

REVIEW ARTICLE

Demonetization and its Impact on Indian Economy- A Review

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Abstract

Demonetization of currency means discontinuity of the particular currency from circulation and replacing it with a new currency. In the context of recent demonetization in India it is the banning of the 500 and 1000 denomination currency notes by the government. The government's stated objective behind the demonetization policy are as follows; an attempt to make India corruption free, to restraint black money, control inflation, stop funds flow to illegal activities, make people accountable for every rupee they possess and to regulate the tax evasion, make a less cash society and create a Digital India. The paper makes an attempt to study the history of demonetization in India & in different countries, need for demonetization in 2016, steps initiated by the government to implement demonetization policy and its overall impact on Indian economy.

Keywords: *Demonetization, Black money, Fake currency, Digital India, Remonetization, Economy, working population.*

Introduction

Demonetization is the act of discontinuing a currency unit as legal tender. Demonetization of currency means discontinuity of the particular currency from circulation and replacing it with a new currency.

In the context of recent demonetization in India it is the banning of the 500 and 1000 denomination currency notes by the government.

The government's objective behind the demonetization are as follows; to make India corruption free, to restraint black money, to control inflation, to stop flow of funds to illegal activities, to make people accountable for every rupee they possess and to regulate the tax evasion. Finally, it is an attempt to make a cashless society and create a Digital India.

Demonetization brings the following benefits

- The demonetization policy helps country to become corruption-free.
- Helps the government to track the black money.

- Stops funding to the unlawful activities that are thriving due to unaccounted cash flow.
- Restricts the circulation of fake currency.

Demonetization may lead to the following side effects

- Demonetization of the currency cause huge inconvenience to the people.
- It deeply affects business.
- Daily wage earners are left with no jobs and their daily income stops because employers are unable to pay their daily wage.

Objectives of the Paper

- To understand the meaning of demonetization
- To study the history of demonetization in India and in different countries
- To assess the need for demonetization
- To examine the overall impact of demonetization on economy

Scope of the Study

The present paper focuses mainly on the recent demonetization, need for demonetization, the steps initiated by the

government to implement the demonetization process & its overall impact on Indian economy. The study covers the period from 8th November 2016 till 31st March 2017.

Research Methodology

The study undertaken is descriptive in nature. The data required for the study is mainly collected from secondary source such as newspapers, magazines, journals, annual reports, periodicals, govt. documents, websites etc.

Demonetization in Past an Overview

Demonetization is the biggest step in Indian economic history. This section of the paper highlights what happened in the past and it also includes the countries which have tasted success, failed and messed-up demonetization in the modern era.

Demonetization in 1946 and 1978

The Government of India announced demonetization of 1000 currency note with effect from 12th January 1946 and gave little time for exchange too. As the notes were accounted only to 3% of the India's population, it didn't affect normal life to an extent. The government through this drive collected Rs.134 crore of the total Rs.143 crore available in the market (according to RBI estimates), only Rs.9 crore was not

exchanged therefore demonetized. It turned out to become more like a currency conversion drive as the government couldn't achieve much of profit in the cash-strapped economy at that time.

We repeated the same mistake by reintroducing Rs.1000, Rs.5000 and Rs.10000 bills in 1954.

The Wanchoo committee has stated in the late 1960s to the government to withdraw all high denominations, but it wasn't heard till 1978. In the Morarji Desai-led Janata Party Govt, the RBI had declared denominations over Rs.1000 as void. The Wanchoo Committee had recommended the government to withdraw the currency because the country was going through a difficult period. i.e. June 6, 1966 — the day our currency lost value.

The demonetization in 1978 failed because there were rumors that the demonetization would come into effect sooner or later. If the previous government had heard the committee's recommendations by agreeing to print 3.5 Billion currency notes in 1972, the public nature of the Wanchoo Committee wouldn't have created such a problem to encounter the inflation.

