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Commerce

Demonetisation and its Effects

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ABSTRACT

The decision of the Government to demonetise Indian currency especially the notes of ₹ 500 and ₹ 1000 caused a quake in the lives of Indians. Everywhere there the talk of demonetisation in the country was apparent. There was appreciation as well as criticism of the decision of the government. The central motive behind this big move was curbing black money, terror funding and stopping the use of fake currency available in the market. This article looks at the basics of demonetisation, its history, the Indian experience and its effects.

Meaning

Demonetisation refers to 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 taken out of circulation and retired, often to be replaced with new notes or coins. Sometimes, a country may completely replace its old currency with new currency.

Reasons for Demonetisation

There are various reasons for demonetisation of their local units of currency, they are:

- to combat inflation
- to combat corruption and crime (counterfeiting, tax evasion)
- to discourage a cash-dependent economy
- to facilitate trade

Instances around the world

1. Nigeria

In Nigeria during the government of Muhammadu Buhari in 1984, a new currency was introduced and banned the old notes. But, the debt-ridden and inflation hit country did not take the change well and the economy collapsed.

2. Ghana

In 1982, Ghana abandoned their 50 cedis note to counter tax evasion and empty excess liquidity. This encouraged the people of the country to support the black market and they started investing in physical assets ultimately making the economy weak.

3. Pakistan

From December 2016, Pakistan phased out the old notes as it brought in new designs. Pakistan legally issued the tender one and half years earlier and therefore, people had time to exchange the old notes and get newly designed notes.

4. Zimbabwe

Zimbabwe used to have \$100,000,000,000 note. Yes, a one hundred trillion dollar note! When President Robert Mugabe announced to fight inflation through this ridiculous value notes the Zimbabwean economy went for a toss. Post demonetisation, the value of the trillion dollar note dropped to \$0.5 dollar and also they were put up on eBay.

5. North Korea

The demonetisation in 2010 in North Korea left people with no food and shelter. With a view to banish black market, Kim-Jong II announced a reform that knocked off two zeros from the face value of the old currency.

6. Soviet Union

Mikhail Gorbachev ordered to withdraw large-ruble bills from circulation to counter the black market. The move wasn't received well by the citizens which resulted in a coup attempt which brought down his authority and the led to Soviet breakup.

7. Australia

Australia became the first country to release polymer (plastic) notes to stop widespread counterfeiting. As the purpose was to replace paper with plastic where only the material changed, it did not have any side-effects on the economy.

8. Myanmar

In 1987, Myanmar's military invalidated around 80% value of money to curb black market. This decision resulted in an economic disruption which in turn caused mass protests that killed many people.

The Indian Experience

The first demonetisation was when ₹ 1,000, ₹ 5,000, and ₹ 10,000 notes were taken out of circulation in January 1946, a year and a half before independence from the British. Introduced for the first time in 1938, the ₹ 10,000 notes were the largest currency denomination ever printed by the Reserve Bank of India. The ban really didn't have much impact, as the currency of such higher denomination was not accessible to the common people. However, the notes were reintroduced in 1954.

In the early 1970s, the Justice Kailas Nath Wanchoo committee, a direct tax inquiry committee set up by the government, suggested demonetization as a measure to unearth and counter the spread of black money. However, the public nature of the recommendation sparked black money hoarders to act fast and rid themselves of high denominations before the government was able to clamp down on them.

One year after the Janata Party coalition government came into power in 1977, party leader Morarji Desai was more bullish about cracking down on counterfeits and black money. The High Denomination Bank Notes (Demonetisation) Act was brought into force on 16th January, 1978 and deemed the ₹ 1,000, ₹ 5,000 and ₹ 10,000 notes illegal for the second time.

Effects of the recent demonetisation in India Banking

The Country saw ₹3 trillion (US\$47 billion) in the form of old ₹500 and ₹1,000 banknotes being deposited in banks and about ₹500 billion (US\$7.8 billion) being dispensed through withdrawals from bank accounts, ATMs as well as exchanges over the bank counters in the first four days after the announcement of the step. Within these four days, the banking system had handled about 180 million (18 crore) transactions. The State Bank of India had received more than ₹300 billion (US\$4.7 billion) in bank deposit in first two days after demonetisation. Post demonetisation the country witnessed a spike in the usage of debit card and credit card.

Between November 10th and November 27th, banks reported exchange and deposits of demonetised banknotes worth ₹8.45 trillion (US\$130 billion) (exchange of ₹339.48 billion (US\$5.3 billion) and deposits of ₹8.11 trillion (US\$130 billion)). During this period, people had withdrawn an amount of ₹2.16 lakh crore

(US\$34 billion) from their accounts.

Human trafficking

Nobel laureate Kailash Satyarthi said that the note ban had led to a huge fall in sex trafficking. Satyarthi said the move to demonetise would be effective in combating exploitation of children as well as corruption and would prove to be a great obstacle to traffickers.

