International Journal of Humanities and Social Science Research
ISSN: 2455-2070; Impact Factor: RJIF 5.22
Received: 20-04-2020; Accepted: 10-05-2020; Published: 28-05-2020
www.socialsciencejournal.in
Volume 6; Issue 3; 2020; Page No. 52-54

Demonetization and its impact on Indian economy

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Abstract
Demonetization is required whenever there is a change of national currency. The monetization process involves introducing a new currency or a coin in the same currency, or completely replacing the old currency with a new currency. There are many reasons why countries demonetize their own currency. Some reasons include combating inflation, combat corruption, and discouraging cash systems. The Demonetization was a huge step taken by the Government of India to curb the Black Money from the Nation. This was the third time in Indian history that the government insisted to demonetize the high denomination notes to attack black currency. The main goal of demonetization in 2016 was to stop the circulation of counterfeit notes in the economy, along with black money removal, stop corruption and funding for terrorist activities. The basic ideology of the policy was to create short-term impacts for long-term purposes and to curb corruption in the economy. The study attempts to understand implications and reasons of demonetization, the sector wise impact of demonetization and an insight into the positive and negative impact of demonetization on Indian economy. This study shows that demonetization had a shorter-term impact than the long-term, and generally failed to achieve its main goal.

Keywords: demonetization, black money, Informal sector, RBI, Economic development, currency

Introduction

Demonetization is the act of removing a currency unit in a state with a purpose. It is required whenever the national currency changes. In the process, the national currency is replaced with a new currency unit. The concept of demonetization is not new to the world, and some countries have embraced it to strengthen the economic recession. And there are many reasons why countries make money in currency. For reasons such as checking inflation, deterring corruption, and encouraging cashless transactions, it ensures transparency within all existing legal trading modes of the country, helping the country's economic development.

Demonetization was carried out by many economies of the world. In 1971, Britain monetized the currency to prevent the circulation of the old currency. However, as the government gave people enough time to send and receive money, and also using money from all banks to ensure the smooth functioning of the national economy, citizens and the economy had little effect on this change. In the case of Congo, commodity prices and stock prices increased due to corruption and sudden demand for currency during the ethnic War. But demonetization was a failure, and the economy led to the fall of the dictator, and as a result, demonetization was over. In 1982, Ghana withdrew 50 negative notes to address the tax evasion issue, and in 1987 the Myanmar government adopted demonetization policy to curb the black market. However, this can lead to economic turmoil, with daily activity paralyzing and rising inflation. In 1984, the Nigerian government banned old banknotes and introduced new currencies. But inflation hit the country and the economy collapsed. In 2010, the demonetization of North Korea left their people without food and shelter. Also, in Russia, a coup attempt was made due to demonetization policy, and which collapsed his authority and led to the Soviet Union.

Many of these countries have conducted an appropriate level of layoffs without adequate safety checks in a new economy, but in the end it has become the worst nightmare, leading to the decline of the government, and people have fallen into little or no money. As such, it can be dangerous and fatal to the country's growth and economy over the next few years, so the results of demonetization will only occur if governmental alternatives are taken into account and existing defects are re-checked and linked into an organized system. And some countries, such as the European Union, Pakistan, Zimbabwe, Australia, and the United Kingdom, with their systematic and organized systems, have proven demonetization as successful in the economy.

The objective of the study is to examine the context of demonetization and to assess the impact of demonetization on the Indian Economy. The study is based on secondary data.

History of Demonetization in India

Demonetization of 1946

In 1946, the currency notes of Rs.1,000 and Rs.10,000 were demonetized. The higher denomination notes were not accessible to common people at that time. So, the currency ban did not have much impact on the common people and the Indian economy. Furthermore, it severely impacted functioning of State Bank of India as there were only 71 bank offices at that time. The bank’s profits also took a hit and they were low as compared to that of previous years. The stock market rallied for two continuous years post the demonetisation reflecting impact on economic activity.

