

Demonetization - Cash Crunch or Cash Curse

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I. DEMONETIZATION – STORIES FROM THE PAST

Ever since our Honorable Prime Minister Mr. Narendra Modi, announced the idea of Demonetization at the night of November 8th, this has been the topic for discussion not only in India but also in all the countries that have been in a close trade relationship with our nation. At this point, it is very significant to turn the pages of Indian history and see the earlier times when similar ideas of demonetization have been implemented and its impact on the Indian economy.

Prior to the remarkable announcement on November 8, there were two similar instances in India. The first was in the year 1946, when India was a British territory. The then Governor General of India Field Marshal Archibald Wavell promulgated the **High Denomination Bank Notes (Demonetization) Ordinance**, the main object of it was to ascertain the amount of notes of the value of Rs. 100 and above held by Banks and Treasuries in comparison with the total note circulation. Congress stalwart Dr. Rajendra Prasad who went on to become the first president of India was not all praise for the ordinance. “I don’t know how far and to what extent the new ordinance will be able to affect people against whom they are intended. One thing is clear. A large number of people belonging to the middle and lower middle classes will be hit hard on the account of demonetization” said Dr. Prasad in one of his interviews to Daily Tej.

The next similar instance was on 1978. The **High Denomination Bank Notes (Demonetization) Act**, which replaced the Ordinance was brought into effect in early 1978. The purpose of the Act was prohibition of transfer and receipt of high denomination bank notes. However the Act was declared invalid on the grounds that it was against the fundamental right to trade and as it stood, then to property. Finally, in 1996, a five judge constitution bench of the Supreme Court upheld it as a valid legislation. “It can’t be said it was not enacted for public purpose” a bench of justices Kuldeep Singh, M M Punchhi, N P Singh, M K Mukherjee and S S Ahmad had said. There was no dissenting judgment.

II. SEVEN COUNTRIES THAT FACED FAILURE OF DEMONETIZATION

1. Soviet Union

In 1991, Mikhail Gorbachev Government banned currency note of Ruble 50 and Ruble 100 which was not welcomed by the people in a positive manner. It finally led to a change of the Government.

2. Ghana

In 1982, currency notes of Cedi 50 were declared valueless. This led to lot of controversies among the people and the Government and crores of money were found on the road.

3. *Britain*

To bring uniformity in currency, Government stopped circulation of old currency in 1971 and bought back coins of 5 and 10. However the policy failed in other countries except Britain.

4. *Congo*

Dictator Mobutu Sese made some changes with currency for smooth running of economy during 90s. But there were no better results.

5. *Myanmar*

Military Government discontinued currency notes in 1987 with the same thought of putting an end to black money and corruption. However this resulted in a political dispute and demonetization came to an end.

6. *Nigeria*

In 1984, Muhammad Buhari, the then President, started new currency notes to bring stability in the economic condition of the country. But it did not give any positive effects and Buhari resigned.

7. *North Korea*

In 2010, Dictator Kim Jong 2 made some changes with currency to lower down the market of black money and improve the economy of the country. But however this resulted in a rise in the price of necessity goods and Kim Jong murdered the Finance Minister in a rage.

III. DEMONETIZATION – SO WHAT NEXT?

Let's analyze the impact of demonetization in a detailed phase.

In an address to the Nation on November 8th, India's PM Modi announced that the two highest denomination notes 1000 and 500 rupee notes will not be a legal tender anymore. The notes were demonetized on midnight on November 8th, as a result of which 86% of India's currency was nullified. This was one of the boldest move by the PM to clean out black market's cash supply and counterfeit notes which completely disrupted the social, political and economic spheres of the World's second largest emerging market i.e our India. Also a 50 day period was given to the public to redeem their money.

IV. MAJOR CHUNK OUT OF CIRCULATION

According to Reserve Bank of India's Annual Report for April 2015 to March 2016, the value of the currency notes at the end of March 2016 was 16.42 trillion Indian rupees. The 500 and 1000 rupee notes forms 86.4% of the value. In one stroke, the Government removed 86.4% of the currency in circulation. In terms of volume, the currency notes of the two denominations formed 24.4% of a total 90.27 billion pieces.

