



## Full Length Review Article

### DEMONETIZATION OF THE INDIAN RUPEE – AN OVERALL PERSPECTIVE

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#### ABSTRACT

The sudden move of the government to demonetize the two biggest denomination notes of Rupees 500 and 1000, from midnight of 8<sup>th</sup> November 2016, has caused ripples in the economy. The entire issue has become a contentious one with arguments being voiced for and against the decision. Simply speaking demonetization would refer to replacement of old currency with new currency units. The objectives of this step include: curbing corruption, restraining parallel economy and controlling terrorism. The proponents point out that the move will help in cracking black money, curbing illegal activities, generating revenue, lowering interest rate, promoting growth, spreading digital culture, helping in the growth of formal economy and encouraging savings in financial forms. On the other hand, critics opine that demonetization has several demerits such as in a country like India it is difficult to share taxes as a proportion of GDP, it adversely affects daily wage earners, causes a lot of hardships to the common man, is ineffective in controlling black money as only a small proportion is in the form of cash and leads to increasing costs on account of issuance of new currency. The demonetization move has had its impact on several sectors of the economy. The point worth noting is that It has many hurdles to face and although a generally acclaimed welcome move, only time will reveal its true benefits.

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#### INTRODUCTION

On the 8<sup>th</sup> of November 2016, in a late evening televised address to the nation, the Hon Prime Minister of India, Shri Narendra Modi, announced the decision of the Government to demonetize the two biggest denomination notes - namely the 500 and 1000 Rupee notes with effect from midnight of the same day. The latter accounted for over 85% of India's cash supply. This surprise move raised a storm. A sense of panic was generated, wherein a lot of arguments were expressed for and against this move. The common man was the main sufferer with the cash starved banks having to combat extreme pressure. In the light of the gravity of the situation, humble efforts have been made to look into the concept of monetization, mention examples of such moves in our own country as well as in other countries, examine the benefits and drawbacks of demonetization, discuss its effects, make suggestions and end with a note on the expected future outcome.

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#### Concept of Demonetization

Demonetization can simply be defined as stripping a currency unit of its status as legal tender. This generally occurs when there is change of national currency. The old currency may be retired and replaced with a new currency unit. The same could be attributed to various factors such as fighting inflation, controlling corruption and discouraging the cash system. The process can either involve introduction of new notes or coins of the same currency or be characterized by complete replacement of the old currency by the new one. In 2015 Zimbabwe demonetized the Zimbabwean Dollar as a measure to fight inflation which touched 2, 31,000,000%. The three month process involved removing the Zimbabwean Dollar from the country's financial system and solidifying the US Dollar, Botswana Pula, and South African Dollar as the country's legal tender with the aim of stabilizing the economy. But with the fragile current state of the economy the decision did not seem to work as the prospects only portray a dismal economic situation even in 2016. Another example of demonetization occurred in 2002, when the nations of European Monetary Union adopted Euro as a common currency. With the introduction of Euro the old national currencies were demonetized. However, the old currencies

remained convertible into Euro for a while so that smooth transaction, through demonetization, would be assured.

### **Monetization in India**

Before independence in 1946 bank notes of 1,000 and 10000 were withdrawn and new notes of 1,000, 5,000 and 10,000 were introduced in 1954. The Janata Party Coalition Government had on 16<sup>th</sup> January 1978; demonetized bank notes of 1,000 and 5,000 and 10000 to curb counterfeit money and black money. The method used by the Government to implement the decision was through an Ordinance which was later converted into a special legislation – The High Denomination bank notes (Demonetization) Act 1978. These moves essentially failed because only 15% of the high currency notes were exchanged as against 85% in recent times. In addition the Wanchoo Committee appointed in 1970, had recommended demonetization which was followed by periodic discussions on the implementation of the same. Besides, the problem of issuing counterfeit currency was not very prevalent then. All this hampered the success of the move. As mentioned earlier Hon Shri Narendra Modi announced that bank notes of Rupees 500 and 1000 of Mahatma Gandhi series would cease to be the legal tender from 9<sup>th</sup> November 2016. He further added that new Rupees 500 and 2000 of bank notes of the Mahatma Gandhi series were being issued in exchange for the new notes. However, bank notes of denominations of Rupees – 100, 50, 20, 10 and 5 of the Mahatma Gandhi series and Rupees 2 and 1 would remain unaffected by the Policy.