Demonetization of 1978

In 1978, Government demonetised Rs.1000, Rs.5000 and Rs. 10,000 notes. Similar to the recent episode, this action was kept confidential and yet an ordinance was issued to carry out the exercise. However, that ordinance contained sufficient measures for the exchange of the old notes and clearly stated the power of central government in framing of the rules. There was a political angle involved in 1978 demonetisation as the then newly formed Janata government wanted to target some of the alleged corrupt elements in the government. The impact of currency ban on common people was limited as the demonetised notes formed only a small portion of the total money supply. However, the move of the Morarji Desai government did not affect the public, and did not end the lashing of "Black Money".

Demonetization of 2016

The total currency in circulation as on March 31, 2016 was Rs.16,415 billion of which notes of Rs.1,000 denomination account for 38.6 per cent (Rs. 6,326 billion) and Rs.500 account for 47.8 per cent (Rs. 7,854 billion). The importance of Rs.500 had been increasing over the years, from 4.1 per cent on March 31, 1990 to 47.8 per cent on March 31, 2016. Similarly, the share of Rs.1,000 note had increased from 1.7 per cent in 2001 to 38.6 per cent in 2016. The total amount of Rs.500 and Rs.1,000 notes amounted to Rs.14,180 billion as compared with India's GDP of Rs.1,35,761 billion in 2015-16 or about 11.5 per cent of GDP, increasing nearly threefold from 2.8 percent in 2001. The history of Rs.1,000 note is interesting. It was first introduced in 1938 and then demonetized in January 1946. It was re-introduced in 1954 and again demonetized in 1978 only to be re-introduced in 2000. The Rs.500 note was introduced in October 1987-88.

On November 8, 2016, the government announced a historic measure by which the two largest denomination notes, Rs 500 and Rs1000, were "demonetized" with immediate effect, ceasing to be legal tender except for few specified purposes. As an one time measure,

86 percent of the cash in circulation was thereby rendered invalid. These notes were to be deposited in the banks by December 30, 2016, while restrictions were placed on cash withdrawals. The objectives of demonetization were to curb corruption; counterfeiting; the use of high denomination notes for terrorist activities; and especially the accumulation of "black money", generated by income that has not been declared to the tax authorities. The public debate on demonetization has raised three sets of questions. First, broader aspects of management, as reflected in the design and implementation of the initiative. Second, its economic impact in the short and medium run. And, third, its implications for the broader vision underlying the future conduct of economic policy. In this context an attempt is made to examine the impacts of demonetization on Indian economy.

Impact on Indian Economy

Demonetization destroyed informal sector which account for 85% of Indian workers and contribute 45% of GDP of India. According to national commission for employment, the entire agriculture except the large plantations came under informal sector. Like a human body transformed to a state of paralysis due to lack of blood for circulation, informal sector economy is transformed to a paralysis situation due to lack of cash. Demonetization has pushed the informal economy to a structural retrogression suppressing investment, production, employment, income, consumption etc. It created unprecedented misery, pains and acute financial problems to the entire workers in the country except the 15 per cent in the organized sector.

Agricultural and Allied Sectors

Agriculture depends heavily on cash on its operations and cash shortage has adversely affected all operations of agriculture from sowing to reaping. Products of markets were disrupted and there was no demand for the harvested products. Large quantities of perishable agricultural products like fruits, vegetables, flowers etc. were destroyed due to lack of demand. In the case of certain crops, the fall in the price was more than 50 per cent during the first week of demonetisation. There was steep fall in the growth of bank credit for agriculture. Similar to an earthquake destroying the entire economy, demonetization has adversely affected agricultural sector.

Small and Medium Enterprises (SME) Sector

Due to acute shortage of cash, resulting in lack of demand for goods, lakhs of SME units were shut down. This severely affected small-scale business. According to Centre for monitoring Indian Economy (CMIE), demonetisation caused loss of about 15 lakh jobs. The micro and small industries sector witnessed a negative growth in bank credit during the post demonetisation period. Companies in the organised sector effected substantial cut in the production due to lack of demand for products. This had badly affected the small-scale producers supplying goods and their finances. There was fall in industrial products produced in the informal sector. Demonetization adversely affected some segments of export sectors such as readymade garments, gems, jewellery etc.