When notes and coins were withdrawn in the past

Year	Details
12 Aug 1946	Rs 500, Rs 1,000 and Rs 10,000 notes were demonetized to control black money.
1954	High denomination notes of Rs 1,000, Rs 5,000, and Rs 10,000 reintroduced.
16 Jan 1978	Denominations higher than Rs 100 demonetized again to control the menace of black money.
1987 & 2000	While Rs 500 note was issued in 1987, the Rs 1,000 note was reintroduced in the year 2000
1995	Re. 1 and Rs. 2 notes were removed from circulation.
2011	25 paise and all paise coins below this denomination were withdrawn.

Demonetization in different countries

The countries where demonetization was a big disaster for Government-

Soviet Union - In the year 1991, Mikhail Gorbachev Government banned the currency note of Ruble 50 and 100 in Soviet Union to end black money in the country. Government expected that it will decrease the market of black money and give a proper life to common people. But this decision of Gorbachev took a very wrong turn and people started doubting on government and this led to the change of government.

Ghana - In 1982, government of Ghana demonetized currency notes of Cedi 50 to control black money in the country. But after this people lost their faith from the economy policies of the country, and after few days, when time period of exchanging notes ended then crores of money were found on roads.

Britain - Before 1971, pond and pens currency used to be circulate in Britain but to bring uniformity in currency government stopped circulation of old currency in 1971, and bought coins of 5 and 10. Though,

government was continuously telling about this big change from last 2 years but this policy failed in other countries except Britain.

Congo - Dictator Mobutu Sese made some changes with currency of Congo for the smooth running of economy during 90s. However, these changes didn't give any better result of it in economy. And resulted in increased prices of necessity goods and share market saw a heavy downfall.

Myanmar - Military government discontinued currency notes in Myanmar in 1987 with the same thought of end of black money and corruption. But this led political dispute among government and citizens of the country.

Nigeria - In 1984, Muhammadu Buhari was the President of Nigeria, that time he started currency notes with new design and colour to bring economy in stable position. But it didn't brought any changes in the economy and as a result Buhari resigned from his position. It took long 21 years for him to become President again.

North Korea - In 2010, dictator Kim Jong-2 made some changes with currency to lower down the market of black money and to improve the economy of North Korea. But this decision of Kim Jong saw opposite face of it in economy. Price of necessity goods increased and this led people to become angry on this decision and resultant Kim Jong murdered finance minister and asked for apology.

Successful Demonetizations

European Union – The countries which joined European Union in the beginning phased out their respective currencies and adopted Euro in 2002 successfully.

United States of America – The highest value of denomination currently in production is the \$100 bill, but in decades past, the Federal Reserve has issued \$1,000, \$5,000, \$10,000 and even \$100,000 bills. The U.S. stopped printing the \$1,000 bill and larger denominations of currency by 1946, but these bills continued circulating until the Federal Reserve decided to recall them in 1969.

Zimbabwe– Zimbabwe used to have \$100,000,000,000,000 note. Yes, a one

hundred trillion dollar note. In 2015, the Zimbabwean government demonetized the Zimbabwean dollar as a way to combat the country's hyperinflation that was recorded at 231,000,000%. The 3-month process involved removing the Zimbabwean dollar from the country's financial system and solidifying the US dollar, Botswana pula, and South African rand as the country's legal tender in a bid to stabilize the economy.

Australia– In 1996, Australia decided to replace its paper-based notes with polymer bank notes.

This move changed all the currency in the country to a new type of banknote that was made of a different more durable material. The first plastic currency in the country was released in 1992 and by 1996, all the banknotes being produced were polymer-based. The notes released by Reserve Bank of Australia were the world's first long-lasting banknotes. Also, the polymer base made them counterfeit-resistant. Since the purpose was to replace paper with plastic and only the material changed, it did not have any side-effects on the economy.