The following steps were taken:

- Existing Rupees 500 and Rupees 1000 notes to be invalid from midnight of 8<sup>th</sup> November 2016;
- All banks and ATMs to remain closed on 9<sup>th</sup> and 10<sup>th</sup> November 2016;
- All old (demonetized) notes should be deposited in the banks from 11<sup>th</sup> November 2016 to 30<sup>th</sup> December 2016;
- After 30<sup>th</sup> December 2016 old notes will be accepted in RBI up to 31<sup>st</sup> March 2017 after making a declaration and submitting adequate proofs;
- Cash withdrawals was limited to Rupees 10,000/ per day and Rupees 20,000 (subsequently raised to Rupees 24000) per week;
- New Rupees 500 and Rupees 1000 and Rupees 2000 were issued by the RBI.

### **Objectives of Demonetization**

One could state the main objectives of demonetization as:

#### **Reduction of Corruption**

Corruption has been a major issue undermining India's economic growth. Its control requires effective administrative system and technology based data processing. Demonetization it is hoped would help in controlling corruption;

#### **Curbing Terrorism**

Demonetization would help in choking the financing of militancy, drug trafficking and terrorism from across the borders;

### **Restrain Parallel economy**

The general feeling was that the sudden move would catch the black market off-guard. High denomination notes were used for storage of unaccounted wealth. Demonetization would help in restraining the parallel economy. On the basis of the above, one can safely say that demonetization would be having a positive outcome as it would be pushing millions of new users onto the country's digital economic growth.

### **Impact of Demonetization**

Demonetization can be looked at as a memorable experience having its effects far and wide. Let us try to turn our attention to the impact of demonetization on the various sectors of the economy.

#### **Impact on the Parallel economy**

The government is optimistic that, this move would temporarily halt the circulation of large amounts of counterfeit currency and curb the funding of anti-social elements like smuggling, terrorism, espionage etc.

#### **Impact on GDP**

In the short run demonetization would adversely affect consumption. This coupled with the negative impact on real estate and informal sectors may lead to lowering of the GDP growth. The people most affected would be the lower strata of society who use currency to carry on transactions.

#### **Deflationary Effect**

Reduction in money supply can have a temporary deflationary effect, which would subsequently subside with the increase in money supply.

#### **Impact on Bond Markets**

Monetization will result in greater demand for both government and other bonds leading to a lower bond yield. At the same time a reduction in leakages in case of systemic liquidity will reduce the scope for open market purchases.

#### **Impact on stock and bullion market**

The gold prices went sky rocketing immediately after demonetization but have now been showing a downward trend. Likewise the stock market is also showing signs of crashing.

#### **Impact on commercial banks**

With demonetization, one is witnessing heavy rush to deposit money in both the savings and commercial accounts of commercial banks. This would immediately improve the liquidity position of banks which could be vital for lending purposes. But the entire effect could be short lived, as people would soon resort to withdrawals.

#### **Impact on Retail**

There is bound to be an impact in the short run due to lack of liquidity in the economy. Indian retail generates a lot of cash transactions and this move may lower the sales. Consequently

retailers are encouraging customers to use digital payment alternative to countering the losses incurred.

### Impact on economic activities

Demonetization is essentially a currency shock which puts a sudden stop on the availability of currency and will therefore disturb economic activities.

### Initiation of vicious circle of poverty

Fall in consumption would lead to fall in production which in turn would adversely affect employment and growth. The consequence would be fall in revenue which would adversely affect the growth of India's GDP.

### Merits and demerits of demonetization

The sudden move of the Government was the centre of debate in both Houses of Parliament where the opposition severely criticized the move. The demonetization move was also severely criticized by several leading economists, as apparently it had detrimental effect on small business, agriculture and transportation. Let us have a look at the Pros and Cons of Demonetization.

#### Merits

- One, the biggest advantage is that it will help to crack people with black money, because the latter tend to accumulate the money as cash at home and when demonetization occurs the accumulated cash has no value.
- Two, it curbs illegal activities because people with black money resort to activities like terrorism funding, gambling, money laundering and raising the prices of important assets like gold and real estate.
- Three by depositing money in banks government gets a good amount of revenue, which can be used for welfare purposes such as provision of better infrastructure, betterment of medical and educational institutions etc.
- Four, the inflow of money into bank accounts will lower the interest rates and this would have a stimulating effect on economic growth.
- Five there is a strong possibility of emergence of a cashless economy with the spread of digital culture. This would pave the way for 'formalization process'. The digitalized economic transactions will help reveal the expenditures – more particularly the big transactions – made by the individuals to the tax authorities.
- Experience of the developed countries reveals that, rapid development and extension of digital platform and digital payments can provide the speed, security, transparency and cost efficiency required to increase financial inclusion and fulfill the policy objectives.
- Six, in the long run the country would see the growth of the formal economy, with unorganized transactions being made accountable.
- Seven, there would be a long term rise in savings. Major portion of household savings are in physical form like gold and land. With low return on real estate and gold holdings people would be tempted to save in financial forms like bank deposits, mutual funds etc.

