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Demonetisation in India: Expectations and effects so far

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Abstract

Prime Minister of India on 8th Nov, 2017 suddenly announced the Government of India's decision to demonetise currency notes of Rs. 500 and Rs. 1,000. The decision was taken to curb the menace of corruption and black money. Apart from this, it was expected that use of illicit and counterfeit cash to fund illegal activity and terrorism will also be curtailed after demonetisation. This article reviews the short term results and effects of demonetisation so far on Indian Economy.

Keywords: Demonetisation, Economy, Corruption, Black Money, RBI

Introduction

Demonetisation of Rs. 500 and Rs. 1000 currency notes in India in Nov, 2016 is not the first step of its kind. History of demonetisation in India dates back to pre-independence era. First such measure was taken by RBI in 1946. As per 'History of The Reserve Bank of India: 1935-51' (pg 707-708), on January 12, 1946, two Ordinances were issued, demonetising notes of the denominational value of Rs. 500 and above. The first Ordinance, viz., the Bank Notes (Declaration of Holdings) Ordinance, 1946, required all banks and Government Treasuries in British India to furnish to the Reserve Bank of India by 3 p.m. on the same day, a statement of their holdings of bank notes of Rs.100, Rs. 500, Rs. 1,000 and Rs.10,000 as at the close of business on the previous day. The second, the High Denomination Bank Notes (Demonetisation) Ordinance, 1946, demonetised bank notes of the denominations of Rs. 500 and above with effect from the expiry of January 12, 1946. Holders of high denomination notes could get them exchanged within 10 days of the commencement of the Ordinance. Later the time limit was extended upto 9th February.

For the second time, demonetisation happened on Jan 16th, 2018, when again, currency notes of Rs. 1,000, Rs. 5,000 and Rs. 10,000 ceased to legal tender under the High Denomination Bank Notes (Demonetization) Ordinance, 1978. This time, the general public was given three only days to surrender high denomination notes for conversion (The Reserve Bank of India, Volume 3: 1967-1981, pg 450-452).

Third such measure has been now adopted by the Govt. of India on 8th Nov, 2017. PM Mr. Narendra Modi, in his address to the nation on national television, announced the decision of demonetising currency notes of the denomination of Rs. 500 and Rs. 1000. In his address he said that "To break the grip of corruption and black money, we have decided that the five hundred rupee and thousand rupee currency notes presently in use will no longer be legal tender from midnight tonight, that is 8th November 2016. This means that these notes will not be acceptable for transactions from midnight onwards."

Expectations

The decision of demonetisation was taken primarily to curb the menace of corruption and black money. Apart from this, it is expected that use of illicit and counterfeit cash to fund illegal activity and terrorism will also be curtailed. Terrorist activities against India which are funded by the forged cash, specially the currency notes of high denomination, i.e. Rs. 500 and Rs. 1000, may also be stopped by the act of demonetisation of these currency notes. To get rid of black money and corruption has been the prime rationale behind the decision of demonetisation every time in India. According to 'History of the Reserve Bank of India: 1935-51' (pg 706), soon after the war, while Governments were giving attention to ways and

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means of averting the expected slump, thought was also given to check black market operations and tax evasion, which were known to have occurred on a considerable scale. Following the action in several foreign countries, including France, Belgium and the U.K., the Government of India decided on demonetisation of high denomination notes, in January 1946. Similarly in 1978 too, curtailing the illegal activities and transactions was the reason for Government's resorting to demonetisation. The Finance Minister, in his budget speech of 28 February 1978, announced that demonetisation was part of a series of measures that the government had taken for controlling illegal transactions and against anti-social elements (The Reserve Bank of India, Volume 3: 1967–1981, pg 450-451). However, the success of these measures in attaining the said objectives has been a matter of debate. The measure of demonetisation in 1946 was not successful in achieving its expected outcomes. According to 'History of The Reserve Bank of India: 1935-51' (pg 708), the measure did not succeed, as by the end of 1947, out of a total issue of Rs. 143.97 crores of the high denomination notes, notes of the value of Rs. 134.9 crores were exchanged. Thus, notes worth only Rs. 9.07 crores were probably 'demonetised', not having been presented. Currency notes of Rs. 1000, Rs. 5,000 and Rs. 10,000 were, however, reintroduced in 1954. Similarly, the decision of demonetisation in 1978 was also debatable. Even, the Governor I G Patel was not in favour of the exercise. He was of the view that such an exercise seldom produces striking results. Most people who accept illegal gratification or are otherwise the recipients of black money do not keep their ill-gotten earnings in the form of currency for long. The idea that black money or wealth is held in the form of notes tucked away in suit cases or pillow cases is naïve. And in any case, even those who are caught napping or waiting will have the chance to convert the notes through paid agents (The Reserve Bank of India, Volume 3: 1967–1981, pg 451). But now in the year 2017, the circumstances are quite different. Agencies are much more competent to keep a check on the defaulters and the wrong doers. Technological advancement has made it easier to keep a watch on the financial transactions.