Pakistan – Pakistan has also decided to move all the currency notes with old designs out of the system. Earlier also, Pakistan had demonetized PKR 5 and PKR 500 denomination notes. From 1st December 2016, Pakistan has phased out the old notes to bring in new designs. Pakistan legally issued the tender a year and a half back, and therefore, the citizens had time to exchange the old notes and get newly designed notes.

United Kingdom – The United Kingdom, adopting decimal currency in place of pounds, shillings, and pence in 1971 can also be cited as a successful example. Banknotes remained unchanged (except for the replacement of the 10 shilling note by the 50 pence coin). In 1968 and 1969 decimal coins which had precise equivalent values in the old currency (5p, 10p, 50p – 1, 2, and 10 shillings respectively) were introduced. Decimal coins with no precise equivalent ($\frac{1}{2}$ p, 1p, 2p equal to 1.2d (old pence), 2.4d and 4.8d respectively) were introduced on 15 February 1971. The smallest and largest non-decimal circulating coins, the half-penny and half crown, were withdrawn in 1969. Other non-decimal coins with no precise equivalent in the new

currency (1d, 3d) were withdrawn later in 1971.

Philippines – In 2015, the country demonetized its bank notes which had been in circulation for 30 years (introduced in 1985) with new ones which had only been in circulation since 2010 to prevent counterfeiting. From January 2017 onward, the old bills have been demonetized and will no longer have monetary value.

Need for Demonitization in 2016

In 2016, the Modi-led government had controlled the inflation. Made India more investment friendly, and getting strong leaders on board. We didn't have much of a problem like in 1946 and 1978. It was a kind of Swacch Bharat Abhiyan drive by the government to get more perspective points and reduce black money effect on the economy controlled by some powerful politician and businessmen.

RBI data shows that in 2015-16, almost 6.5 lakh counterfeit notes were detected in commercial banks of which almost 4 lakh were in the Rs 500 and Rs 1,000 category. It

is in this context that the government wanted to remonetize the Rs 500 note while demonetizing the Rs 1,000 note & Rs 2,000 note will be introduced as a new denomination. 86% of currency by value in India were of Rs 500 & Rs 1,000 denominations. It has been estimated that Rs 17, 54,000 crore worth of notes were in circulation according to the RBI's database on the Indian economy. Of this Rs 500 notes constituted almost 45% of the currency in circulation while 39% of the notes were of the Rs 1,000 denomination. However in terms of volume, Rs 10 and Rs 100 notes constituted 53% of the notes in circulation.

According to the data available with the RBI (chart below), the number of Rs 500 notes in circulation increased from 1,141 crore as of 31 March 2014 to 1,571 crore as of 31 March 2016, an increase of whopping 38 percent over two years. Similarly, the number of Rs 1,000 notes rose 24.5 percent from 508 crore to 633 crore during the period. Both the denominations together witnessed a jump of 33.6 percent over the two-year period.

Rs 500 and Rs 1,000 banknotes in circulation						
Denomination (Rs)	Volume (crore pieces)			Value (Rs lakh crore)		
	Mar-14	Mar-15	Mar-16	Mar-14	Mar-15	Mar-16
500	1141	1313	1571	5.7	6.6	7.9
(% share)	14.7	15.7	17.4	44.4	45.9	47.8
1,000	508	561	633	5.1	5.6	6.3
(% share)	6.6	6.7	7.0	39.6	39.3	38.5
500 and 1000 together	1649	1874	2203	10.8	12.2	14.2
(% share)	21.3	22.4	24.4	84.1	85.2	86.4
Total of all notes	7733	8358	9027	12.8	14.3	16.4
Source: RBI						

Meanwhile, share of Rs 500 notes as a percent of total currency notes in circulation increased during the period from 14.7 percent to 17.4 percent. The corresponding figures for Rs 1,000 stood at 6.6 percent as of 31 March 2014 and 7 percent as of 31 March 2016.

In value terms, Rs 500 and Rs 1000 notes together accounted for Rs 14.2 lakh crore, which is 86.4 percent of the total as of 31 March 2016. This is an increase from Rs 10.8 lakh crore (84.1 percent) in fiscal 2014.

