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List of Contributors

Theme I - Economics of Financial Markets in India

Dubey ,G.M.	Head, Department of Economics,Dr. Harisingh Gour Vishwavidyalaya, Sagar
Gupta, Neha	Junior Research Fellow (UGC-New Delhi), School of Economics, Devi Ahilya University, Indore
Gupta, Anish	Asst. Prof., Dr. B.R.A. College, University of Delhi
Kawadia, Ganesh	Chair Head, SPC, School of Economics, Devi Ahilya University, Indore
Kushwaha, V.S.	Director, IPS Academy, Institute of Business Management and Research, Indore
Kutumbale, Vishakha	Sr. Lecturer, School of Economics, Devi Ahilya University, Indore
Nayak, Vinamra	Research Scholar
Phatak, Sujay S.	Project-Fellow, School of Economics, Devi Ahilya University, Indore
Salvi, Prakash Anant	Associate Professor and Head, Department of Economics, D. G. Ruparel College,Mumbai
Suri, Davinder Kaur	Research Scholar, Department of Economics, University of Mumbai
Sahu, Neha	Asst. Prof., IPS Academy, Institute of Business Management and Research, Indore
Sen, Vinod	Asst. Prof., Department of Economics, Faculty of Social Sciences, Indira Gandhi National Tribal University Lalpur, Amarkantak
Shevalkar , Roopali	Asst. Prof., Regional Planning and Economic Growth department Barkatullah University, Bhopal.
Shukla, S.K.	Prof., and Head, SOS in Economics, Jiwaji University, Gwalior
Shukla, Narendra K.	Prof., and Head, Dept. of MBA, Gyan Ganga Institute of Technology Sciences, Jabalpur, Chairman, Board of Studies, Faculty of Management, RDVV, Jabalpur
Singh, Dolly	Research Scholar, Department of Economics Dr. Harisingh Gour Vishwavidyalaya, Sagar,
Suryawanshi, Ankit Kumar	JRF, School of Economics, Devi Ahilya University, Indore
Tripathi, Minakshi	Faculty, Kamla Raja Govt. Girls P.G. College, Gwalior

Contents

Effect of Recent Demonetization on Money Market in India

G.M.Dubey, Dolly Singh

Abstract

Money market plays a key role in bank's liquidity management and the transmission of monetary policy.Money markets facilitate the conduct of monetary policy in a country and the development of money market in India.The study sought to examine the Recent Demonetization effect from 8th Nov. 2016 Tuesday Midnight PM ShriNarendraModiJi Banned the Currency notes of 500 and 1000. It is a strict decision of banning regular 500 and 1000 rupee notes from circulation which is a result of finding 1.25 lakh crore black money and relationship between different money market instruments and the economic development of India. The demonetization immediate effect on money market of India, giving little time for hoarders or small-time savers to convert their stock of illegal tender money into legal tender money. Small traders, in the informal sector, are facing a tough time with a decline in sales, and small units have shut down, unable to meet their working capital expenditure. The growing importance of the money market in the Indian economy has helped to stimulate interest among a wide variety of people in the study and practice of money market structure and Indian economic development.

Key words : Demonetization, Indian Money Market, Black Money,Currency Circulation

Introduction

Money markets facilitate the conduct of monetary policy in a country and the development of money market in India. Money market plays a key role in bank's liquidity management and the transmission of monetary policy. Demonetizationon the 8th November 2016, byIndian Prime Minister Mr. NarendraModi announced a sudden denomination of 500 and 1000 rupee notes.It has an effect on the savings of Indians as the money that was running in the parallel economy was brought into the banking system. High denomination notes, accounting for almost 86 per cent of the in-circulation currency were deposited, flooding banks with liquidity immediately after demonetization.Banks forced to slash interest rates on fixed deposits with poor demand for credit and the overall reduction in interest rates. Fixed deposits were the most in-demand interest option for Indians, because of guaranteed returns and the assured safety of capital. The dropping interest rates, made more people turn to mutual funds.Demonetization was not the primary trigger pushing people towards investment alternatives, factors such as falling interest rates, good returns from equity markets and poor performance of real estate were also in play. Demonetization place downward pressure on interest rates generating more appeal for mutual funds.

