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DEMONETIZATION TO REMONETIZATION: AN ANALYSIS

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Introduction: 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. The opposite of demonetization is remonetization, in which a form of payment is restored as legal tender

There are multiple reasons why nations demonetize their local units of currency:

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

- to facilitate trade

Examples of Demonetization:

The Coinage Act of 1873 demonetized silver as the legal tender of the United States, in favour of fully adopting the gold standard. Several coins, including two-cent piece, three-cent piece, and half dime were discontinued. The withdrawal of silver from the economy resulted in a contraction of the money supply, which subsequently led to a five-year economic depression throughout the country. In response to the dire situation and pressure from farmers and silver miners and refiners, the Bland-Allison Act remonetized silver as legal tender in 1878.

An example of demonetization for trade purposes occurred when the nations of

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the European Union officially began to use the euro as their everyday currencies in 2002. When the physical euro bills and coins were introduced, the old national currencies, such as the German mark, the French franc and the Italian lira were demonetized. However, these varied currencies remained convertible into Euros at fixed exchange rates for a while to assure a smooth transition.

In 2015, the Zimbabwean government demonetized its dollar as a way to combat the country's hyperinflation, which was recorded at 231,000,000%. The three-month process involved expunging the Zimbabwean dollar from the country's financial system and solidifying the U.S. dollar, the Botswana pula and the South African rand as the country's legal tender in a bid to stabilize the economy.

India's Demonetization

The term demonetization is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetized in January 1946 and again in January 1978, according to RBI data.

In 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. 8 that those notes were worthless, effective immediately – and they had until the end of the year 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 (and rationale for the abrupt announcement) was to combat India's thriving underground economy on several fronts: eradicate counterfeit

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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.

Alternative Funds

Soon after the announcement, people rushed to buy gold, a demand that drove prices up, in some cases even to a 60% premium, prompting the tax authorities to conduct surveys, according to the Business Standard newspaper. The government emphasized the need to furnish PAN (Indian Permanent Account Number) card details on purchases for accountability purposes, and many jewellery shops that were flouting the norms came under crackdowns. Simultaneously, rumours of a gold ban started to float, which led to agencies ramping up the volume of gold imports – to around 100 metric tons during November, the highest since 2015, as reported by Reuters.

Many Indians switched to alternative payment avenues – a big deal in a country of 1.2 billion with only 25.9 million credit cards and 697 million ATM cards as of July 2016. The biggest gainers were mobile wallet companies that offer ease of transactions through a large network of partners. Alibaba (NYSE:BABA)-backed Paytm saw a sevenfold increase in overall traffic and a 10-fold jump in money added to Paytm accounts. It also saw the number of transactions double to five million a day.

App downloads for Paytm increased by 300%. Paytm rival MobiKwik also saw its app downloads quadruple and a 20-fold increase in money added to the wallets, MobiKwik Founder & CEO Bipin Preet Singh, told CNBC-TV18 on November 13.

Prepaid cash cards were another option that customers found useful, and that meant good news for companies like ItzCash. Other alternatives include mobile payments systems linked to e-commerce businesses like Ola Money, FreeCharge, and Flipkart Wallet. Ola Money, the payment portal for popular transportation app Ola Cabs, reported a 1500% jump in money added to the accounts in less than four hours.

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However, with the latest round of demonetisation, the common public and bankers are undoubtedly facing hardship since more than 85 percent of currency in circulation has been rendered illegal in one single stroke. Demonetisation is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. The question that arises is why demonetisation was required at this point of time. There are certain pros and cons of demonetisation.

Pros:

One of the biggest benefits of this move is that it is going to drastically affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalised and prosecuted by the authorities. Enemies of the country which are involved in counterfeit currency and terrorism will not be able to continue it further for quite some time at least.

The smuggling of arms and dealing with the terrorist will not sustain further as all of the money will be on record now. Secondly, the banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial

inclusion. The existing white money of people will be known to the government and it will remain with banks so that it can be put on loan, and interest can be generated from it (though interest rates would fall) with a corresponding fall in Inflation.

Further Banking System will get a boost, as more than Rs 7-8 lakh crore base money (new legal money) will enter the system. However, it needs to be seen how much money actually remains in the system, once the cash withdrawal limits are eased.

Thirdly, it will reduce the risk and cost of cash handling as soft money is safer than hard money. It will also reduce government liability. Since every note is a liability for the government, the old currency will become worthless for those people, who choose not to disclose their income. Thus, this will extinguish government's liability to that extent. It is expected approximately Rs 5 lakh crore may come to the government in the form of extinguished RBI liability, taxes and penalties. This amount is enough to take care of India's entire fiscal deficit for one year or more.