The hoarding of cash by some people would be equivalent to withdrawing that cash from effective circulation as neither the hoarders nor anyone else would be using it to make payments. The total currency issued by the RBI would therefore get divided into two parts – one that was part of a cash hoard and another part in active circulation. If the hoarded part tends to be large relative to the total currency issued and the active part small, then the only possible explanation for us not feeling the cash shortage before demonetization would have to be that a much smaller amount of cash in

active circulation (than the total amount issued by the RBI) was enough to meet most of our requirements. Thus, it stands to reason that the replacement of a smaller amount of currency, than what was rendered useless by demonetization, should be able to restore normalcy, provided of course that this replacement does not go into converting the cash hoards of India's black money holders.

Steps Initiated for Demonitization in 2016

- Except for Finance Minister and top officials of the RBI, no one had the news about the activity which was on cards since 6 months.
 - The Cabinet was briefed early on Tuesday 8th November and were not allowed to move out of the premises till the PM finished his address.
 - It came as a shocker, but the government seemed well prepared to handle the situation.
 - PM has left no stone unturned for any hue and cry among the public.
 - Most of the unbanked sector brought into the banking ecosystem by the Jan Dhan Yojana with Rupay Cards.
 - Opportunity without extension was given **(through the Income Declaration Scheme)** to declare the black money and strictly warned of action to be taken by the government against hoarders.
 - The Indian Media is the freest media in the world. Media starts protesting for even a small issue. NDTV India received a ban for 24-hours of the Pathankot Attack coverage (later upheld by the Ministry of Information and Broadcasting till December 5, 2016) on 9th November 2016. All newspapers, journals, TV reporters spoke about this issue as a serious matter diverting the attention of the media from the demonetization. (P.S. Rumors had made the 1978 demonetization drive a culmination)
 - The government announced the decision after Diwali, making fewer problems for the general public.
 - The Best part: – The announcement was done by PM at 8 pm IST rather by the RBI in the morning.
 - Most of the businesses were shut for the day and people were wrapping up from their day's work.
 - Banks remained closed for the next day.
 - Black money hoarders couldn't find a way out to funnel the black money, making it a fool proof plan to nab all the hoarders under the tax radar.
 - Persons holding old notes of five hundred or one thousand rupees were allowed to deposit these notes in their bank or post office accounts from 10th November till close of banking hours on 30th December 2016 without any limit.
 - Withdrawal limit of ten thousand rupees per day and twenty thousand rupees per week. This limit was increased subsequently.
 - For immediate needs, citizens were allowed to convert the old 500 & 1000 notes worth Rs 4000 in a day in legal tender from any bank, head post office or sub post office, by showing identity proof like Aadhaar card, voter card, ration card, passport, PAN card or other approved proofs.
 - Those who were not able to deposit their old five hundred or thousand rupee notes by 30th December 2016, they were allowed to approach specified offices of the Reserve Bank of India up to 31st March 2017 and deposit the notes after submitting a declaration form.
 - There was a withdrawal limit of two thousand rupees per day per card from ATMs. Which was subsequently raised to Rs. 4000 per day per card.
 - For humanitarian reasons, to reduce hardship to citizens, some special arrangements for accepting the Rs. 500 & 1000 notes were made for the first 72 hours that is till midnight on 11th November.
 - Government hospitals for payment.
 - Railway ticket booking counters, ticket counters of government buses and airline ticket counters at airports for purchase of tickets. This was for the benefit of those who may be travelling at that time.
 - Petrol, diesel and CNG gas stations authorized by public sector oil companies
 - Consumer co-operative stores authorized by State or Central Government
 - Milk booths authorized by State governments
 - Crematoria and burial grounds.
- These outlets were asked to maintain proper records of stock and collections.
- Arrangements were made at international airports for arriving and departing

