

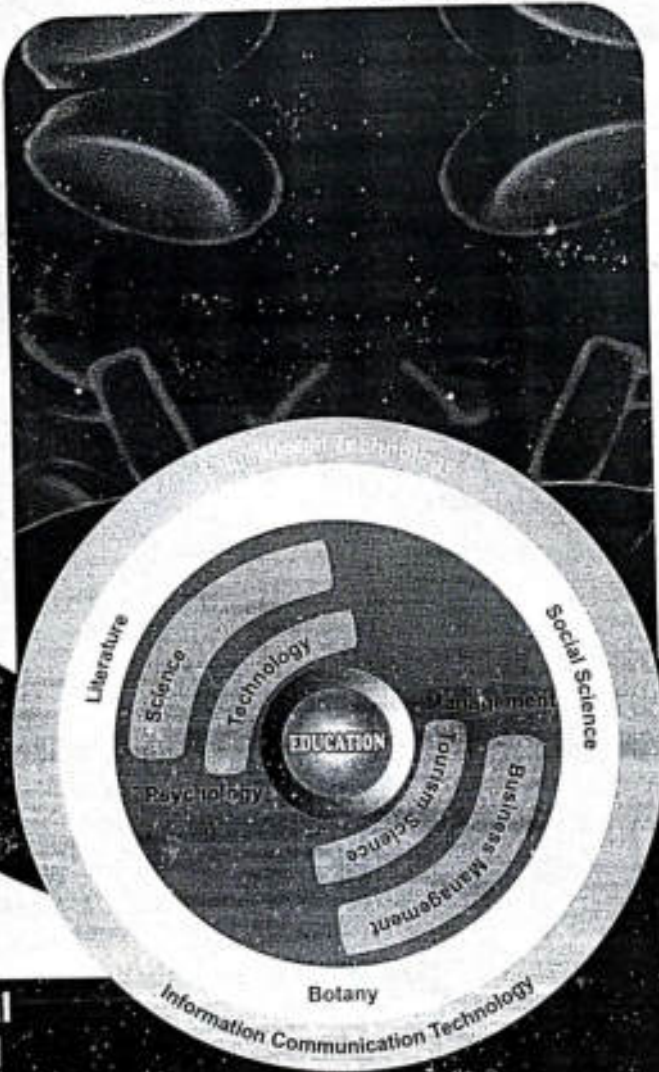
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-
- 1 **EFFECT OF BOARD DIVERSITY AND CORPORATE GOVERNANCE STRUCTURE ON OPERATING PERFORMANCE: EVIDENCE FROM THE NEPALESE ENTERPRISES**
Radhe S. Pradhan, Ritu Kumari Gupta, Rupa Chand, Sabeena Sadaula, Sangita Saud, and Sapana Ambai (1-11)
 - 2 **THE STATUS AND MANAGEMENT OF CORPORATE SOCIAL RESPONSIBILITY (CSR): THE CASE OF MAURITIUS**
Rajen Suntoo (12-17)
 - 3 **SOCIO ECONOMIC ROLES OF THE STATE: WELFARE STATE IN MAURITIUS**
Dr. Beedun Abba (18-20)
 - 4 **GST TAX ON GOOD'S & IT'S IMPACT ON INDIAN ECONOMY**
Dr. R.K. Datir (21-24)
 - 5 **SYSTEM SOFTWARE ANALYSIS & MODELING OF FOREIGN TRADE OF INDIA 1949 – 2015**
Dr. Vijay Kumar Advani (25-30)
 - 6 **THE INS & OUTS OF IN FILM BRANDING IN INDIA**
Mr. Vijayakumar Jadhav (31-36)
 - 7 **MODERN TRENDS IN MANAGEMENT & COMMERCE**
Dr. Girishkumar N. Rana (37-45)
 - 8 **FOREIGN TRADE POLICY IN INDIA**
Dr. Suresh Ashad (46-48)
 - 9 **CHILD LABOUR IN AGRICULTURE: PROBLEMS AND PROSPECT**
Navghan K. Divraniya (49-54)
 - 10 **GREEN JOBS: A STRATEGY FOR ENVIRONMENTALLY SUSTAINABLE ECONOMY AND SOCIAL DEVELOPMENT**
Sanjit Mondal (55-58)
-



