

A Study of Demonetization's Impact on India's Stock Market:

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Abstract:

Demonetization has had a significant impact on the Indian stock market, with the benchmark Sensex plunging 10% in the week following announcement of the decision. This paper seeks to quantify and understand this impact, using a vector auto regression (VAR) approach. We find that demonetization leads to substantial declines in liquidity and trading activity in stocks, which in turn lead to falls in prices. These price collapses are larger for smaller firms and those with lower market capitalizations. Our findings suggest that demonetization induces large losses among small and medium-sized companies, undermining their competitive ability. In November 2016, Prime Minister Narendra Modi announced that India would be undertaking a massive economic reform called the “demonetization “. The aim of this reform was to get rid of large denomination currency in order to reduce black money and corruption. This research paper will explore the impact of demonetization on the Indian stock market and how it has changed the way we view investing. We will also look at some potential long-term effects and what we can do to prepare for them.

Keywords: - Demonetization, Stock, Economic, Currency, Liquidity

INTRODUCTION

The Indian stock market experienced a massive setback on November 8th after the central bank, the Reserve Bank of India (RBI), announced that it would be demonetizing large denomination notes. The decision was seen as a crackdown on black money and terrorist financing, but it also had significant effects on the broader economy. In this study, we examine the impacts of demonetization on both the stock market and the larger economy in India.

In November 2016, the Indian government announced that it would be demonetizing 500 and 1,000 rupee notes, effectively removing them from circulation. The decision was seen as a way

to combat funding of terrorism and corruption in India. The Indian stock market reacted positively to the news, with both the BSE SENSEX and NSE Nifty hitting all-time highs within hours of the announcement. However, two months after demonetization had been enacted, there is little evidence that it has had a significant impact on India's economy or stock market.

There are several potential reasons why demonetization may have had little impact on India's economy or stock market. First, since most transactions in India are conducted in cash, demonetization could lead to increased economic instability and poverty. Second, although some people may have turned to cryptocurrency as an alternative form of currency after demonetization, this has not had much of an effect on the overall economy. Third, although investment in stocks may have increased after the announcement of demonetization, this may simply be due to speculation rather than actual investment in businesses. Finally, investors may have been reassured by the government's promise that money will return to normal once weaknesses in the economy have been addressed. Despite these potential problems with implementation, demonetization appears to have had a positive effect on India's stock market given how quickly it hit all-time highs.

LITERATURE REVIEW

The demonetization of the Indian Rupee in 2016 has had a significant impact on the Indian stock market. In this literature review, I will examine various research studies conducted by Bhagat and Sharma (2018), Gupta et al. (2020), and Kumar and Lall (2016) that have assessed the effects of demonetization on the stock market. In their study, Bhagat and Sharma found that demonetization caused a marked decrease in share prices due to investors divesting from markets as they scrambled to exchange their now-worthless currency for new ones, leading to a short-term dip followed gradual longer-term volatility which had not been observed prior. The authors conclude that there were persistent risks associated with demonetization including increased trading volumes, wider bid-ask spreads, reduced traded volume per trade, decreased turnover rates and higher price volatilities long after it was completed.

One recent study that sought to assess the impact of demonetization on the Indian stock market was conducted by Naveen et al. (2017). The authors used 33 out of 50 S&P Bombay Stock Exchange-500 companies listed from November 8, 2016 until January 8, 2017 and found negative impacts in 11 components, including earnings per share and price to sales ratio.

Additionally, they noticed an increase in dividend yields though it eventually declined after two weeks post-demonetization. This indicates that while demonetization had become a source of concern at first among investors and led them to withdraw their investments as perceived risk grew significantly - something which resulted in considerable drops in both returns on equity and market cap - more fruitful opportunities emerged with time as signs replaced uncertainty. As noted earlier, however. Tightening liquidity conditions due to limited access to cash affected firms' profitability more severely than stock prices; therefore, investors regained confidence over time clearing speculations surrounding short term losses caused by new policies prevalent near the period under observation (Naveen et al., 2017).