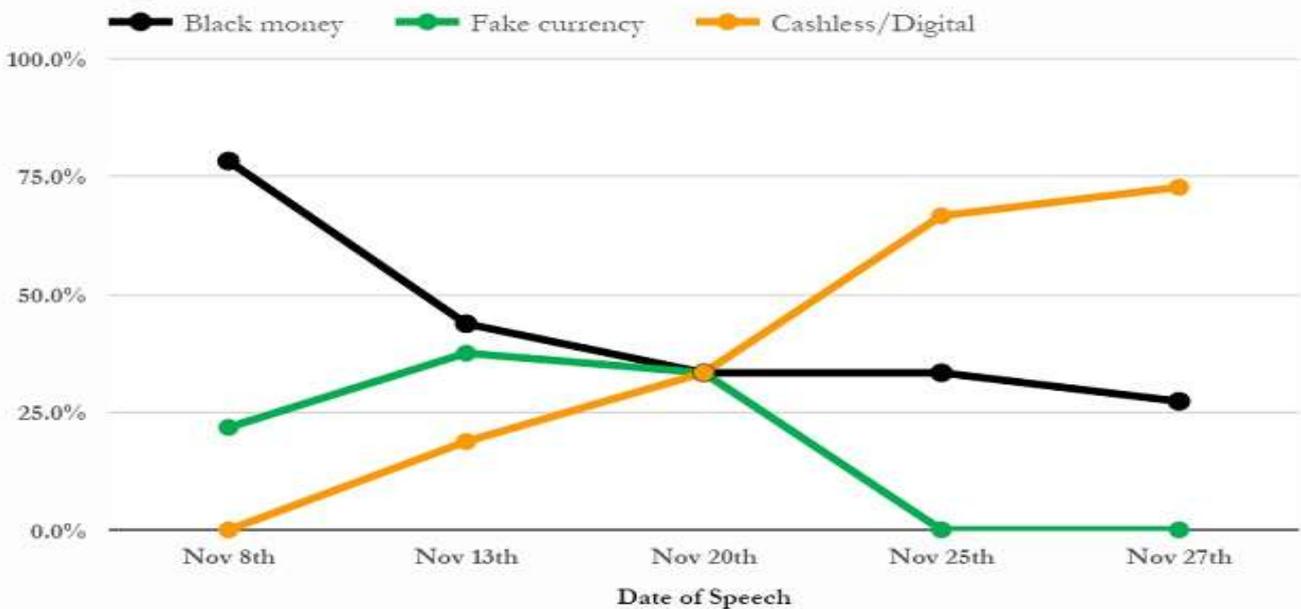
passengers who have five hundred or thousand rupee notes of not more than five thousand rupees, to exchange them for new notes or other legal tender.

- Foreign tourists were allowed to exchange foreign currency or old notes of not more than Rs 5000 into legal tender.
- There was no restriction of any kind on non-cash payments by cheques, demand drafts, debit or credit cards and electronic fund transfer.

Progression of key words in the Prime Minister’s speeches during 8th Nov, 2016 to December 2016

- On November 8, 2016, when the PM announced the demonetization policy, the Prime Minister used the phrase “black money” four times more than “fake/counterfeit currency”.
- By November 27, he used the phrase “digital/cashless” thrice as much as “black money” with no mention of “fake currency”. Recall, there was zero mention of “digital/cashless” in the initial November 8 speech.
- The chart below shows the ratio of the three narratives–“black money”, “fake currency” and “cashless/digital pay”–in each of the Prime Minister’s speeches over three weeks and seven speeches.

Progression Of Keywords In The Prime Minister's Speeches



- The saffron line representing the “cashless/digital” phrase in the Prime Minister’s speeches went from 0 in the November 8 speech to a 73% ratio in the November 27 speech.
- The green line representing the phrase “fake currency” went from 22% to 0 in the same period suggesting the Prime Minister no longer believes that terror financing was the primary or secondary driver of this demonetization exercise.
- The black line representing the phrase “black money” went from a high of 80% ratio on November 8 to only 27% on November 27. Apparently, it is no longer a “war on black money” but instead a “war on all currency” to go cashless.

