

Demonetization of Currency and Its Impact on Economy

Dr.M.Purushotamma Rao¹ and Dr. K.V.A.Naidu²

1. Associate Professor in Commerce and EC Member of Dr BR Ambedkar University, Srikakulam.
2. Associate Professor in Commerce, Sri GCSR College, GMR Nagar, Rajam, Andhra Pradesh.

Abstract: *Demonetisation is the act of stripping a currency unit of its status as legal tender. Demonetisation 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. 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 of 8th November 2016. 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. This article has made an attempt to assess how the tool of Demonetisation can be used to eradicate parallel economy. Demonetisation is one of the big steps initiated by Government in addressing the various issues which have a negative impact in the total economy. Liquidity shock through Demonetisation disturbs the total Indian economy, and there is no exception to any sector, as the hard money is the prime factor for economic activities. The revolutionary initiative of the NDA government creates awareness among the dominant segments of BPL and middle in the Indian demography. The other sector critical sector which has been suffering is Banking and its cascading impact on Agriculture, Insurance, state governments' revenue, software and other related sectors which are influencing. Majority of the national and international economists, financial analysts opined that Modi governments decision of Demonetisation, is a panacea for chronic issues which hinder the fast growth rate of Indian economy.*

Introduction

Demonetisation is the act of stripping a currency unit of its status as Legal tender. 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. Sometimes, a country completely replaces the old currency with new currency.

Meaning of Demonitisation

The dictionary meaning of Demonetise is "To deprive (a metal) of its capacity as a monetary standard" or "To withdraw from use as currency" So, Demonetisation is the act of stripping a currency unit of its status as legal tender. It is the act or process of removing the legal status of

currency unit. A currency on which Governor of RBI on behalf of Central Government guarantees by making statement "I promises to pay the bearer, the sum of money" which empowers it a legal status. From the date of Demonetisation, all old currencies which are demonetized will cease to be a legal tender. Such currency cannot be used as money to do any transaction henceforth, but to replace with a new currency.

History of Demonitisation in India

India had an experience of Demonetisation of its currency twice before. The first was when Rs. 1000, Rs. 5000 and Rs 10000 notes were taken out of circulation on 12th January 1946, a 1 ½ year before the Independence. The highest denomination note ever printed by RBI in India was Rs. 10000 note introduced for the first time in the year 1938.

However all three of Rs. 1000, Rs 5000 and Rs. 10000 notes were again reintroduced in 1954. The second phase of Demonetisation was done on 16th January 1978 when an ordinance was promulgated to phase out notes with denomination of Rs. 1000, Rs 5000 and Rs. 10000.

On 12th January 1946 Demonetisation was resorted to but the Direct Tax Enquiry Committee in its interim report observed, "Demonetisation was not successful then, because only a very small proportion of total notes in circulation were demonetized in 1946 and its worth was Rs. 1,235.93 crores". On 16th January 1978, Demonetisation of high denomination notes was introduced. The high Demonetisation notes as on that day amounted to Rs. 146 crore and total notes tendered to RBI amounted to Rs. 125 crore as per data available till August 1981.

On 8 November 2016, India's Prime Minister Narendra Modi announced the Government of India's decision to cancel the legal tender character of ₹500 and ₹1,000 banknotes with effect from 9 November 2016. He also announced the issuance of new ₹500 and ₹2,000 banknotes in exchange for the old banknotes.

While the announcement essentially rendered the ₹500 and ₹1,000 banknotes invalid from 9 November 2016, the Ministry of Finance has been monitoring the implementation of these measures in a number of ways:

- Exchange of old currency notes for new ₹500 and ₹2,000 currency notes has been permitted until 31 December 2016 (i.e. 50 days from the date of the announcement)
- Such currency exchanges have been limited to certain specified amounts announced from time to time and excess amounts are required

to be deposited with banks subject to applicable KYC requirements

- Cash withdrawals have been limited to ensure adequate supply of new currency notes
- Usage of old currency notes has been permitted for certain specified periods and purposes, such as at hospitals and pharmacies, gas stations and foreign currency exchange for tourists

The Demonetisation of the highest denomination currency notes is part of several measures undertaken by the government to address tax evasion, counterfeit currency and funding of illegal activities. The requirement to deposit currency notes in excess of specified limits directly into bank accounts has resulted in the declaration of hitherto unaccounted income, subject to higher tax and other penalties.

Objectives of Demonetisation:

The main objectives of Demonetisation are:

1. To eradicate black money
2. To remove counterfeit currency
3. To fight against terrorism
4. To stop money laundering activities
5. To mitigate corruption and so on

Research Methodology

The paper is based on secondary data. The data has been collected from internet.

Impact of Demonitisation on Indian Economy

These Demonetisation measures have had significant and immediate impact on the state of the Indian economy. These measures are also expected

to result in long-term impact on certain industries and sectors.

These measures have resulted in a significant decrease in liquidity in the short term, which is expected to ease gradually with the introduction and circulation of the new currency notes. As a result of these measures and increased deposits with banks, the bank deposit base has increased significantly, and financial savings are expected to increase as a result of the shift from unproductive physical asset based savings to interest-bearing financial assets. This, in turn, is expected to enhance the liquidity position of banks, which can be leveraged for lending purposes.

The 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 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 supply will decrease permanently. However gradually as the new notes 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 the 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.

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.

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 Demonetisation process and the introduction of new notes in circulation.

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

In spite of the initial hiccups and disruptions in the system, eventually this change will be well assimilated and will prove positive for the economy in the long run.. The overall economy is expected to benefit from a decrease in unaccounted cash transactions and an elimination of counterfeit currency notes, leading to more effective tax collection and increased transparency in ascertaining transaction costs. Black money hoarders will definitely lose out, eventually boosting the formal economy in the long run. Short term fall in real estate prices might benefit middle class citizens. An increase in transparency is also likely to improve attractiveness for foreign

investors, while higher bank deposits and formalizing large hitherto unaccounted for income streams is expected to improve the fiscal deficit of India. This move by the Government along with the implementation of the GST will eventually make the system more accountable and efficient.