

---

---

## DEMONETIZATION – AN APPROACH TO INDIAN MONETARY SYSTEM

**Dr.H.Sudhakara**

*Full Time Guest Faculty in Economics,  
Bangalore University, Bangalore,  
Karnataka*

---

---

### Abstract

*Demonetization is an act of stripping currency units of its status as a legal tender. The term demonetization is not new to the Indian economy. In 1938, Rs. 10,000 note was printed and again in 1954. These notes were demonetised in 1946 and 1978 respectively. But during those times, very few people had access to such high demonetization currency notes and that is why people had not suffered much. The act demonetization announced on 8<sup>th</sup> November 2016 is not demonetization in its strictest term but it is more of an exchange of old notes with new notes. While the increase in the circulation of notes of all demonetization had grown by 40% between 2011 to 2016, those of Rs. 500 note had increased by 76 % and those of Rs. 1000 note had increased by only 109%. However, the economy had expanded by only 30% in this period. This shows disproportionate increase of high demonetization notes.*

**Keywords:** *Demonetization, RBI, Pradhan Mantri Jan Dhan Yojana, Income Disclosure Scheme, black money, cashless' economy*

According to RBI, which manages currency in India on the basis of Reserve Bank Act 1939, as of March 2016, currency in circulation amounted to Rs.16415 billion, of these Rs.500 denomination notes accounted for 47.8% in value and Rs 1000 notes accounted for 38.6% in value. However together they were more than 86% the value of the notes in circulation. This tell us the existence of counterfeited currency of Rs.500 and Rs. 1000. That is because of some specific reasons. One reason is because they are easier to carry. Also because, it takes only Rs. 3 to print Rs.100 notes, which is 0.3% of the face value. But to print Rs.109 note require 96 Paise, hence 9.6% of the face value. Financial action task force that looks at the criminal use of international financial system notes that high value notes are used in money laundering schemes, racketeering, drugs and human trafficking.

This decision of demonetization was a pre-planned strategy of Government. First, Government announced Pradhan Mantri Jan Dhan Yojana (PMJDY) which offered people to open zero balance bank accounts.

This scheme entered into Guinness Book of World Records of highest number of accounts opened under this scheme. This account was linked to Aadhar Number which assured the identity of person with no existence of multiple accounts of same name. Then Government launched Income Disclosure Scheme (IDS) which said even if you have black money, uncounted money declares it and pay taxes on it. This got Government more than Rs. 65000 crore and finally demonetization was announced. We can look at demonetization on the basis of four dimensions which are busting of fake currency, fighting corruption, destroying black money and India moving towards cashless economy.

With this background the present paper seeks to examine the following are as follows:

1. Need for demonetization
2. Impact of demonetization

**DEMONETIZATION – AN APPROACH TO INDIAN MONETARY SYSTEM****Need for Demonetization**

Any decision to withdraw the legal tender status of currency in circulation creates a sense of confusion and some despair. The monopoly rights of the sovereign to issue currency notes and coins are asserted in reverse in demonetization episodes for achieving economic and political goals that seem difficult with normal policy measures. Its economic costs and benefits are hard to assess *ex ante*. More importantly, only a few among the population have a clear idea of how demonetization could deliver the intended outcomes. Even under the best of circumstances, it's a hard sell for any government. According to Investopedia, "Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit".

In India the demonetization announced at prime time on November 8 is among the rare, bold economic policy decisions in the history of independent India. It is clear that that a good bit of planning and preparation involving the ministry of finance and the Reserve Bank of India were completed beforehand. That this was done in absolute secrecy is no small feat. To be fair, the authorities have identified nullification of black money hoarded in cash, tackling of counterfeiting Indian currency notes, and curbing of terror financing with fake currency notes as the three objectives of this round of demonetization. But quite a few commentators and analysts have opined that this will engender a marked fall in the use of cash transactions in India and thus pave the way for the transition to a 'cashless' economy.

**Impact of Demonetization**

The immediate impact would be on the general cash market transactions until the current value denominations have been replaced with new ones. While the impact of the measures would bring about a disruption and ambiguity in the short term, there will be positive implications in the long run. Even if it does not completely eliminate the cash flow of black money, it would certainly raise the costs and risks of such activities significantly in future.

**Informal Sector in the Economy**

A large part of the informal sector that engages only in cash transactions will face disruption. Sectors to be impacted would be retail, transportation, metal scrap and dealings in agriculture land. In the long term, this initiative along with Goods and Services Tax (GST), will push the informal sector to become more organised and transparent. This changeover will occur over a period of time and this segment of the economy is likely to take the longest time to recover from the current impact.

**Money Supply**

Money supply is the basis for the result of the demonetization that took place in 1978; if 25-30 percentage of the unaccounted/ undeclared money does not come back in the system i.e. `3.5 million to `4.3 million, it will impact growth in money supply by approximately 3 percent. Considering the average growth of money supply for the last three years i.e. around 12 percent growth in money supply might moderate to 9 percent in near term. If the RBI decides to print the entire 86 percent of the high denomination currency, money supply will pick up with the new notes being gradually circulated over a period of time.