- So, between November 8 and November 27, the objective for the demonetization exercise has swung from black money elimination to going cashless, as evident in the Prime Minister’s speeches.
- On December 10, 2016 over a month into the demonetization exercise, figures from the RBI imply that about Rs 7 lakh crore was available to the public. This consists of the valid currency withdrawn from banks against deposits or conversion of Specified Bank Notes (SBNs) between November 10 and December 10 (Rs 4.61 lakh crore) and the old currency of smaller denominations held by the public on November 8 (roughly

Rs 2.4 lakh crore). By December 10, a total of at least Rs 12.44 lakh crore of the invalid SBNs (more than 80% of the total in circulation on November 8) have also been deposited into bank accounts. The balance of these deposits, after deducting the amount withdrawn, or about Rs 8 lakh crore, was also usable by the depositors to make payments through non-cash modes on which there was no restriction.

Impact of Demonetization

On fake currency - A study by the National Investigation Agency and the Indian Statistical Institute, in 2016, estimated that fake Indian currency notes in circulation have a face value of Rs 400 crore. This is an incidence of fake currency of 0.022%.

The scale of counterfeiting of the Indian rupee is not out of line with what is seen in other countries, and the procedures adopted worldwide to address this include investigative actions against counterfeiters, phased replacement of old series of notes with new notes that have better security features, etc. Demonetization is generally not seen as a tool for dealing with counterfeiting. We must also not forget that the counterfeiters will now get to work on the new 500/2000 rupee notes, while India will likely never do a demonetization again.

On unaccounted wealth - The analysis presented in the Finance Ministry's White Paper on Black Money, 2012, shows that, on an average, the amount of cash seized during raids by income tax authorities is 4.88 percent of total undisclosed income admitted in those cases.

This data is from more than 23 thousand warrants executed. Even if this decision inflicted a 100% loss upon holders of unaccounted cash, this would imply a loss of 4.88% of their total unaccounted wealth, which is not much of a shock for those with such wealth. If, as is more likely, the demonetization has imposed a 40% loss upon holders of unaccounted wealth (who suffer a 40% discount when laundering the money), this implies a loss of about 2% of unaccounted wealth.

Working Population - As per Income tax return statistics report published by Central

Board of Direct Taxes (CBDT) The total number of individual returns filled in the assessment year 2014-15 were 36513034 out of which 34072124 returns were having income below Rs. 10 Lakhs which means 93.34% of the total returns were of below Rs. 10 lakhs. Approximately 5% of working population files income tax returns that means 95% of the working population is having income below Rs. 2 lakhs or they don't disclose the income. During the first few days of demonetization the individuals were allowed to withdraw Rs.2000 per day to a maximum ceiling of Rs. 10,000/- per week from ATM (i.e. Rs.40000/- per month) which was subsequently increased and there was no restriction on money transfer through account transfers. Therefore the impact of demonetization on working population was negligible.

Towards Cashless economy - Cash is expensive as a store of value - it gives negative returns and is amenable to loss and theft. Many households are forced to save in cash or other similar assets, because they do not have convenient and reliable access to the modern financial system. It would be beneficial for many households and enterprises to move most of their store of value to financial instruments, but only if considerable comfort around security, convenience and reliability of these instruments is created. Towards this end, the Finance ministry, RBI and NITI Aayog announced a host of incentives to boost cashless transactions. This was also done to ease some of the problems that have resulted due to acute shortage of cash in the economy.

Some of these incentives include:

- No Service Tax on cashless transactions below Rs 2000
- Providing cash backs ranging from 0.25-0.75 percent on various transactions like paying for fuel, govt utility bills, stamp papers, property registrations etc.
- Encouraging use of Point-of-Sale (PoS) machines and mobile wallets by businesses and individuals
- Reducing self-assessment tax from 8% to 6% on businesses with annual turnover of less than Rs 2 crores
- Announcing monthly jackpots for people using cashless transactions in govt services.

