



Impact of Demonetization in Indian Economy

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Abstract

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency. While this is the third time in the Indian history that Indian high value currency has been stripped of its status as a legal tender, the first two instances of demonetization did not have an impact like the recent one. This is primarily because, this time, the demonetized currency represents 86% of the total currency in circulation. Immediate impact People's purchasing power would be lowered resulting in a reduction in demand since they are left with no cash. Though some may presume that prices will fall as supply would exceed demand, there is a possibility of prices rising if supply too is curtailed. Since money supply has been severely contracted, certain sectors will be hit hard as cash transactions will stop. As income and consumption are closely linked to transactions, they would be severely contracted. The most of the people affected in demonstration India.

Key Word: Money, Income, Transactions, Demonetization, Reduce Corruption, Economy etc.

Introduction

Demonetization 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.

Understanding Demonetization

Removing the legal tender status of a unit of currency is a drastic intervention into an economy because it directly affects the medium of exchange used in all economic transactions. It can help stabilize existing problems, or it can cause chaos in an economy, especially if undertaken suddenly or without warning.

The first currency ban:

In 1946, the currency note of Rs 1,000 and Rs 10,000 were removed from

circulation. The ban really did not have much impact, as the currency of such higher denomination was not accessible to the common people. However, both the notes were reintroduced in 1954 with an additional introduction of Rs 5,000 currency. Rs 500 and Rs 1000 notes were introduced in 1934 and after four years in 1938, Rs 10,000 notes were introduced.

The second:

That came in 1978; the then Prime Minister of India Morarji Desai announced the currency ban taking Rs 1000, Rs 5000 and Rs 10,000 out of circulation. The sole aim of the ban was to curb black money generation in the country.

The Third:

The Prime Minister of India, Mr Narendra Modi, took the entire country by surprise when he declared demonetization of INR 500/- (USD 7.69)



and INR 1,000/- (USD 15.4) currency on 8th November, 2016. As per Modi Government, the agenda of this move was 3 fold:

- To eliminate counterfeit currency;
- To shrink the size of the parallel economy and black money in India; and
- To reduce corruption.

While this is the third time in the Indian history that Indian high value currency has been stripped of its status as a legal tender, the first two instances of demonetization did not have an impact like the recent one. This is primarily because, this time, the demonetized currency represents 86% of the total currency in circulation

The first instance was in 1946 and the second in 1978 when an ordinance was promulgated to phase out notes with denomination of Rs 1,000, Rs 5,000 and Rs 10,000.

A Times of India report (sourced in-house) published on 17th January 1978 said:

"A press note issued tonight said that the ordinance had been promulgated because there was reason to think that high-denomination notes were facilitating the illegal transfer of money for financing transactions which are harmful to the national economy or which are for illegal purposes. There has been concern in recent months over the behavior of agricultural prices particularly of edible oils. In spite of a bumper harvest agricultural prices are ruling much higher than after the poor harvest of 1976- 77. Massive imports of edible oil have failed to bring down prices and the

mustard oil price control order has failed miserably to give the consumer his requirements at the specified rate. There has been a feeling that a considerable amount of black money has gone to finance hoarding and speculation. The demonetization of high denomination currency notes will hit black money hard." Then, in 1977, the Janata Party coalition government came into power. A year into the government's term, party leader Morarji Desai was more bullish about cracking down on counterfeits and black money. The High Denomination Bank Notes (Demonetization) Act, instated by the ruling party on Jan. 16, 1978, deemed the Rs1,000, Rs5,000 and Rs10,000 notes illegal for the second time.

Impact on Banks Deposit and Interest Rates - Positive

The growth in Bank deposits, which was at a 53 year low at the end of March 2016, has seen a spike ever since the demonetization was announced in India. The total deposits collected by banks amounted to Rs 6 trillion (~USD 92bn) by 23rd of November 2016. With this rate of money deposited, entire INR 15 trillion (~USD230 bn) of currency demonetized is expected to be deposited by end of December 2016. If most of these deposits being made in the banks are emergency savings of households, most of these deposits will be withdrawn after government uplifts the withdrawal limit. Given the huge surge in liquidity post demonetization, major banks in India like the ICICI (NYSE:IBN), HDFC (NYSE:HDB) and SBI have lowered their interest rates. For fixed deposit between 390 days to 2 years, ICICI bank has lowered interest rate to 7.10% from 7.25% while HDFC has made a reduction of interest rates up to deposits of 1 year



to 6.75% from 7% and to 6.5% from 6.75% on maturities ranging from one year to years. Similarly, SBI has also announced reduction of interest rates on deposits for select tenors. With the reduction in fixed deposit rates, a reduction in lending rate was on the cards. However, on Saturday, 26th November Reserve Bank of India (the Central Bank of the country) released a circular that banks will have to deposit a 100% CRR with the RBI on any incremental deposits due to demonetization. Although banks are seeking further clarification from the central government, if applied this move will shatter expectations of a sharp decline in interest rates

How Will Demonetization Affect Business in India in 2017?