Demonetization pushing people towards investment alternatives, factors such as falling interest rates, good returns from equity markets and poor performance of real estate.Demonetization place downward pressure on interest rates generating more appeal for mutual funds.Demonetizations led to a distinct accentuated shift towards capital market instruments such as mutual funds both directly and indirectly. It acted as an added driver. The direct impact has been due convergence of cash pools to the banking system, while the indirect impact has been due to changing macro factors and structurally lower inflation. (***ManojNagpal, CEO, and Outlook Asia Capital)***

Various analysts, experts and scholars have expressed their views regarding impact ofdemonetization on the economy and have estimated 0.5% - 3% impact on the Gross DomesticProduct (GDP) of the country in the previous financial year 2016-17.

Demonetization can be said as a Surgical Strike? on Black Money, Terrorism, Fake Currency, Unorganized trading, Real Estate, Share market etc. on the other hand if we talk about the Indian industry on a broader way it can be categories in three parts Manufacturing sector, Service sector and Agriculture sector. After demonetization only Agriculture sector shows some positive improvement while if we talk about the manufacturing and service sector both were crashed down and these will affect the whole Indian market in 2017.

Objectives of the Study

The aim of this paper is to study the previous instances of demonetization around the Indian Economy.The study to understand the possible outcomes of our demonetization to reduce the negatives and to maximize the positive ones by learning from the good decisions taken by the country.This study also takes the views of many other authors and collects them to make a perspective about the possible effects of the demonetization on Indian Money Market .One of the most important part of this paper is the one to explain the behavior of people at the time of demonetization, and the effect of it further on money market, savings and investment. This paper based on secondary data collected from different Government Reports,Articles, Websitesand Research Papers.

Reasons of Demonetization

According to The Reserve Bank of India, there were mainly three reasons to take the said initiatives which are like:

- To address black money in the economy.
- To control the cash circulation in the country relevant to corruption
- To remove fake currency and dodgy funds used by terror groups to fund terrorism in India

Financial Markets

Demonetization impacted various segments of the financial markets in varying degrees. However, in most segments, the impact was transient. Surplus liquidity conditions post-demonetization have imparted an easing bias to G-sec yields. Overnight call money market rates remained within the corridor but traded with a distinct softening bias. In sympathy with the overnight call rate, other short-term rates also eased. In the equity market, share prices relating to cash intensive sectors such as realty, consumer durables, auto and FMCG declined significantly in November and December.

Money market refers to a section of the 'financial market where financial instruments with high liquidity and short-term maturities are traded. Money market has become a component of the financial market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers. Over-the-counter trading is done in the money market and it is a wholesale process. It is used by the participants as a way of borrowing and lending for the short term.It consists of negotiable instruments such as treasury bills, commercial papers and certificates of deposit. It is used by many participants, including companies, to raise funds by selling commercial papers in the market. Money market is considered a safe place to invest due to the high liquidity of securities. It has certain risks which investors should be aware of, one of them being default on securities such as commercial papers.Money markets are different from capital markets as they are for a shorter period of time while capital markets are used for longer time periods. .

Effect of Demonetisation on Money Market

Government announced the demonetization with immediate effect, giving little time for hoarders or small-time savers to convert their stock of henceforth illegal tender money into legal tender money. This was followed by subsequent policy announcements from the Reserve Bank of India (RBI) to ease the hardships faced by the citizens.However, even after 50 days of the announcement, the long queues of people outside ATMs to withdraw their savings continue.

- Small traders, especially in the informal sector, are facing a tough time with a decline in sales, and small units have shut down, unable to meet their working capital expenditure.
- Setting aside the hardships faced by the common man, how much black money or unaccounted money was disclosed or turned into white money is yet to be announced.
- Experts believe that shift in investor behavior in how they view financial assets is likely to continue. Demonetization was a onetime event, a year later its effects are almost negligible a most of the upheaval has been absorbed.

But it did create a cusp in investors' saving patterns and those will continue to accrue to capital markets in general and mutual funds in particular.

- This decision is considered as biggest cleanliness drive against the black money in the history of Indian economy benefits will be reaped in the long run. However, the impact of this sudden move is causing major cash crunch in the economy affecting day to day requirements of the common man and businesses.
- There are many reasons, why governments demonetized their nation's currency. Some reasons are like resisting inflation, resist corruption, and discourage a cash system in the country.
- According to RBI report on 31st march 2016, 500 and 1000 banknotes consist around 86% of total cash circulation having value of 15.44 lakh crore. In this process 97% of old notes around 14.97 lakh crore were deposited in bank before 31st December. Demonetization Effect unearths the black money and to curb the corruption, counterfeit currency as well as terror funding.