Usage of debit/credit cards



Source – RBI, CEIC, MOSL

According to the government data, the number of daily transactions through e-wallet services such as Oxigen, Paytm and MobiKwik has shot up from 17 lakh- recorded on November 8 when demonetization was announced — to 63 lakh as on December 7 (a growth of 271%). In terms of value, the surge has been 267%, from Rs 52 crore daily to Rs 191 crore now. Transactions through RuPay Cards (e-commerce and point-of-sale) were up 316% at 16 lakh daily (3.85 lakh on November 8), while in terms of

value the growth has been 503% at Rs 236 crore (Rs 39 crore).

On Overall Economy -The Indian economy grew by 7% (year-on-year) in the fourth quarter of 2017, which is at odds with expectations. Private consumption contributed strongly to growth by 5.7 percentage points. Moreover, other drivers were government investment and consumption, contributing an addition 3 percentage points to the headline figure.

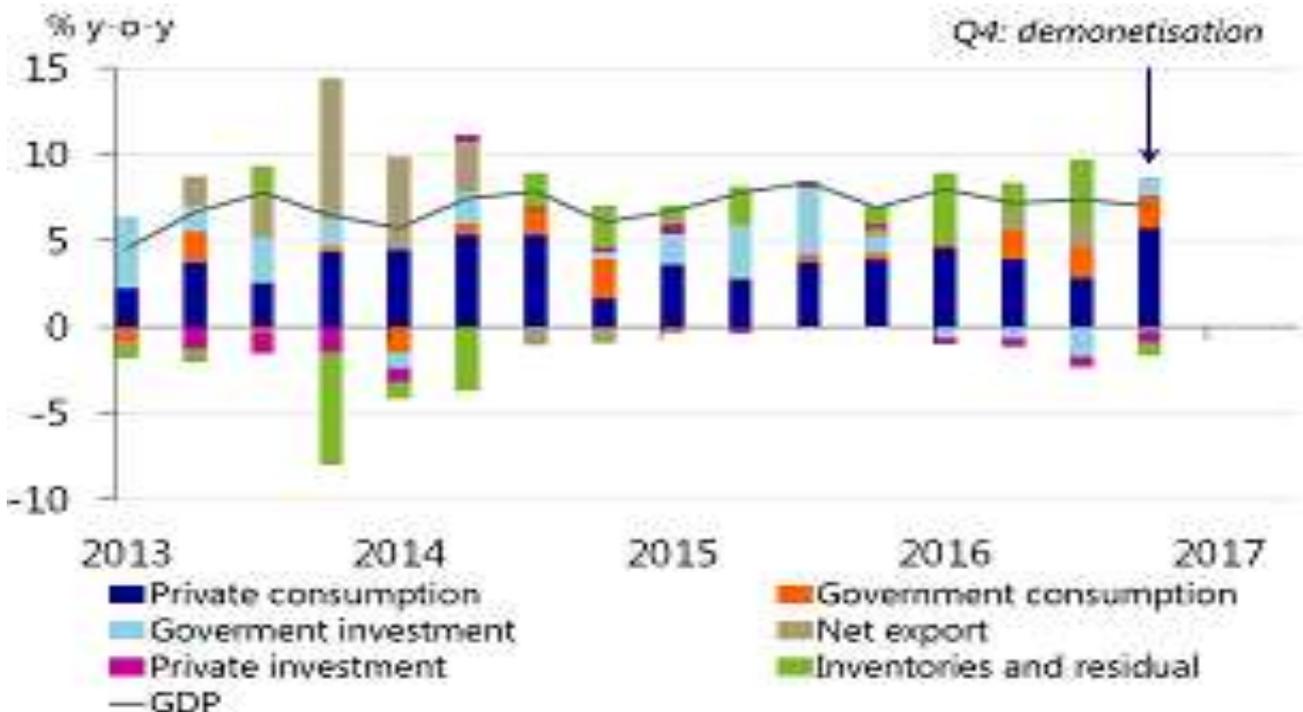


Figure: Indian economy didn't budge in Q4

Source: economics.rabobank.com

If we look at the sector contribution to the macro growth figure, the real estate sector seems to have taken a hit in the fourth quarter, but this was largely counterbalanced by a strong contribution of the agricultural