Banking Sector

There has been a significant impact on banking sector due to demonetization. The sudden surge in liquidity brought down the interest rate affecting asset quality. Domestic credit rose steeply between October-December 2016. It started to ease out recording a slight dent in February 2017 but picked up to a new high since July 2017. Similarly, Non-Food credit has also recorded an upward trend since November-2016 while witnessing an 8.7 percent growth till February 2017. Demand and Time deposits have been increasing since demonetization. Demand deposits particularly reached a staggering high of Rs. 12.95 trillion and after easing out for a short duration have rebounded to the same level in September 2017.

Costs to RBI

When the demonitisation was announced, the RBI was not prepared to replace the amount of currency notes recalled. Currency printing machines had to work overtime to achieve their goals. The RBI spent close to 13,000 crores over the next two years to generate revenue for the Indian currency market in the post-withdrawal phase. New notes for Rs 500 and Rs 2,000 had been introduced. The design was significantly different from the recalled one. There were several new features, which increased the cost of printing. According to the RBI report, Rs 7,965 crore in 2016-17 was used to print new notes for both old and new denominations.

In 2017-18, the amount spent on printing notes amounted to 4,912 rupees. The cost of printing notes after withdrawal was very high. The RBI spent 3421 crore rupees on printing currency notes a year ago, that is, 2015-16 (July to June). These high expenditures on the printing of notes influenced the profits of the RBI reflected in the dividends paid to the government. The RBI transferred a surplus 65,876 crore to the government in 2015-16. However, when grouping was conducted in 2016-17, dividends were cut by more than half. The RBI paid a dividend of $ 30,659. It rose again in 2017-18, but didn't touch the mark of 2015-16. The RBI allocated 50,000 crore rupees to the government earlier this month. The spoiler of RBI revenue seems to be demonetisation.

Money Market - Impact

Before demonetization, the Indian money market had a circulation of banknotes worth Rs 17.97 lakh crore on November 4, 2016. Banned banknotes represented 86.4% of the total amount in circulation. According to the RBI, the overall banknotes in circulation are worth Rs 18.03 lakh crore in March 2018. This means the volume of currency in circulation is 9.9 per cent more compared to March 2016-level. The proportion of high-denomination banknotes was 86.4% at the time of demonetization. The RBI reports that the ratio of 500 rupee and 2,000-rupee banknotes is 80.6%. This shows a 5.8% increase in the use of small value notes.

Was Demonetisation a Success

The government argues so officially. Economic Affairs Secretary Subhash Chandra Garg says that demonetisation has achieved its goal. The currency of the system is currently 87-88%, i.e. about 3-4 lakh crore less than the old system.

Another claim was an attack on counterfeit bills after withdrawal. However, according to the RBI report, the detection of fake Rs 500 and Rs 1,000 notes decreased 59.7% and 59.6% after withdrawal. However, the detection of forged notes increased in the Rs 100 and Rs 50 denominations. "The counterfeit bill on the denomination of Rs 100 increased 35% compared to the previous year, while the counterfeit bill on the denomination of Rs 50 increased by 154.3%," RBI said. The government said in August 2017 that almost 3 lakh crore money left outside in the banking system was deposited in the bank after withdrawal. It claimed that black money over Rs 2 lakh crore reached the bank. More than 105 people have died in cash related incidents since the post-demonetization era. In addition, demonetization also affected small businesses. According to the CMIE (Indian Economic Monitoring Center), about 15 lakh jobs were lost from January to April 2017 with figures from September to December 2016. Between the supporters and the opponents of democratization, a new word war broke out, sorted broadly according to the political gap.

One of the main reasons behind demonetisation move was to curb black money but only a small portion of the black money is actually stored in the form of cash. Most of the black money is kept in the form of land, gold and buildings etc. Hence the amount of unaccounted money deposited with the banks is only up to the amount of cash deposited.

Conclusions

The major aims of demonetization were to curb corruption; counterfeiting; the use of high denomination notes for terrorist activities; and especially the accumulation of “black money”, generated by income that has not been declared to the tax authorities. But demonetization has adversely affected the informal sector, agricultural sector, Small and Medium Enterprises.

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