Radical groups

The Demonetisation had severely hit Maoist and Naxalites as well. The surrender rate has reached its highest since the demonetisation is announced. It is said that the money these organisations have collected over the years were left with no value and it has caused them to reach to this decision. The move also crippled naxalites financing through money laundering. It is also claimed that the move has also helped in reducing the incidents of stone-pelting in the Kashmir valley, this claim has been disputed.

Hawala

Mumbai Police reported a setback to Hawala operations. Hawala dealers in Kerala were also affected. The Jammu and Kashmir Police reported wide spread effect of demonetisation on hawala transactions of separatists.

Railways

Till November 2016, Indian Railways did not have the option of processing payment with cards at the counters. After the demonetisation move, card payment options were made available at railway counters in the country. Orders for card reader machines were placed in January 2017 by the railways.

Cash shortage

The scarcity of cash due to demonetisation led to chaos and most people holding old banknotes faced difficulties exchanging them due to endless queues outside banks and ATMs across India, which became a daily routine for millions of people waiting to deposit or exchange the ₹500 and ₹1000 banknotes from 9 November. ATMs ran out of cash within a few hours of being functional and around half the ATMs in the country were non-functional. Many people were reported to have died from standing in queues for hours to exchange their old banknotes.

Stock market crash

As a combined effect of demonetisation and US presidential election, the stock market indices dropped to a six-month low in the week following the announcement. The day after the announcement, BSE SENSEX crashed nearly 1,689 points and NIFTY 50 plunged by over 541 points. By the end of the intraday trading section on 15th November 2016, the SENSEX index fell by 565 points and the NIFTY index was below 8100 intraday.

Transportation disruption

After the announcement of the demonetisation, about 8,00,000 truck drivers were affected with paucity of new notes, around 4,00,000 trucks were stranded at major highways across India. Many major highway toll junctions saw long queues as toll plaza operators refused the old banknotes.

Nitin Gadkari, the Minister of Transport, subsequently announced a suspension of toll collections on all national highways across India until midnight of 11th November, later extended until 14th November and again until midnight of 18th November, and yet again till 2nd December.

Agriculture

The Indian agriculture sector heavily depending on transactions through cash was adversely affected by the demonetisation of ₹500 and ₹1,000 banknotes. With the scarcity of the new banknotes many farmers had insufficient cash to purchase seeds, fertilisers and pesticides needed for the plantation of rabi crops usually sown around mid-November. In many places of the country, the farmers and their unions conducted protest rallies against the demonetisation as well as against restrictions imposed by the Reserve Bank of India on district cooperative central banks

which were ordered not to accept or exchange the demonetised banknotes.

The demonetisation led to unavailability of cash to pay for food products. The reduction in demand led to a crash in the prices of crops. Farmers were not able to recover even the costs of transportation from their fields to the market as the prices offered were very low. The prices of onions and tomatoes dropped to as low as 50 paise per kilo. This forced the farmers across the country to dump their products in desperation and in protest against the government. Some farmers resorted to burying unsold vegetables.

Business

By the second week after demonetisation, cigarette sales across India witnessed a fall of 30–40%, while E-commerce companies saw up to a 30% decline in cash on delivery (COD) orders.

Digital transactions

The e-commerce companies welcomed the demonetisation decision as a push to increase digital payments, with a hope that it would lead to a decline in COD returns which could cut down their costs. There was a hike in the demand for point of sales (POS) or card swipe machines. After peaking in December 2016, digital transactions declined from January 2017 onwards, thus thwarting the objective of increasing digital payments through demonetisation.

Forecast of GDP growth rate

The forecasts by global analysts revealed a cut in India's GDP growth rate due to demonetisation. India's estimated GDP in 2016 was US\$2.25 trillion, hence, each 1 per cent reduction in growth rate would amount to a shortfall of US\$22.5 billion (₹1.54 lakh crores) for the Indian economy. Societe Generale predicted that, India's quarterly GDP growth rates would drop below 7% for an entire year at a stretch for the first time since June 2011.

Drop in industrial output

Industrial output declined as industries were hit by the cash crisis. The Purchasing Managers' Index (PMI) fell to 46.7 in November from 54.5 in October, recording its sharpest reduction in three years. The PMI report also showed a reduction in inflation in November was due to shortage in money supply.

The growth in eight core sectors, which constitute 38% of the Index of Industrial Production (IIP), was only to 4.9 percent in November as compared with 6.6 percent in October.

Job losses

There were job losses due to demonetisation, particularly in the unorganized, informal sector and in small enterprises.

Municipal and local tax payments

As the use of the demonetised notes was allowed by the government for the payment of municipal and local body taxes, people used the demonetised ₹500 and ₹1,000 notes for paying huge amounts of outstanding and advance taxes. This resulted in a jump in revenue collections of the local civic bodies.

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