sector and manufacturing, two sector which were also expected to be damaged by demonetization due to heavy cash-dependency and shrinking investment, respectively.

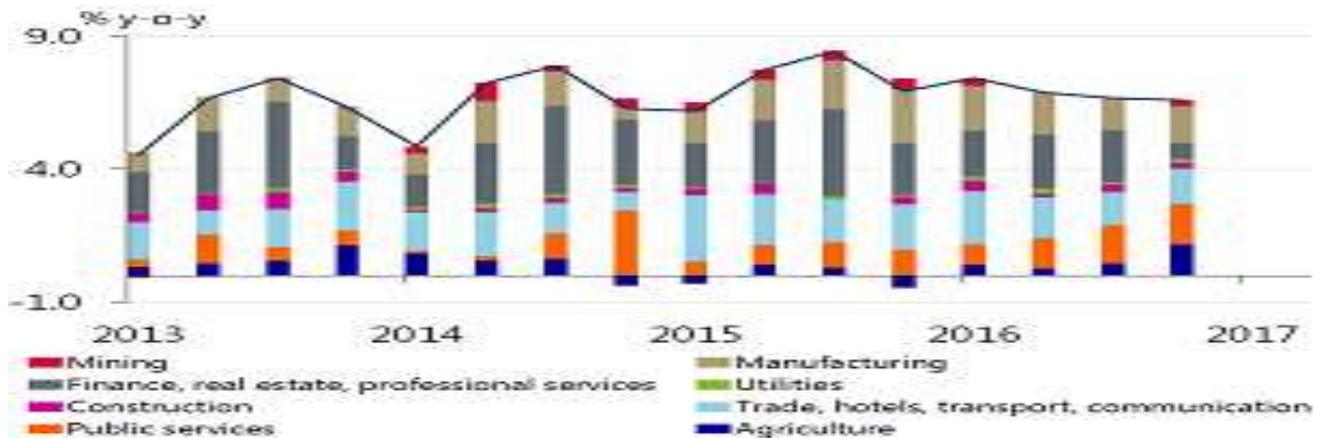


Figure: Lower real estate activity has been counterbalanced by higher manufacturing and agricultural activity

Source: economics.rabobank.com

The GDP growth rate has held up at more than 7%. Foreign direct investment went up significantly during the year. (It rose 30% on a year-on-year basis to \$21.6 billion between April and September 2016, according to public data published by the India Brand Equity Foundation, a government-sponsored trust.)

Conclusion

Demonetization of old currency notes surely has had some positive impact like reducing the cash flow to terror organizations, dismantling of counterfeit currency infrastructure, better income tax and indirect taxation, boost to digital economy. Demonetization is a one-time event and will not have much long term effect. It alone is not sufficient to counter black money and corruption in the country; rather other measures are more crucial like bringing the

offshore tax evaders to book whose names figure in the Panama papers, raid on benami properties, making donations to political parties open to public scrutiny and making it mandatory for all donations above Rs 2000 to political parties and religious places to be through digital means only.

However we need to remember that increase in cashless transactions is against a very low base of digital transactions and most of this increase has been noticed in the urban areas where people have ready access to Point of Sale (PoS) machines, internet banking, and mobile wallets. Cashless transactions are still rarely used in rural areas and in the informal sector like road side vendors, small shops, buying seeds, wage payments etc. The government should take concrete steps to increase the usage of cashless mode of transactions by the informal sector [1-10].

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