Prior to the demonetization announcement, under the Income Declaration Scheme 2016, the Government was able to unearth 65,250 crores of undisclosed income through 64,275 declarations upto 30 September, 2016.What are the developments in the money market after demonetization? In India, where almost 50% of the sector is informal, it is but natural that money supply in the form of 'currency with the public' is the most important medium for conducting economic transactions. Out of the money supply, referred to as M1, consisting of currency with the public, and demand deposits and other deposits with the RBI, 'currency with the public' accounted for almost 61% of the total supply, prior to the announcement of demonetization.

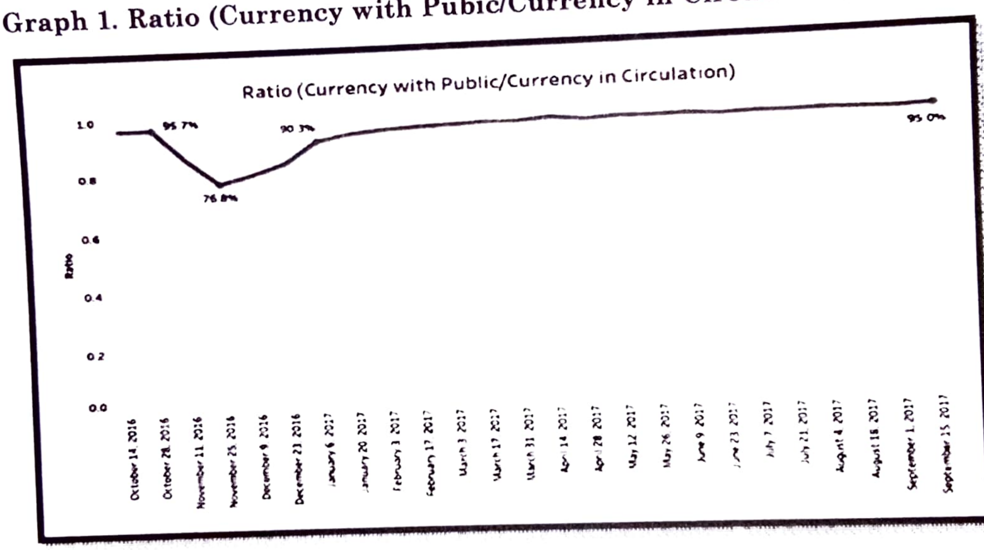
As per the Weekly Statistical Supplement of the RBI for the week ending 9 December 2016, the share of currency with the public in the total money supply 'M1' was reduced to 39.1%. In actual terms, between 28 October and 9 December 2016, there was a decline of `9204.3 billion rupees, indicating that almost 54% of the currency with the public was absorbed from the economy. The' currency with the public' saw a year-on-year increase of 17.7% (as on 28 October, 2016) as compared to an 11.1%increase in 2015. One month after demonetization, the picture changed, with the 'currency with the public' seeing a year-on-year decline of 48% in 2016 (as on 9 December) as compared to a 12.4% increase in 2015.Demand Deposits with banks as on 28 October, 2016 saw a year-on-year increase of 11.5% as compared to 12.1% in 2015. But as on 9 December 2016, demand deposits with the banks saw a year-on-year increase of 29.4% in 2016, as compared to 13% in 2015.

Currency Circulation in the Country after Demonetisation

According to annual report of Reserve Bank of Indiafor the year 2016-17 demonetization has helped the country's currency in circulation (CIC) to GDP ratio compare with advanced economies like Germany and France.

- Last year, the cash to GDP ratio in India was 12.2%. It came down to 8.8% by the end of March 2017 as demonetization hit the total high value currency in circulation. The demonetization decision announced by the government on November 8 had scrapped old high-value currency notes of Rs 500 and Rs 1000.(*RBI report,2017)*
- Demonetization until December 31, 2016, the RBI pumped in 23.8 billion pieces of bank notes into circulation, which was Rs 5,540 billion in value. By the end of March 2017, CIC had reached 74.3% of the peak.
- The RBI annual report also revealed that only around 1.4% of scrapped Rs 1,000 notes didn't come back into the banking system post demonetization. Out of 632.6 crore pieces of Rs 1,000 currency notes in circulation, 8.9 crore haven't yet returned to banks.
- According to the report, around 89 million old Rs 1000 notes were in circulation in March 2017, while in March 2016, around 6.3 billion Rs 1000 notes were in circulation. This means that 89 million (or 8.9 crore) of Rs 1000 notes, which were banned by Centre in November, didn't return to the banks.