Effects So far

Government has kept a close watch on the money being deposited in various accounts. Huge money has also been deposited in Jan Dhan accounts too. According to newspapers reports, deposits in Jan Dhan accounts had more than doubled to Rs 87,000 crore in 45 days post demonetisation, prompting the tax department to "dissect" information relating to such deposits. Between November 10-December 23, the total deposits in Jan Dhan accounts reported was Rs 41,523 crore in 48 lakh accounts. This, together with the total deposits of Rs 45,637 crore as on November 9, took the aggregate amount in Jan Dhan accounts to over Rs 87,100 crores. Apart from this there were large a number of cases of unaccounted cash (old currency) being dumped or seized by police and other agencies. Report on Macroeconomic Impact of demonetisation published by RBI on 10th March, 2010 sated that demonetisation had impacted various sectors of the economy in varying degrees; however, in the affected sectors, the adverse impact was transient and felt mainly in November and December 2016. The report said that

demonetisation held huge potential benefits in the medium to long-term, given the scale of operation. The report stated modest impact of demonetisation on Gross Value Addition (GVA) growth, decline in food inflation during Nov 2016 to Jan 2017, decline in currency in circulation and increase in deposits with banks, sharp decline in the share prices of cash intensive sectors such as automobiles, FMCG, consumer durables and real estate. Apart from these, significant improvement in the use of digital modes of payments post demonetisation was also reported. The report summed up that, overall, demonetisation has had some negative macroeconomic impact, which, however, has been transient. Despite various estimates reported time to time by newspapers, RBI has not given any exact figure of old currency deposited so far.

Criticism

Apart from the criticism for its expected/visible ill effects on the economy, decision of demonetisation was also criticized for the way it was implemented. Many were of the view that there was no need to demonetise the currency at such a short notice as it didn't give the people any chance to make necessary arrangements. On the days following the demonetisation announcement, people encountered problems in purchasing even the necessities from the markets as no shopkeeper was ready to accept the demonetised currency notes. People faced problems even in availing emergency services like hospitalization and medication. However Government hospitals were kept outside from the purview of demonetisation, but problem of liquidity affected the services. But this criticism can be turned down on the basis of this rationale that if time would have been given, the prime objective of the decision would have failed. That time could have been used by the holder of black money to make their ways to convert it in some other form.

Another shortcoming observed in the decision was that it was implemented without full preparation. Enough new currency notes were not issued to banks to replace the old ones. This resulted in long queues at the banks because the upper limit (changed time to time) on withdrawals or conversions was imposed due to shortage of new currency. Most of the ATMs also ran out of cash. Another reason for which the decision was criticized was the frequent changes in the notification of rules and regulations regarding amount of conversion, deposits, withdrawals, etc. Printing of Rs. 2,000 notes was also a surprising decision, specially, when it was argued that most of the black money is held in the form of high denomination notes of Rs. 500 and 1,000. So what was the rationale behind issuing even bigger denomination note? It is not sure. Economists also doubted that demonetisation of currency only is sufficient in achieving the objective of black money free economy. Most of the black money is invested in other types of assets like real estate, gold, jewelry, etc. A study by Ambit Capital Pvt. Ltd suggests that more than 30% of India's real estate sector is funded by black money

Conclusion

No doubt, decision of demonetisation has been taken in good spirit with noble objective of curbing black money, corruption and curtailing illegal activities. Its long term impacts on the economy will be more visible in the future.

But it is observed that its visible short term effects are more or less on a negative side. Shortage of currency, inconvenience to the general public, adverse effect, specially, on small and unorganized business sectors, etc., were the immediate effects. But these were, more or less, expected ones. In long run, if the objectives of black money and corruption free economy are achieved, the short run ill effects will easily be forgotten. It can also be suggested that apart from the act of demonetisation, Government of India should also consider other measures too, so that black money invested in assets other than cash can also be unearthed. Digitalisation of monetary transactions and other efforts towards making India a 'Cash Less Economy' is another welcoming step.

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