks.

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 Its effect will be a telling one because nearly 86% of currency value in circulation was withdrawn without replacing bulk.

Easy accessibility, its certainty of acceptance and efficiency as the settlement is not dependent on any additional infrastructure, and no additional charges make it universally the most preferred mode. The only problem of cash transactions is the anonymity and difficulty of establishing expenditure trail which make it an ideal mode for unreported transactions as well.

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.

II. HISTORY OF INDIAN CURRENCY

The Indian rupee (INR) is the official currency of Republic of India. The Reserve Bank manages currency in India and derives its role in currency management on the basis of the Reserve Bank of India Act, 1934. The rupee is named after the silver coin, rupiya, first issued by Sultan Sher Shah Suri in the 16th century and later continued by the Mughal Empire. In 2010, a new symbol “₹” was officially adopted. It was derived from the combination of the Devanagari consonant “R” and the Latin capital letter “R” without its vertical bar. The parallel lines at the top (with white space between them) are said to make an allusion to the tri color Indian flag and also depict and equality sign that symbolizes the nation’s desire to reduce economic disparity. The first series of coins with the new rupee symbol started in circulation on 8, July 2011.

III. HISTORY AND BACKGROUND

In a major step to check undeclared black money, fake currency (used to finance terrorism) and corruption, the Govt. of India on 8, November 2016 announced demonetization of Rs. 500 and Rs. 1000 bank notes with effect from the same day’s midnight, making these notes invalid.

A new redesigned series of Rs. 500 bank note, in addition to a new denomination of Rs. 2000 bank note is in circulation since 10 November 2016. The new redesigned series is also expected to be introduced to the bank note denomination of Rs. 1000, Rs. 100 and Rs. 50 in the coming months.

The sudden move to demonetization of Rs. 500 and Rs. 1000 currency notes is not new. Rs. 1000 and higher Denomination notes were first demonetized in January 1946 and again in 1978.

The higher 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. 1000 and Rs. 10,000 bank noted were in circulation prior to January 1946. Higher denomination bank notes of Rs. 1000, Rs. 5000 and Rs. 10,000 were reintroduced in 1954 and all of them were demonetized in January 1978.

**IV. MAIN CAUSES OF DEMONETIZATION**

In 2016, the Indian government decided to demonetize the 500 and 1000 rupee notes, the two biggest denomination notes. These notes accounted for 86% of the country’s cash supply. According to Govt. of India total 14.4 lacrores of rupee was in circulation through Rs. 500 and Rs. 1000 bank notes. The Govt’s goal was to eradicate counterfeit currency, fight tax evasion, eliminate black money gotten from money laundering and terrorist financing activities and promote a cashless economy.

By making the larger denomination notes worthless, individuals and entities with huge sums of black money gotten from parallel cash systems were forced to convert the money at a bank which is by law required to acquire tax information from the entity. If the entity could not provide proof of making any tax payment on the cast, a tax penalty of 200% of the tax owed was imposed.

**VI. WORLD HISTORY OF DEMONETIZATION**

The coinage Act of 1873 demonetized silver in favor of adopting the gold standard as the legal tender of the United States. The withdrawal of silver from the economy resulted in a contraction the money supply, which subsequently let to a 5 year economic depression in the country.

In response to the dire situation and pressure from silver miners and farmers, the Bland-Allison Act remonetized silver as legal tender in 1878. Other countries in the world who took decision of demonetization of their currency met with same fate as United States. Reduction in growth rate, unemployment, economic depression etc is the result of demonetization. Objectives of demonetization do not met with success.

**VII. RECENT DEMONETIZATION EFFECTS ON OUR ECONOMY**

The most important objective of the Govt. to catch black money through it has failed due to lack of preparation and hasty decision. Govt. gave 15 days to convert old Rs. 500 and Rs. 1000 notes into other currency notes. Corrupt system used it to convert black money into White.

Govt. gave 50 days to deposit old Rs. 500 and Rs. 1000 into their Bank accounts and announced that person deposited more than 2.5 lakh will be enquired about tax deposited on the income. The corrupt people deposited their black money into the accounts of poor labourers, farmers & others. Almost all currency notes in the denomination of Rs. 500 & Rs. 1000 came into banking system. To conceal her failure, the Govt. of India has announced cashless economy.

As we know the developed worlds still do not have fully cashless economy where literacy rate in near 100%. According to Dr. Manmohan Singh, 65% Indian do not have bank accounts; corporate houses will get benefits of cashless economy. Shopkeepers, businessmen, traders, private professionals own huge property in India but they do not pay tax. They don’t accept payment through banks and e-transfer of money. Demonetization and cashless economy both has slowed down our growth rate. Our planning commission has revised our growth from 7.6% per annum to 7.1% per annum during 2016-17.

Leading world economists do not agree with our revises growth rate. According to them, it might be around 5% per annum. It has created unemployment among already employed workers. Common people are suffering due to lack of money. It has created fear psychosis about money.

They are not sure to get their own money form banks. They are eager to withdraw money from banks as soon as possible they prefer to hold money in cash in small denomination of notes. Some producers have orders, money in their accounts, raw materials, workers but sill they are unable to produce.

**VIII. IMPACT ON BANK DEPOSITS AND INTEREST RATE**

Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes.

These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full fledged new currency supply takes place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time.

It is not necessary that demonetization will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term.

**IX. INDIAN GOVERNMENT’S SURPRISE**

In an address to the nation on November 8, India’s prime minister, Narendra Modi, declared that the two highest denomination currency notes—the 500 rupee note and the 1000 rupee note—won’t remain legal tender. The notes were demonetized at midnight on November 8.

The move aimed to curb black money in the financial system. Black money is one of the factors holding back the economy. The demonetization was a surprise. Since the annoucement, the media discussed the pros and cons for consumers and the banking system (HDB) (IBN).
According to 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. Also, RBI data showed that as of March 2016, 632,926 currency notes were counterfeit—known as an FICN (Fake Indian Currency Note). As a proportion of NIC (Notes in Circulation), the 1,000 rupee and 500 rupee notes were the highest. Nullifying these FICNs was also part of the demonetization move.1

X. POLICY MEASURES

To reduce the hardship of common people, Govt. should increase the money supply particularly in ₹ 500 note. Banks should allow their customer free withdrawal of cash as much as they want. So that people again start depositing of surplus money into their accounts. Then Govt. should educate the Common people about cashless economy, how can they make payment without cash and without any cost.

XI. CONCLUSION

Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn’t have the digital transaction culture. Overall economic activities will be dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits. Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depends upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. such a nationwide awareness and urge will encourage government to come out with even strong measures.

XII. REFERENCES


[2]. Deposit old notes of RS. 500 or Rs. 1000 in bank or post office accounts from 10th November till 30th December, 2016 without any limit. There will be a limit on withdrawal: Rs. 10,000 per day and Rs. 20,000 per week. This limit will be increased in the coming days.

[3]. Exchange old notes of Rs. 500 or Rs. 1000 at any bank, head post office or sub post office while showing ID proof. The limit for this is Rs. 4000 upto 24th November.

[4]. No restriction of any kind on non-cash payments by cheques, demand drafts, debit or credit cards and electronic fund transfer.

[5]. On 9th November and in some places on 10th November also ATMs will not work. In the first few days, there will be a limit of Rs. 2000 per day per card. This will be raised to Rs.4000 later.