
DEMONETIZATION AND ITS IMPACT

* *Mr. Mohd. Abdul Taufeeq*, Research Scholar, Dr. Babasaheb Ambedkar Marathwada University, Aurangabad.

DEFINITION OF DEMONETIZATION:

Demonetization is 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 pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with new currency.

DEMONETIZATION IN INDIA:

On 28 November 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denominations in its currency system. These notes accounted for 86% of the country's circulating cash. With little warning, India's Prime Minister Narendra Modi announced to the citizenry on Nov. 28 that those notes were worthless, effective immediately – and they had until the end of the year (31 Dec 2016) to deposit or exchange them for newly introduced 2000 rupee and 500 rupee bills. Chaos ensued in the cash-dependent economy (some 78% of all Indian customer transactions are in cash), as long, snaking lines formed outside ATMs and banks, which had to shut down for a day. The new rupee notes have different specifications, including size and thickness, requiring re-calibration of ATMs: only 60% of the country's 200,000 ATMs were operational. Even those dispensing bills of lower denominations faced shortages. The government's restriction on daily withdrawal amounts added to the misery, though a waiver on transaction fees did help a bit.

Small businesses and households struggled to find cash and reports of daily wage workers not receiving their dues surfaced. The government's goal was to combat India's thriving underground economy on several fronts: eradicate counterfeit currency, fight tax evasion (only 1% of the population pays taxes), eliminate black money gotten from money laundering and terrorist-financing activities, and to promote a cashless economy. Individuals and entities with huge sums of black money gotten from parallel cash systems were forced to take their large-denomination notes to a bank, which was by law required to acquire tax information on them. If the owner could not provide proof of making any tax payments on the cash, a penalty of 200% of the owed amount was imposed.

EXCHANGE OF OLD NOTES

The Reserve Bank of India stipulated a window of fifty days until 30 December 2016 to deposit the demonetized banknotes as credit in bank accounts. The banknotes could also be exchanged over the counter of bank branches up to a limit that varied over the days:

- Initially, the limit was fixed at 4,000 per person from 8 to 13 November.
- This limit was increased to 4,500 per person from 14 to 17 November.
- The limit was reduced to 2,000 per person from 18 November.

All exchange of banknotes was abruptly stopped from 25 November 2016.

International airports were also instructed to facilitate an exchange of notes amounting to a total value of 5,000 for foreign tourists and out-bound passengers.

WITHDRAWAL LIMITS

Cash withdrawals from bank accounts were restricted to 10,000 per day and 20,000 per week per account from 10 to 13 November. This limit was increased to 24,000 per week from 14 November 2016.

A daily limit on withdrawals from ATMs was also imposed varying from 2,000 per day till 14 November, and 2,500 per day till 31 December. This limit was increased to 4,500 per day from January 1, and again to 10,000 from January 16, 2017. Limits placed vide the circulars cited above on cash withdrawals from Current accounts/ Cash credit accounts/ Overdraft accounts stand withdrawn with immediate effect. The limits on Savings Bank accounts will continue for the present and are under consideration for withdrawal in the near future. Limits vide the circulars cited above placed on cash withdrawals from ATMs stand withdrawn from February 01, 2017. However, banks may, at their discretion, have their own operating limits as was the case before November 8, 2016, subject to 2 (ii) above

BACKGROUND OF DEMONETIZATION

The Indian government had demonetized bank notes on two prior occasions—once in 1946 and then again in 1978—and in both cases, the goal was to combat tax evasion by "black money" held outside the formal economic system. In 1946, the pre-independence government hoped demonetization would penalize Indian businesses that were concealing the fortunes amassed supplying the Allies in World War II. In 1978, the Janata Party coalition government demonetized bank notes of 1000, 5000 and 10,000 rupees, again in the hopes of curbing counterfeit money and black money.

In 2012, the Central Board of Direct Taxes had recommended against demonetization, saying in a report that "demonetization may not be a solution for tackling black money or economy, which is largely held in the form of benami properties, bullion and jewellery." According to data from income tax probes, black money holders kept only 6% or less of their wealth as cash, suggesting that targeting this cash would not be a successful strategy.

IMPACT OF DEMONETIZATION

- **Cash shortage**

The shortage of cash due to demonetization led to confusion, and most people holding old banknotes faced difficulties exchanging them due to endless lines 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 since 9 November. ATMs were running out of cash after a few hours of being functional, and around half the ATMs in the country were non-functional.

- **Deaths**

Several people were reported to have died from standing in queues for hours to exchange their old banknotes. Deaths were also attributed to lack of medical help due to refusal of old banknotes by hospitals.

- **Stock market crash**

As a combined effect of demonetization and US presidential election, the stock market indices dropped to an around six-month low in the week following the announcement. The day after the demonetization 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 15 November 2016, the BSE SENSEX index was lower by 565 points and the NIFTY 50 index was below 8100 intraday

- ***Transportation halts***

After the demonetization was announced, about 800,000 truck drivers were affected with scarcity of cash, with around 400,000 trucks stranded at major highways across India were reported.

- ***Agriculture***

Transactions in the Indian agriculture sector are heavily dependent on cash and were adversely affected by the demonetization of 500 and 1,000 banknotes. Due to scarcity of the new banknotes, many farmers have insufficient cash to purchase seeds, fertilizers and pesticides needed for the plantation of rabi crops usually sown around mid-November.

- ***Banking***

In the first four days after the announcement of the step, about 3 trillion in the form of old 500 and 1,000 banknotes had been deposited in the banking system and about 500 billion had been dispensed via withdrawals from bank accounts, ATMs as well as exchanges over the bank counters. Within these four days, the banking system has handled about 180 million transactions.

- ***Drop in industrial output***

There was a reduction in industrial output 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. A reading above 50 indicates growth and a reading below shows contraction. This indicates a slowdown in both, manufacturing and services industries. The PMI report also showed that the reduction in inflation in November was due to shortage in money supply. The growth in eight core sectors such as cement, steel and refinery products, 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 was a loss of jobs due to demonetization, particularly in the unorganized and informal sector and in small enterprises

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