V. THE IMPACT OF DEMONETIZATION ON THE INDIAN ECONOMY

Demonetization, undoubtedly, will hit the economy hard in the short run. As it was announced without any prior warning, the announcement will surely grind the consumption activity in the Indian economy to a virtual halt. The service sector which contributes the most to the economic activity involves a sizeable amount of cash transactions and will be the sector which will be affected the most in the short run.

VI. IMPACT ON THE ECONOMIC GROWTH

As per reports, growth in the Indian economy remained solid in the Quarter from April to June 2016. During that period, the Gross Domestic Product (GDP) rose 7.1%, while the Gross Value Added (GVA) rose 7.3%.

The relationship between GDP and GVA is given as follows:

$$\text{GDP} = \text{GVA} + \text{Taxes on products} - \text{Subsidies on products}$$

The base year for calculating the GVA is 2011-12.

The fall in the economic activity due to demonetization will last from two to three quarters at the maximum. As a result, there is a possibility that GDP and GVA growth in the Quarters from September to December 2016 and January to March 2017 could be significantly lower than the previous years. However, some improvement could be expected in the first Quarter of the fiscal year 2017-18. In due course, the Indian economy can be expected to grow considerably after nullifying the negative impacts caused by demonetization. A fall in discretionary consumption will affect the companies operating in many sectors but however a rise in the tax flow and lower interest rates might result in an improvement in the economy.

VII. IMPACT OF DEMONETIZATION ON INDIA'S INFLATION

The Reserve Bank of India considers the Consumer Price Index (CPI) as its primary tool to measure inflation. The RBI has CPI growth targets to adhere to, while deciding its Monetary Policy. By January 2016, it was expected to keep inflation below a target of 6%, which was successfully achieved by it. Its next target is to keep inflation at or below the 5% mark by March 2017.

The demonetization which has been in effect since November 9th, is expected to have a negative impact on inflation. As result of a crunch in the circulation of currency notes, there has been a sudden fall in the consumption activities of the public. The customers are refraining from indulging in any purchasing activities except buying essential commodities like food items, medicines and other necessities. The Real estate sectors which comprises majorly of undocumented transactions faced a lull. Metropolitan and Tier 1 cities reported upto a 30% fall in house prices.

Food item inflation, which is measured by the changes in the Consumer Food Price Index, accounts for 47.3% of the overall CPI. Due to 86.4% of the value of the currency notes in circulation going out of the financial system, both the supply and the demand for the food items fall automatically. This will exert more downward pressure on inflation.

VIII. IMPACT OF DEMONETIZATION ON INDIAN FINANCIAL MARKETS

Indian Equity markets have seen a falling trend since the Government demonetized the 500 and 1000 rupees notes after the midnight on November 8th. The two benchmark Equity indices, Nifty 50 and S&P BSE Sensex fell on each trading day since the day of demonetization except for on November 10 and 22. While the Nifty 50 fell 6.3% from November 8; until 22, the S&P BSE Sensex fell 5.9% during the same period. Due to the rise in the US dollar, the dollar equivalents of the Sensex and Nifty fell more than 8% each. The S&P BSE 100 index which is comprised of 100 stocks compared to the Sensex's 30, fell 6.6% during this period. Mid and Small Cap indices have been hit much harder than broader market indices. Even after a rise on November 22, the S&P BSE MidCap and the S&P BSE SmallCap indices fell 8.2% and 10.9% respectively, in the previously mentioned period.

IX. SO.... IS DEMONETIZATION A CURSE?

The real impact good or bad will be known only after the completion of the demonetization drive after March 2017. Its early impact has been felt positively on 'Hawala' Trade and terror financing. Demonetization of higher denomination currencies seems to have caused a serious death blow to funding of terrorism in Jammu and Kashmir as well as Left winged extremist violence across several states. With no unaccounted cash to fund violence and protests in the valley, the lead trouble makers have been forced to lie low.

To conclude, it will be a litmus test to PM Modi who gambled very boldly on the sensitive issue of black money. Presently the public have no other option except to wait to see whether they will be reaping the fruits of demonetization or they will be caught in the curse of cash crunch!!!!

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