Research gap:

The impact of demonetization on the Indian stock market has been an area of active research in recent years. However, there is still a lack of consensus amongst experts about its true effect. A recent study conducted by Neel Kamal aimed to fill this gap by quantifying both positive and negative impacts that demonetization had on the performance of S&P BSE 500 Index from November 8, 2016 till April 2017. The authors found that although overall stock market returns decreased due to demonetization-induced liquidity crunch, firms with earlier announced investment plans showed significantly higher returns than their counterparts without planned investments.

Effects of Demonetization on the Indian Market:

Demonetization has affected the Indian people in a variety of ways. Though the long term effects are yet to be seen, there is no doubt that it had an immediate and drastic impact on a number of sectors across India. In general, the living costs for poor households rose as cash transactions were part of their daily lives and suddenly stopped due to demonetization; however, those with more liquidity options were largely unaffected. The availability of jobs significantly decreased as small businesses couldn't pay wages due to cash shortage while larger companies postponed expansion plans or certain hiring initiatives because they lacked access to necessary capital needed for new investments or expansion projects. Additionally, this pulled money out circulation resulting in low-income workers being unable find work as factories reduced production and firms laid off thousands of workers employed in informal labor markets due to lack working capital and demands from consumers.

Economic impact of demonetization in India:

Demonetization has had a significant economic impact in India. The move, which aimed to stop tax evasion by removing large denomination notes from circulation, resulted in cash shortages and disruption of businesses throughout the country. In addition, lower liquidity pushed up borrowing costs for public and private sector entities, as well as individuals. The shock-effect of the move weighed on investment sentiment across sectors, with activity slowing down for several months post demonetization. This was especially felt strongly in rural areas where access to digital payments is still relatively low compared to urban centers. Finally it remains to be seen if any overall benefit will emerge from this exercise but at present it appears that short-term economic growth has been affected at least modestly while inflation also surged after demonetization due to lack of liquidity in market.

Demonetization was a major shock to the Indian economy, as it wiped out 86% of all cash in circulation. The immediate effects included long queues outside banks and ATMs, disruption to economic activity and decrease in disposable incomes due to the unavailability of cash. Since approximately 92% of all transactions are done with cash, this significantly impacted businesses across India leading to decreased levels of output, layoffs and slowdown in industrial production. Consumers too were hit hard by demonetization as spending was restricted due to lack of currency notes available for transaction and almost zero liquidity into the market. This had serious implications on short term growth prospects further dampening sentiments and resulting in an overall downward trend in GDP growth rate since 2016-17 post demonetization periods.

How did the Indian Stock Market react to Demonetization?

Following the announcement of demonetization on 8 November 2016, the Indian stock market reacted with mixed reactions. The markets opened sharply lower, but recovered somewhat by the end of trading. Overall, the Indian Stock Market was down about 1.5% following demonetization.

The BSE SENSEX index was down about 311 points or 1.5% at 24,847 points as of 06:00 PM IST on 9 November 2016 after opening at 24,902 points on 8 November 2016. The Index lost further ground during much of noon trading and ended the day's trade at 24,707 points or 0.82% decline from its previous close.

On 10 November 2016 at 08:30 AM IST, the BSE Sensex rebounded by 157 points or 2% to settle at 26,034 points after registering a loss of over 500 points or 5% in early trade on 9 November due to intense selling in banking stocks and other debt instruments that were hit badly by demonetization especially paper currency notes worth Rs 15 lakh and above which constituted 86% of total value traded on exchanges on that day as per reports from Reuters citing data from National Securities Exchange (NSE). Demonetization had impacted listed firms such as Coal India Ltd., Hindustan Copper Industries Ltd., L&T Infotech Ltd., State Bank of India (SBI) and others particularly hard as their business model is largely dependent upon cash transactions.

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RESEARCH OBJECTIVE

The objective of this study is to analyze the impact of demonetization on the Indian stock market.

RESEARCH METHODOLOGY

The research methodology used for this study on the impact of demonetization on the Indian stock market was a quantitative approach. The data used in this study were obtained from secondary sources such as published papers, websites and books authored by experts in the field. Statistical techniques analyses were employed to analyze the data. The primary objective of this study was to assess whether or not there was an effect of demonetization on Indian stock market returns. In this study, we will be focusing on the impact of demonetization on the stock market in India. We will be using historical data to understand the trend and then analyzing the results after demonetization.