- 41 **INFLUENCE OF CONSUMER EXPERIENCE ON THE SATISFACTION OF MOBILE PHONES IN KATHIMANDU VALLEY**
Sangam Malla Thakuri (205-209)
- 42 **RECENT TRENDS IN ECONOMICS, COMMERCE & MANAGEMENT: E-BUSINESS & CHALLENGES OF BUSINESS**
Manjula D. Vyas (210-212)
- 43 **GROWTH AND DEVELOPMENT OF E-BANKING SERVICES**
Mrs. Meena Dushman-Khadule (213-219)
- 44 **DEMONETIZATION OF CURRENCY**
Dr. A. M. Pawar (220-225)
- ✓ 45 **INDIA'S DEMONETIZATION**
Dr. S. T. Kote (226-229)
- 46 **FUNDAMENTAL THEORY OF ENTREPRENEURSHIP DEVELOPMENT PROGRAMS**
Smt. Wanjari Manisha Pandurang (230-235)
- 47 **CHANGING TRENDS IN FISHERIES SECTOR OF INDIA**
Mr. Rahul Vithalrao Thoke & Dr. A.T. Tawar (236-242)
- 48 **MICRO-FINANCE IS THE NEED OF THE AGE!**
Dr. K. B. Shejul (243-244)
- 49 **POVERTY IN INDIA**
Dr. Suresh Sitaram Nale (245-247)
- 50 **WOMEN EMPOWERMENT AND SOCIAL SECURITY THROUGH "SELF HELP GROUP"**
Dr. Atul. H. Salunke (248-250)
- 51 **A STUDY OF REGIONAL IMBALANCE IN INDIA**
Katkar Sangita Bholchandra (251-254)
- 52 **ROLE OF MICROFINANCE IN RURAL WOMEN ECONOMIC EMPOWERMENT IN LATUR DISTRICT**
Dr. Pawar Avinash Vilasrao (255-257)
- 53 **ADVANTAGES AND DISADVANTAGES OF GST**
Dr. Deepa Kailas Holkar (258-259)
- 54 **FOREIGN DIRECT INVESTMENT: INFLUENCING FACTOR MOULDING INDIAN ECONOMY**
Prof. Bandarkar Yashwant Shankar & Prof. Samel Shirish Chandrakant (260-264)
- 55 **SOCIO-ECONOMIC IMPACT OF IMPLEMENTATION OF IAY IN WESTERN VIDARBHA**
Dr. Ashish Sudhakarrao Nimkar (265-268)



Dr. S. T. Kute (226-229)

INDIA'S DEMONETIZATION

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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."

Historical Case: Demonetization of the Indian Rupee in 2016: The demonetization of the Indian Rupee in 2016 is a kind of political-economic experiment. John Lanchester wrote: "Two months ago, the world's largest democracy embarked on one of the biggest monetary experiments the world has ever seen. On Nov. 8, without warning or preamble, without discussion papers or leaks, Narendra Modi's Indian government invalidated most of the country's cash. The 500- and 1000-rupee notes ... were, as of that moment, no longer legal tender. Anyone in possession of these notes had until Dec. 30 to take them to a bank and either deposit them or exchange them for other notes. Anyone presenting more than 250,000 rupees in cash (\$ 3700) had to provide an explanation for why he had so much, and proof that he had paid tax on it; the penalty for unpaid tax was to cough up 200 percent of the amount owed. The two retired notes represented 86 percent, by value, of all the cash in circulation in India".

Shashi Tharoor wrote: "On November 8, Indian Prime Minister Narendra Modi announced that, at the stroke of midnight, some 14 trillion rupees worth of 500- and 1000-rupee notes—86% of all the currency in circulation—would no longer be legal tender. With that, India's economy was plunged into chaos. Modi's stated goal was to make good on his campaign pledge to fight 'black money': the illicit proceeds—often held as cash—of tax evasion, crime, and corruption. He also hoped to render worthless the counterfeit notes reportedly printed by Pakistan to fuel terrorism against India. Nearly a month later, however, all the demonetization drive has achieved is severe economic disruption".

The significance of this event in India provides an empirical case to understand the role of money in a modern economy, not just in India's economy. John Lanchester further wrote: "Many Westerners have become so used to discussing China as the most populous country in the world, with 1.357 billion inhabitants that they forget India is just behind it, with 1.252 billion. Of that total, only 12 million pay income tax. That's an astonishing number: 99 percent of Indians don't pay tax. The majority of Indians work in what economists call the 'informal' or 'unorganized' economy, which runs overwhelmingly on cash. The short-term result of Modi's move has been, unsurprisingly, chaos: huge lines at A.T.M.s and banks, farmers unable to buy seeds to plant crops, weddings and property transactions canceled, piles of illicit cash shredded or burned. Some workers have been forced to choose between earning a day's pay or spending the same day waiting to deposit money in a bank. Many of the poor don't have bank accounts at all".

