

Effect of demonetisation in India

¹ Athira TA, ² Bindu PK, ³ Kavya KR

^{1, 3} M com, M Phil, Assistant professor on contract, Carmel College Mala, Kerala, India

² Research scholar, St Xavier's College for Women Aluva, Kerala, India

Abstract

In an important move, the Government of India declared yesterday that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 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. 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. The demonetisation was done in an effort to stop the counterfeiting of the current banknotes alleged to be used for funding terrorism and for cracking down on black money in the country.

Keywords: Demonetization, India, corruption, currency

Introduction

Demonetization means that Reserve Bank of India has withdrawn the old ₹500 and ₹1000 notes as an official mode of payment. According to Investopedia, demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is essential whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit. The demonetisation was done in an effort to stop the counterfeiting of the current banknotes alleged to be used for funding terrorism and for cracking down on black money in the country. Following the announcement by the Prime Minister and the Governor of the Reserve Bank of India (RBI), Urjit Patel made a press release with details on the procedure for exchanging the 500 and 1000 rupee notes that are currently in circulation. On 8 November, other than the notification that these denomination will be discontinued. This study mainly used secondary data which is collected from different newspapers and websites.

There are potentially two ways in which the pre-demonetisation money supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be accessible only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange.

Demonetization is the act of cracking a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. It also helps to wipe out the black money and black market activities. The old unit of currency must be retired and replaced with a new currency unit. The coins issued under the authority of Section 6 of The Coinage Act, 2011, shall be legal tender in payment or on account. The demonetisation was done in an effort to stop the count of terrorism and for cracking down on black money in the country especially in the real estate world.

Need for the demonetisation

Demonetization is very essential due to this stage to control the over flow of currency. The fake Indian currency notes in higher denomination have increased. To trace the unaccounted money, often used in any form of corruption or illicit deals, usually takes the form of high-value notes, which in this case are the Rs 500 and Rs 1,000 bills. The Financial Action Task Force, a global body that looks at the criminal use of the international financial system, notes that high-value bills are used in money laundering schemes, mugging, and drug and people trafficking. Comparison of high value bills across the world. To control the black activities in the real estate area. In India, up until now the highest denomination note was Rs 1,000 and this was 1,000 times the smallest denomination note of Re 1 (Note: Re 1 notes are issued by the ministry of finance). When a currency has notes of higher denomination, it is easier to launder money i.e. store black money, as it takes less space and weighs less as well.

The positive side of demonetisation

Deposits increase for the banks and that means eventually interest rates might come down. Curb on black money,

corruption, terrorism etc. Boost to cashless economy with people adopting habits of wallets and other e –banking technologies. Boost to Jan Dhan Account’s relevance for poor people. Would be interesting to factor the surge in new account creation and activity in dormant accounts. Politics and various elections are known to run on cash. Same is the case with sectors such as real estate. Demonetization will likely result in people adopting virtual wallets such as Paytm, Ola Money etc. This behavioural change could be a game changer for India. Govt. is also introducing schemes of discounts for digital transactions. E.g.: Fuel stations/Railway tickets/Life Insurance etc.

New launches are expected to dry up rapidly as realtors adopt a wait and watch approach and customers anticipate a further drop in housing prices. The situation will be aggravated as new approvals will be slow and builders will have to be more compliant with the Real Estate Regulatory Act (RERA) which comes into effect next year. "The RERA will put a lot of unorganised players out of the market as they will not be able to start any project before they have all mandatory certificates with them. Moreover, approvals have been slow and input cost, including labour cost, is set to go up," said Razack.

The negatives side of demonetisation

Public will face minor problem for a few days owing to the scarcity of lower denomination notes in the system. Everything else being equal, withdrawal of currency in circulation, in the short-run, might actually drive up interest rates. Short-term liquidity squeeze could be severe and hence economic activity could suffer. Supreme ruler credit rating possibly no impact. But if there are short-term impact on economic activity which dampens government revenues and widens deficit, you can expect a short term decline in ratings. Cost of printing the new currency (if high) would create another political rumpus. Immediate chaos and public mayhem (which will bring out potential issues of execution). There is need for a significant upgrade of the banking system as well as in the telecom infrastructure that would provide the backbone for digital transactions. For people to be able to transact at any time and place as well as for them to consider it a steadfast medium of exchange, it is important that not only the banking system is upgraded to ensure that transactions can be completed without a hold-up, but the supporting infrastructure too is up to the mark.

Effect of Demonetisation

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 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.
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 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.

3. **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.

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.
 - Retail outlets

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

With a view to curbing financing of terrorism through the proceeds of Fake Indian Currency Notes (FICN) and use of such funds for subversive activities such as espionage, smuggling of arms, drugs and other contrabands into India, and for eliminating Black Money which casts a long shadow of parallel economy on our real economy, it has been decided to cancel the legal tender character of the High Denomination bank notes of Rs.500 and Rs.1000 denominations issued by RBI till now. The timing of the announcement has been somewhat of a surprise. The demonetisation undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be “black money” and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange.

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