#### Demerits

Firstly, Paul Krugman, a Renowned American economist, was of the view that in a developing country like India with a large unorganized sector, it is difficult to raise the share of taxes as a proportion of GDP by relying on income tax. Secondly, critics point out that the demonetization move adversely affects the lower strata of society like the daily wage earners who are against the digital transaction culture. Thirdly, following days after the announcement of demonetization witnessed cash starved banks and ATMs across the country being characterized by long queues leading to sickness and even deaths in extreme cases. Fourthly, the move has been strongly criticized by the Ex Union Finance Minister Shri P. Chidambaram. Calling it a big scam, he said that it is demonization – that is exchange of old currency notes for new - and not demonetization in the true sense.

According to him all black money is not cash, in fact only 6% is in the form of cash. Apart from rendering anything positive, it has only dented the confidence of the people in the economy, which will negatively impact the economy, and most importantly cause misery to the common man. One can add here that the major attack of demonetization is on black money, but the same is used for real estate/gold purpose and hence it follows that there is no guarantee that demonetization will help in nabbing corruption. Fifthly, critics point out that replacing old currency with new ones would increase the costs which would have to be borne by the government thereby leading to rise in public expenditure. Finally as mentioned earlier this move of the government will hit the poor the hardest. This would thereby have an adverse effect on the welfare of the society

#### Suggestions /Recommendations

On the basis of the discussion so far one can make the following suggestions

- We must remember that India is essentially an Agrarian economy and from the point of view of the farmers the move seems to have come at the wrong time. Farmers are unable to get enough cash to buy seeds and fertilizers for their winter crops. The farmers who are just recovering from a two year drought are being put to severe hardships. The government has no doubt extended the date for use of old notes for the farming sector, besides Schemes are being introduced but they are taking their own time. Speedy implementation and provision of adequate safeguards is required in keeping with the interest of the poor and marginalized farmers.
- One of the advantages of demonetization experts say is digitalization of the economy. Digitalization is no doubt important in this information era, but one cannot, in this context forget the common man. Majority of them work in the unorganized sector and do not have bank account or ID proof and the question that arises is under this situation where do they exchange their old notes and deposit their savings. It therefore follows that it would be better to first introduce and extend digitalization, before going in for demonetization.
- One of the aims of demonetization is to attack black money, but the latter is only one facet of corruption. What is crucial here is to attack corruption at the grassroot level and carry it on in a sustained manner.

Besides one of the sources of black money is tax evasion, which is very rampant in India, more so in case of direct taxes like income tax. This calls for stringent measures to curb tax evasion and thereby try to put a hold on accumulation of black money.

- One of the major functions of money is precautionary motive, where people keep some liquid cash to meet future unwarranted emergencies like sickness, unemployment, old age, calamities etc. In addition they invest in assets like gold. Therefore all hoarding is not black money. A ceiling should be laid on the amount of cash that can be kept aside.

### Conclusion and Future of Demonetization

The announcement by Shri Narendra Modi thus has caused a lot of ripples with arguments being voiced for and against the move. While on one side some call the policy makers criminals for implementing the move; on the other side those opposing the same are called anti-nationals. Experts opine that the question is not whether the plan will be successful but rather will the cost of implementation be worth it. One can fully understand the government's aspirations for India. After all India boasts of the largest young population possessing Renowned Brain Power, which is bursting with potential in a computerized era of digitalization and accelerated growth. The pertinent question in every mind is whether this move will help curb the parallel economy in the long run. There is no doubt of the fact that black money holders must be feeling the heat. But the answer to the question of how far currency ban will help in curbing corruption, only time will tell. The long term gains will largely depend on speedy implementation. What is most crucial in this context is conversion of dreams into reality.

A worrisome factor is that soon after the announcement of the demonetization move reports have already started pouring in of seizures of new Rupee 2000 notes found in tranches between Rupees 1 Crore and 5 Crores by government agencies all over the country. The pertinent question emerging from this is how new notes have made their way in such pockets when there is paucity of funds to be disbursed through banks and other channels of distribution – thereby subjecting the common man to unnecessary turmoil. The answer is awaited. What is worse is there is general sense of fear and apprehension as rumors of fake 2000 Rupee notes are being circulated in the market.

This seems to have negated the purposes of demonetization such as drug trafficking at least in the initial stages. The demonetization move though appreciated by many has a number of hurdles to face and only time will tell us about the success of this measure.

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