It's work in progress. Three events dominated India's economic landscape last year, but whether they can be described as "progress" is debatable. One definitely isn't: the unseemly brawl that broke out over control of the Tata group with Ratan Tata returning as interim chairman after ousting incumbent Cyrus Mistry. A lot of dirty linen is being washed in public, putting partly in the shade the political charges being traded elsewhere.

The second is the goods and services tax (GST), whose objective is to replace all taxes levied by the federal government and the states with one central tax. The GST is scheduled to come into effect by April or-at the latest - by September. Although both houses of Parliament have approved the bill and the President has signed off on it, a GST Council is now squabbling over the details, which could delay implementation.

"The timing is not right for implementation," says West Bengal finance minister Amit Mitra, who is also chairman of the empowered committee of state finance ministers. He lays the blame squarely on the center's move to demonetize Rs500 (\$7.4) and Rs1,000 notes. "We all supported the GST under the premise that this would be the only destabilization factor," Mitra told a TV channel. "We did not know that there would be a much bigger destabilization in the form of demonetization that would be let loose on the country." According to Wharton emeritus professor of management Jitendra Singh, while it is too early to assess the impact of demonetization, the move raises long-term questions. "What will have been gained from this step, and at what cost and mostly borne by whom?" he asks. He notes that rival political parties that have protested against demonetization could "broaden their tactical agenda to harm or even derail the GST implementation." It also remains to be seen how the negative sentiment against demonetization could hurt the BJP and its allies in assembly elections in Uttar Pradesh in February-March, he adds.

How Will Demonetization Affect People in India in 2017?

demonetisation may spell doom for the economy. People have been forced to line up for hours, sometimes overnight, outside banks and ATMs to get cash across the country. Realty, gold and the informal sectors have been hit the hardest as they rely heavily on cash. The situation is worse in villages where a large number of people are unbanked. The move has united the opposition, drawn criticism from experts, the public, and even the Supreme Court that said the problem was very serious and that



"the country will have riots on the streets". The NIPFP's recent paper examined the very short-term, short-term, and medium-term impact of the move on the economy. It said the impact in the medium term is dependent on how much of the currency will be replaced and how much of it is extinguished. The paper said if the extinguished currency was being used as a medium of exchange in legitimate economic activity, then the economy would contract. It also said if the incomes and consumption continue to be compressed, there could be social unrest. It added if the extinguished cash is being used in accounted transactions and the informal sector, then the impact on the economy could be substantial, resulting in a closing down of these activities. This would lead to a reduction in incomes and employment. The effect could then spill over to the organized sector as consumption from the incomes generated would be linked to it. Immediate impact: People's purchasing power would be lowered resulting in a reduction in demand since they are left with no cash. Though some may presume that prices will fall as supply would exceed demand, there is a possibility of prices rising if supply too is curtailed. Since money supply has been severely contracted, certain sectors will be hit hard as cash transactions will stop. As income and consumption are closely linked to transactions, they would be severely contracted. If the entire currency is not replaced soon, a few sectors such as agriculture, automobiles and construction will be affected. It is the sowing season for the Rabi crop in some parts of the country and the harvesting season most purchases and sales in the segment would be made in cash. The farmers would find it difficult to sell their crops due to the cash crunch. This would

then affect their bargaining power, preventing them from getting a good price.

Though the move will result in a surge in bank deposits, bank lending wouldn't go up as there is little demand for credit. It further said if the demand for credit is not sensitive to interest rates, then banks could take more risks while lending. That most people with large amounts of black money do not keep it in cash. So the government still has the opportunity to take corrective action. It can either roll back the move or allow people to use the old currency notes for a few more months, or even postpone the deadline to submit them.

Conclusions

Due to poorly executed plan by government, people are suffering. a great impact of this move of the Central government on Indian Society and Economy. The first and foremost impact was that people had lower expenditure power. There were no ostentatious expenditures on marriages and other ceremonies.

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