Graph 1. Ratio (Currency with Pubic/Currency in Circulation)



Source : EPW, research Foundations, 2017

The currency in circulation is about 20 per cent lower than the levels at the beginning of November 2016, the sharp decline in the pace of remonetisation over the past few weeks and indications from government officials suggest that the government and the Reserve Bank of India (RBI) may not go for full replacement of the currency that was in circulation during the pre-demonetization period.According to data from the RBI, while the net addition of currency into the system in the week ended January 13 stood at Rs 52,787 crore that in the week ended April 28 slipped to Rs 14,561 crore.The government announced the withdrawal of old Rs 1,000 and Rs 500 notes *(aggregating to Rs 15.5 lakh crore)* from circulation on November 8, 2016.

Removal Fake Currency Funds Used by Terror Groups

Demonetization would break the back of terror funding, which is far from true. This was made on the false premise that terror is fully funded by fake currency. The objective of terror is not to kill, but to scare.Attacks like 26/11 forced the government to guard every public place, diverting billions of dollars to an already ballooning defense budget. Hence, terrorism aims to strike fear into the hearts of people and distract economic resources.Demonetization was unlikely to have a great effect, and it has not.Naxal terror has increased; with the month of April 2017 is the deadliest in terms of security personnel killed since May 2011. In the span of January to October 2017, the number of security personnel killed in action stands at 58, as compared to 62 in the entire year of 2016. In fact, in the span of January to March, the number of soldiers killed has doubled on a year on year basis.

Effect of Demonetisation on Black Money

The biggest mission of demonetization is described as fighting Black Money. India's economy historically holds a big parallel economy where unreported income is the norm.

The effectiveness of demonetization against black money depends upon the follow-up and supportive measures were made by the government.Demonetizations bring several long -term besides netting black deposited in the form of banned notes. It is logical netting black money fighting effect of demonetization as Direct or immediate and long term.

Direct or Immediate Effects

- Immediate effect of demonetization comes through the netting of black money deposited in the banking system in the form of banned Rs 500 and Rs 1000 notes from November 10 onwards.
- Around Rs 12 lakh crore of the Rs 15.44 lakh crore demonetized currency is with banks now and the extent of black money identified out of this will be the direct effect.
- It is believed that an estimated Rs 1.5 to 2 lakh crore may be identified as black money .Out of this,around Rs 1.2 lakh crores collected as taxes at 50 % to 85 % tax rate.

- The Rs 2 lakh crore is revealed as black money out of demonetization. it will amount to around 1.75% of India's GDP.According to National Institute of public Finance and Policy (NIPFP), black income amounts to nearly 40% of the country's GDP.

Indirect Effects

- Theindirecteffect of the demonetization has been much stronger as it has strengthened tad enforcement mechanism.It helped to add more people into the tax net.
- A minimum of 1.56 lac people is expected to be added to the income tax under the operation clean money.
- The tax department has got information about such people when they saved money in the bank accounts during demonetization period.
- According to parliamentary information more than 11.44 lakh permanent account no. (PAN) were deleted or de-activated as they are cases of multiple PAN.
- Demonetizationproduced some unavoidable negative effects in the short/ medium term.
- Demonetization led to decline in economic activities and contributes to low GDP growth.
- The unorganized sector daily wages earners and other low-Income groups have suffered from income fall during demonetization period.

Long term effects of Demonetization on Black Money

- The long –term effects will be much impactful and depends considerably upon how government deploys more measures to depress the shadow or black economy.
- A high proportion of the economic transaction happens in the shadow economy are unaccounted.The real estate sector is the most important example.
- Reducing the size of the shadow economy by enlarging formal economy is the way out.Transaction is recorded.
- To be recorded, disclosure about the buying and selling people by quoting their financial ID or PAN card is mandatory especially for big transaction .The real estate sector amounts to nearly 45% of India 's parallel Economy.