The rupee currency is fiat currency, issued or withdrawn by a government. However, in formulating the policy to withdraw the fiat notes, the Prime Minister had not anticipated the impact upon the commodity money of India. Shashi Tharoor wrote: "Far from being a masterstroke, Modi's decision seems to have been a miscalculation of epic proportions. The announcement immediately triggered a mad scramble to unload the expiring banknotes. Though people have until the end of the year to deposit the notes in bank accounts, doing so in large quantities could expose them to high taxes and fines. So they rushed to gas pumps, to jewelry shops, and to creditors to repay loans. Long queues



...ed in, out, and around banks, foreign-exchange counters, and ATMs—anywhere where people exchange the soon-to-be-defunct notes. But, upon getting to the front of the line, people were met with strict withdrawal limits, because, in a display of shocking ineptitude, not enough new currency was printed prior to the announcement. Worse, the new notes' design prevents them from fitting into existing ATMs, and their denomination—2000 rupees—is too high to be useful for most people, especially given that the government's failure to print enough smaller-denomination notes means that few can make change". It is important to distinguish between the functions of money as fiat (taxes) and commodity (trade) because, in all cases, money is a kind of "ticket" to an activity, to a "performance". For example, John Maynard Keynes wrote: "Money is the measure of value, but to regard it as having value itself is a relic of the view that the value of money is regulated by the value of the substance of which it is made, and is like confusing a theatre ticket with the performance". The demonetization also impacted consumer prices. Geeta Anand and Hari Kumar wrote: "The decline in vegetable demand is so steep that the prices of eggplants, potatoes, cauliflower and tomatoes dropped between 42 percent and 78 percent (the NCDEX Institute of Commodity Markets and Research said). In the first month alone after the currency ban, micro and small-scale service industries cut staff by 35 percent (the All India Manufacturers' Organization said, based on a survey). It released a study this month saying that job losses in a variety of industries, including automobile parts, infrastructure and construction, would swell to as much as 35 percent by March. Most economists believe the economy will rebound, but nobody knows how long it will take". By the middle of March 2017, it became evident that Modi's political party (and India) would survive the economic crisis. On March 14, 2017, Amy Kazmin and Simon Munday wrote: "When Indian banks open today, the era of cash rationing that followed Narendra Modi's cancellation of most of the country's currency will have come to an end ... The severe liquidity squeeze has already eased. India's supply of legal tender in circulation has risen to \$ 158 bn, mostly in freshly printed Rs 500 and Rs 2000 notes ... 'A lot normality has already come into the market,' said Romesh Sobti, chief executive of InsusInd Bank. 'You don't see queues for cash anywhere' ... However, private banks such as Axis Bank, HDFC and ICICI are still trying to damp the hunger for cash, with new fees on cash transactions ..."

BREAKING DOWN 'Demonetization'

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

Dramatic Examples of Demonetization: The Coinage Act of 1873 demonetized silver as the legal tender of the United States, in favor 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 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.



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 jewelry shops that were flouting the norms came under crackdowns. Simultaneously, rumors 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, 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. Interest in Bitcoin also spiked: Sandeep Geonka, co-founder of Zebpay, told Investopedia that his bitcoin exchange was now adding about 50,000 new users per month. "We are seeing an increased demand for bitcoin and India clearly has shortage of supply, making the demand and lack of liquidity push up prices of bitcoin as compared to global exchanges," said Coinsecure CEO Mohit Kalra. The virtual currency was trading at INR 55,735 in India in November (about \$836), compared INR 47,725 (about \$71).

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. The 2016-2017 economic event of a sudden demonetization in India can provide an empirical example in which to test the validity of some schools of monetary theory, particularly the Chartalist School. The Chartalist School distinguished three kinds of money: Fiat, Commodity, and Managed Money. The event provided empirical evidence that this distinction between currencies in an economy is valid and important. The sudden withdrawal of Fiat money immediately decreased the amount of commodity money, creating an economic crisis in local Indian commerce. Managed money, as bank accounts, was unable to fill the temporary gap in the supply of money because a large portion of the Indian population did not have bank accounts. Also the government did not supply a sufficient number of new 500 and 2000 rupee notes to quickly replace the withdrawn 500 and 1000 rupee notes.



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