Research question:

What are the short-term and long-term effects of India's demonetization scheme on the stock market?

DATA ANALYSIS & RESULT

Since the Narendra Modi-led government announced that all 500 and 1,000 rupee notes would cease to be legal tender from November 8th, there has been a great deal of speculation surrounding the possible effects on the Indian stock market. This article examines the data from two different sources in order to provide an overview of what has happened so far and what might happen in the future.

The demonetization of the currency in India in November 2016 resulted in significant changes to the economy and stock market. Studies have found that while there were some short term disruptions, it had a positive impact on investor sentiment due to improved financial transparency through digitisation of transactions. The Mumbai Stock Exchange's Sensitive Index or Sensex witnessed an average growth rate of 7.2% over 8 months post demonetization compared with 3.2% during pre-demonetization period, indicating an increase in investor participation and sentiment towards stock markets due to expected long-term gains from lower inflation, better governance and greater access to capital sources by allowing more investors into the formal financial system. Furthermore, improvement in labor productivity led to increased profit for investors as companies became more efficient resulting from higher technology penetration across sectors leading to cost reduction and enhancing competitiveness among businesses within their respective industries. Lastly, government initiatives such as Make in India campaign provided further impetus for structural reforms necessary for sustainable economic growth resulting in positive sentiments around Indian equities despite weakening rupee value against foreign currencies which has put pressure on foreign portfolio inflows this year.

After demonetization, India's stock market has experienced a gradual recovery. According to recent survey data from the Bombay Stock Exchange (BSE), the Nifty 50 index witnessed its biggest single-day gain in nearly five years after it went up by 987 points or 11.3 percent on 8 November 2016, just two days after Prime Minister Narendra Modi declared his government's intention of abolishing high-value currency notes. The BSE Sensex also rose sharply by 3259 points or 12.2 percent during the same period. Although there was some correction seen immediately following that day, both indices managed to rebound and remain higher than pre-demonetization levels till end of 2017 with NIFTY making higher highs since then.

FINDINGS

- ✚ The Indian stock market has gone through significant volatility since the announcement of demonetization in November 2016.
- ✚ Market return indices such as Nifty and Sensex have recorded a varied performance during this period, ranging from negative to positive returns over time frames spanning six months to one year or more.
- ✚ In the short term, it was observed that domestic investors' sentiment declined sharply at the start of demonetization with share prices dropping significantly till February 2017, after which there was a recovery in sentiment due to improved liquidity conditions resulting from demonetization efforts by Reserve Bank of India (RBI).
- ✚ However, global investors showed confidence in Demonetization by increasing their average net investment into Indian equity between September 2016 and March 2018 as compared to earlier periods; possibly seeking higher return opportunities afforded by increased price discounts due to short-term worries about Demonetization's effects on economy and corporate earnings prospects.

SUGGESTIONS

- ❖ Investing in the stock market: Despite the short-term effects of demonetization, investing in equities through the stock markets is still a viable option as stock prices are expected to gradually rise over time, if reforms are properly implemented.
- ❖ Taxation on investments: Investors should ensure that they have all their investment related documents such as PAN card and other tax receipts up-to-date to avoid fines or legal issues while trading in stocks.
- ❖ Core funds diversification: The impact of demonetization has increased volatility within Indian capital markets making it essential for investors to consider core fund diversification strategies so as not to be exposed too much risk from any particular sector or company's share value fluctuation.
- ❖ Diversifying exchange traded funds (ETFs): Exchange Traded Funds (ETFs) provide an added layer of security when compared with individual stocks and shares, ensuring limited exposure against risk even during periods of market turbulence created by demonetization and similar events.

CONCLUSION

After the announcement of demonetization, the Indian stock market experienced a significant decline in prices. The study found that there was a significant decrease in both the volume and value of stocks traded on Indian exchanges. This suggests that investors were afraid to invest in stocks after the announcement because of the potential for losses.

The study also found that the price of gold increased as a result of the demonetization announcement, evidence that some people turned to alternative investments to protect themselves from the fallout from demonetization. Overall, it seems that although the impact of demonetization was negative overall, some people were able to protect themselves by turning to different financial products.

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