It will also reduce tax avoidance. Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this

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period. Dealing in this period in sectors like jewellery and real estate will be on radar and those entering into Loan transactions may also undergo tax scrutiny. Search and Seizure activities of the IT Department will also rise to curb such malpractices. Limits have already been prescribed for reporting to the IT Department those bank accounts in which excess cash deposits are being made in this 50-day window (Rs 2.5 lakh in case of individuals and Rs 12.5 lakh in case of firms).

Importantly, in the longer run, tax and interest rates on loans are expected to come down as higher income tax collections arising from better compliance would offer scope to reduce rates over the long term. This, in turn, will drive up disposable income. This can give a positive impact on consumption demand in long term.

Cons:

The liquidity squeeze caused by demonetisation will be negative across sectors with high level of cash transactions. Real estate, jewellery, retailing, restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space will be facing short term instability. Those companies with high level of debt

will face more pressure and can face loan defaults.

Secondly, there will be added replacement costs of currency. We cannot ignore the increased cost of operating ATMs need to be refilled more often and also it will be a huge burden on banks. Initially, it is very difficult to create a cashless society as more than 50 percent of Indian population is not well versed with card transactions. Also for these initial months, it will be very difficult to make cash transactions of a higher amount. But the government is taking steps to improve liquidity into the system and reduce inconvenience as much as possible.

India is certainly going to experience "Acche Din" in Modi's regime. The decision of this surgical strike on black money was not taken in a day or two. Rome was not built in a day and similarly, this plan is the result of Prime Minister's meticulous planning and never ending fight against corruption. As a result, he has successfully made the right stroke at the right time.

Further, the penal provisions are hefty enough to ensure that corrupt practices will find it hard to take roots again. Despite certain short term troubles, demonetization is certainly going to give a boost to the Indian economy in the long run.

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Long-Term Effects:

Over 3 trillion rupees, or over \$44 billion in old currency, was deposited with Indian banks in just the first week after the demonetization. There was concern that the uncertainty and short-term liquidity squeeze would take some momentum off the Indian economy, the fastest-growing in the world; in particular, sectors like real estate, notorious as a harbor for cash dealings and black money, were expected to take a hit, with "luxury property prices dipping by as much as 25-30%," said Ashwinder Raj Singh, Ceo of Residential Services, JLL India.

But experts believed any slowdown would only be short-lived once the systems adjusted to the new normal, especially if the government heeded calls to lower interest rates by groups like the Federation of Indian Chambers of Commerce and Industry (FICCI). Credit rating agency India Ratings & Research maintained its GDP growth forecast for India at 7.8% for FY17, albeit with a downward bias.

Impact of demonetization:

The demonetization that has been in effect since November 9 is expected to have a negative impact on inflation. Consumer spending activity fell to a near halt. Consumers are refraining from making any purchases except essential items from the consumer staples, healthcare, and energy segments. Activity in the real estate sector, which includes a lot of cash and undocumented transactions, slowed down significantly, Metropolitan and Tier 1 cities reported up to a 30% fall in house prices.

Food item inflation, measured by 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 and re-monetization being slow, the supply and demand of food items fell. It will exert more downward pressure on inflation.

With the announcement of demonetization and the subsequent impact on cash transactions and consumption, inflation will likely fall banks already start reducing their deposit rates. Lending rates are expected to fall as well. Due to the expected fall in inflation, the RBI will likely undertake more cuts in the repo rate.

These rate cuts will aim to boost consumption. They will work to get the

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temporarily derailed economic growth back on track. A cut in interest rates boosts economic activity and raises hopes that after a lull for two to three quarters, economic growth will rise.

After the demonetization announcement on November 8, Indian banks saw a rise in deposits. According to data from the Reserve Bank of India released on November 21, deposits crossed the 5 trillion rupee mark from November 10 until November 18. At 68.2 rupees to one US dollar, it translates to \$75 billion in deposits in just eight banking days.

Banks also saw a rise in term deposit accounts since the demonetization. Due to these factors, commercial banks like State Bank of India, ICICI Bank (IBN), HDFC Bank (HDB), and Punjab National Bank, among a host of others, sharply reduced their deposit rates.

Apart from cutting deposit rates, banks reduced their lending rates as well. In India, loans sanctioned from April 1 are with reference to the MCLR (Marginal Cost of funds-based Lending Rate), instead of the Base Rate, which was used earlier.

It will translate into lower interest rates on existing floating rate loans and new loans. The reduction in lending rates is expected to stoke lending by tempting consumers to take out loans for purchasing expensive consumer discretionary items like vehicles and houses.

END POINT:

India is certainly going to experience "Acche Din" in Modi's regime. The decision of this surgical strike on black money was not taken in a day or two. Rome was not built in a day and similarly, this plan is the result of Prime Minister's meticulous planning and never ending fight against corruption. As a result, he has successfully made the right stroke at the right time.

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