Effect of Demonetization on Indian Economy

Demonetization had created various impacts on the economy. Most of the sectors where transactions are done on cash basis were affected highly. Somewhere it was boom where in other sectors temporary slowdown was found. Following are the effects of the Demonetizations:

Temporary Liquidity shortage: It was the time when people were standing in long queue to exchange the money. The highly used denomination currency is Rs.500. People were not getting that money currency. There was a shortage of the currency which was clearly observed.

Time of Currency Shortage: reports suggested that all printing presses could print 2000 million units of Rs 500 notes by the end of year. Nearly 16000 million Rs 500 notes were in circulation as on end March 2016. Some portions of this were bridged by the new Rs 2000 notes. Towards end of March approximately 10000 million units were printed and replaced. All these suggested that currency crunch was going to be continued in our economy for the next four months.

Loss for population using currency: Most of the poor section of society uses cash for their livelihood. They depend most of the time on cash basis transactions as such they receive wages in daily basis in cash. Due to shortage of cash it was assumed that companies will try to lower down cash expenses and may reduce their labor cost. Because of shortage of cash poor section of society including labors and workers will not get enough wage and payment.

Consumption affected: Consumption was adversely affected because of the liquidity problems and because of consumption the entire cycle was disturbed temporarily.

Predicted Loss of Growth: India wants to be fastest growing economy but because of liquidity position there was a doubt on growth position of India. Because of liquidity crisis GDPand income figures also were at risk.

Effect on bank deposits and interest rate: For short run deposits with banks were hiked as people deposited their money to convert their old currency into new one but once when the new currency supply in the economy was full-fledged once again people had withdrawn their money from the banks because it was the money they deposited to convert in to new currency. This was the amount deposited by people which they were using for liquidity not for investment. Interest rates were predicted to be reduced only for short to medium run but not for long run.

Effect on black money: The problem of black money had been addressed but only to limited extent because only few portion of black money is held in cash and rest other portion of black money is held in the assets and properties. The extent of addressing black money depended on the amount of black money held in the form of cash. However this measure had created huge awareness among the public and citizens of the country to address the issue of black money.

Effect on fake currencies: The major effect of this measure had been on fake currency as its circulation has been evaluated after this exercise.

Conclusion

In this study, we have found some important points about the short-term effects of demonetization as well as about the long-term effects by observing the previous cases of demonetization in other countries. We have to be alert and thoughtful to sustain our growth because many countries which have done demonetizations could not sustain the same.

- In short run, almost all the sector in the Indian economy has been affected negatively due to shorting of cash.
- In long-run Informal Economy would be formalize. So, government has to focus on informal economy and need to make appropriate policies for them. Money supply reduction results to fall in interest rate and accessibility of loan will be easier as interest rate decrease. It will be helpful to new entrepreneur for their startup.
- After demonetization, Indian economy got the momentum towards Case less economy. Long- term effect of demonetization couldn't identify yet due to less availability of information set.
- Due to demonetization counterfeiting currency market offhand shut down for a while but they have capability to create new notes' duplicate so we can say in short run their activity will be slowdown but in long run they can rebuilt their market and also it is easy to handle 2000 rupees notes instead of 1000 rupees notes in briefcase to giving bribe.

Government's Objective was to curb black money but if we look at the figure, 97% of 500 and 1000 rupees' banknotes were deposited in banks and only 3% (.43 trillion rupees) black money scraped as undeclared income hence we can say a less part of Black Money is in cash so this action isn't effective to curb black money.

Policy Implications

Demonetization in India is a great effort taken by Indian government to combat with black money and corruption. It is a bold decision taken by government. The main purpose of demonetization is eradicating the black money and reduces the corruption. Government of India has become success to some extent. Most of the black money has been crushed. Amount of cash liquidity increased in the bank day by day. The bank has more deposits then bank become stronger. The country in which bank is strong then that county is more financially strong. In future banks will able to do more and more loans to the individual and to the industrial sectors sot that production will grow in our country, employment will be generate, and our country can develop at very fast rate. But this is only future perfections; upcoming few months will show the actual economic condition of our country.

Indian financial market, real estate market, FMCG Sector, Auto assets backed loans etc. all are declined for a short time. Some economics expert said that positive impact of demonetization will showed in future. Government has also increased the withdrawal limits. The queues in front of banks and ATMs have reduced. Somehow black money also comes out. Now we should wait and watch the overall impact of demonetization drive.

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