## DEMONETIZATION – AN APPROACH TO INDIAN MONETARY SYSTEM

### Interest Rates

With regard to the cash deposit by the households and business units in the banking system and the restrictions on withdrawals placed by the Government, liquidity has increased and is expected to surge further in the near term. This has led to reduction in deposit rates. With fall in the cost of funds, the lending rates are also expected to come down, with some banks already having initiated this move. Banks have reported that deposits effected from Nov 10, 2016 up to Nov 27, 2016 amounted to `8.1 million. The increase in funds in the banking system along with the fall in the Government borrowing owing to improved tax collection can herald a period of low interest rates in the near term.

### Savings

The note exchange terms and condition, to a larger extent, would impact the mind-set of the house hold sector. Thus, this move would bring about a change in the behaviour of the Indian population who would now prefer to keep cash in the banking system instead of hoarding it. The channelization of the cash savings in the formal banking system would be redeployed for physical and financial asset creation.

### MSME Sector

The MSME sector consists of approximately 51 million units and almost 93 percentage of them are unregistered. Small traders and businesses, particularly in the rural and semi-urban parts of India will be hit, mainly where modern banking is yet to make inroads and cash is the principle mode of transaction. Micro and small units which mainly thrive on cash transactions have been hit hard and face tight liquidity crunch and fall in business. Small and medium sized businesses across the country are likely to be struggling to cope with lower consumer demand, fewer supplies and pending salaries in the short term. It is likely to impact flow of funds to MSMEs in the short term.

### Impact on Select Sectors

The liquidity crunch and crackdown on black money on account of demonetization move is expected to have varying degrees of impact on sectors across the spectrum. Sectors with a high proportion of cash-based transactions would witness the most disruption. These would include real estate, retail, jewellery, hotels & restaurants and consumer durables, among others. From a short term perspective, demand slowdown is expected to be seen in certain sectors such as real estate, high-ticket consumer durables, jewellery, luxury brands, etc. However, over a period of time, with the introduction of new high value currency notes, the current short term liquidity concerns would be resolved. From a long term perspective, demonetization would be a big positive for the growing economy. Demonetization is a move towards a transparent & cashless economy particularly sectors such as infrastructure, real estate, hospitality, gold & jewellery, e-commerce etc.

### Long Term Impact

Demonetization is expected to have a long term positive impact on the infrastructure sector. The dividend realised by the government through benefit to the RBI's balance sheet, can be

**DEMONETIZATION – AN APPROACH TO INDIAN MONETARY SYSTEM**

used for need based funding. The direct positive impact on tax revenue collection will improve the government's ability to spend on infrastructure. This will have a multiplier effect as it will also drive employment and income in the related sectors. The government spending on the large infrastructure projects would kick start capex cycle and push economic growth higher in the mid to long term.

From a long term perspective, demonetization will bring in greater transparency in this sector and empower property buyers with buying decisions based on more realistic prices. This along with the Real Estate (Regulation and Development) Act will benefit the established and reputed developers by bringing in transparency in transactions. Construction activities are expected to be affected temporarily, due to which demand for cement, steel and other metals is expected to weaken in the short term.

**Conclusion**

In an important move, the Government of India declared that the five hundred and one thousand rupee noted will no longer be legal tender from midnight, 8<sup>th</sup> November 2016. This move expected to cleanse the formal economic system and declared black money from the same. It was a good move which reduce black and have a large impact on India. It is indication from the Centre that we need to move on and use technology more and more. While bureaucrats do a great job in administration of the country but they lack in subject matter of expertise giving such a technology challenging problem to bureaucrats is not the right thing.

**References**

1. Demonetization  
<http://www.investopedia.com/terms/d/demonetization.asp#ixzz4QRacCuLL>
2. How demonetization has impacted the Indian Equity Market data as on November 17, 2016 (Source: NSE, Personal FN Research)
3. Dr. Rangarajan, The writer was chairman of the economic advisory council to the Prime Minister and Governor of RBI.
4. Barendra Kumar Bhoi Demonetization's good policy too: The writer was principal adviser to the Monetary Policy Department, RBI. The views are personal. Via The Billion Press.
5. Radhika Merwin; Demonetization will serve two purposes, columnist, Business Line
6. Dipankar Dasgupta. (2016). Theoretical Analysis of demonetization, Economic and Political Weekly, December 7<sup>th</sup>, 2016 Vol II No. 51.
7. Vineet Kohli, R Ramakumar. (2017). Economic Rationale of demonetization, Economic and Political Weekly, January 4<sup>th</sup> 2017, Vol. 51, Issue No. 53.
8. Kobad Ghandy; (2016). Demonetization - One Step Forward and Two Steps Back, Economic and Political Weekly, December 10<sup>th</sup>, 2016 Vol II No. 50.
9. Arun Kumar. (2017). Economic Consequences of Demonetization, Money Supply and Economic Structure, Economic and Political Weekly, January 7<sup>th</sup>, Vol III No. 1.
10. Parag Waknis. (2017). Demonetization through Segmented Markets: Some Theoretical Perspectives, Economic and Political Weekly February 27, 2017 Vol. 52, Issue No. 9.