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On the heels of The Undisclosed Foreign Income and Assets (Imposition of Tax) act of 2015; and the Income Disclosure Scheme of 2016, the Narendra Modi government had announced demonetization of Rs 500 and Rs 1000 currency, which has been referred to as a masterstroke by many experts.

This article is an essay on demonetisation. It elaborates on the concept, merit and demerits, and the effect of demonetisation in India. It also showcases the critical analysis of demonetisation in India.

Essay On Demonetisation in India

Concept Of Demonetisation

The withdrawal of currencies or other valuables by the central bank to be used as the legal tender in the nation. Such currencies either turn into scrap or a deposited in the banks and replaced by the new currencies.

Governments of many countries across the world have taken this drastic measure to curb black money and stop the counterfeiting of currency notes. Some countries failed miserably while others were successful in their goals behind demonetization. Let's take a glance at the countries that underwent demonetisation and the impacts they had to face.

The Decimal System in the United Kingdom in 1971: The biggest change to the currency of Britain for more than a thousand years took place in 1971 when the British adopted the decimal system. As per this system the pound was divided into 100 pence. The transition of Britain's currency to decimal was a success as it was done after spreading awareness and doing education campaigns for three years.

African countries:

In the year 1984 during the government of Muhammadu Buhari, Nigeria banned old notes and introduced a new currency. However, the inflation hit, and the debt-ridden country did not make the change well and the economy collapsed.

Similar is the case with Ghana, another African country that underwent Demonetisation in the year 1982. Ghana wanted to curb tax evasion and empty excess liquidity so they ditched their 50 cedis note. This made the nationalists support the black market and they started investing in physical assets which resulted in further weakening of the economy.

The Government of Zimbabwe in 2015 replaced the Zimbabwe dollar with the American dollar. Before this, Zimbabwe had a currency denomination of 100 trillion Zimbabwean dollars. Now, the multiple currency system is abolished by the Reserve Bank of Zimbabwe and replaced with a new Zimbabwe dollar known as the RTGS Dollar.

Myanmar:

In 1987 the military government in Myanmar invalidated eighty percent of the Myanmar kyat to curb black-marketeering and smuggling. This demonetisation drive caused terrible economic unease as it had no provision for any exchange of the scrapped denominations. There were mass protests and resulted in the ruthless killing of around a thousand people.

Soviet Union Monetary Reform 1991:

In 1991 Mikhail Gorbachev decided to withdraw 50 and 100 ruble notes. It was also known as Pavlov Reform on the name of Minister of Finance Valentin Pavlov. Due to this reform, the economy collapsed and even resulted in the break-up of the USSR.

Australia:

The Australian government was the first to introduce polymer-based plastic notes in 1992. To curb black money and improve the security features, Australia underwent Demonetisation and replaced all paper notes by plastic currency in 1996. As polymer-based notes were already in use for four years, the transition was smooth and didn't have any impact on the economy.

Pakistan:

Pakistan's central bank, in 2016 decided to phase out banknotes of older design to curb black money and gave the general public six years to exchange their currency. People were notified regarding the change and there wasn't any chaos in the process. But field officers of the central bank will continue to accept the notes of older design till December 31, 2021.

Demonetisation In India

Basic meaning

- It refers to the decision of RBI/Government to recall the status of a currency note to be used as a legal tender. Usually, all the currencies issued by RBI can be used as a legal tender as the value they carry is promised by RBI and once the value has been demonetized/recalled/revoked, the currency note cannot be used. Globally the central banks follow a practice wherein older currency notes are recalled and new currency notes with enhanced security features are issued to overcome the menace of counterfeit currency.

Why was demonetization done (as per the reasons given by the government in the present case)

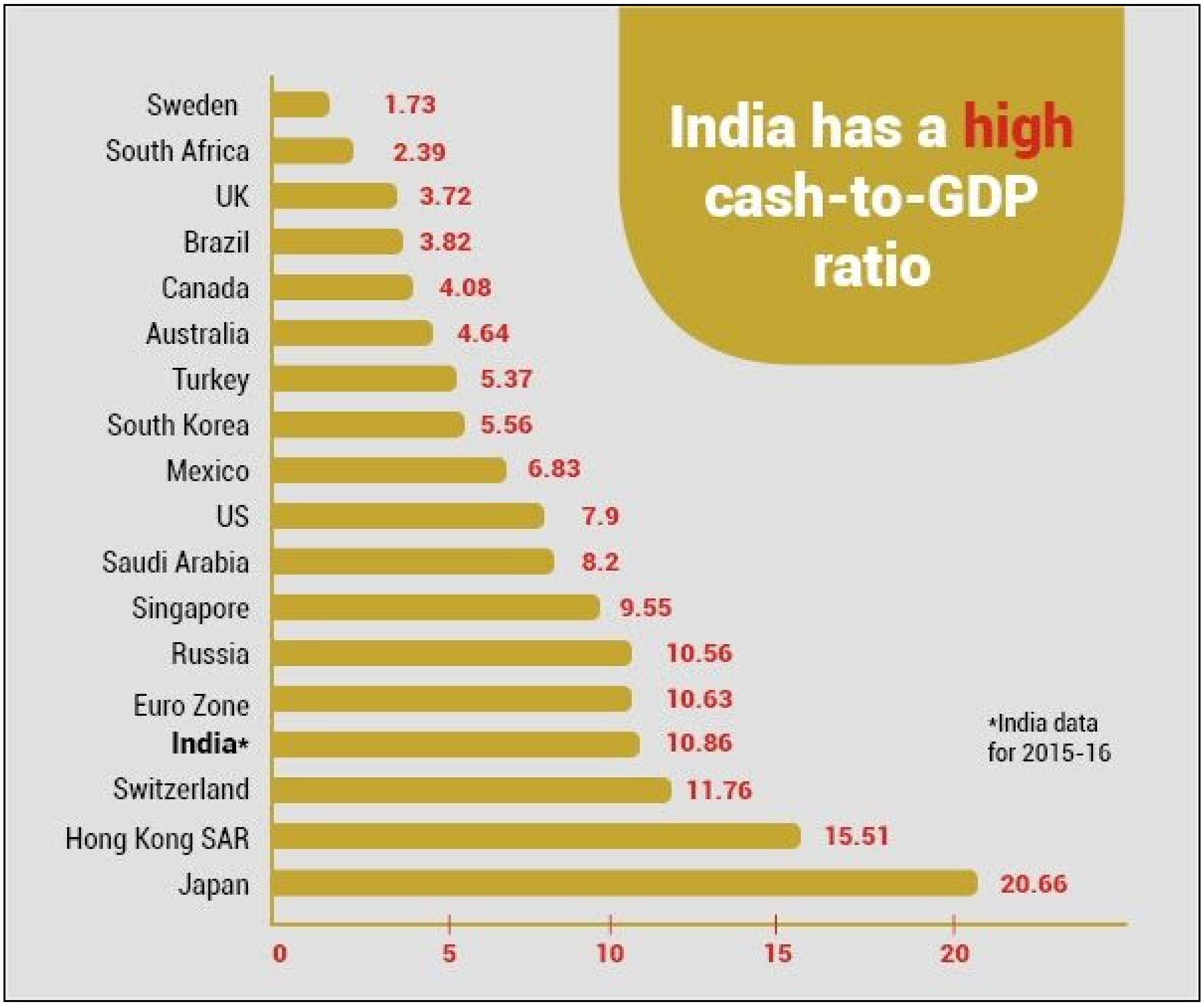
- To tackle the menace of black money/parallel economy/shadow economy
- The cash circulation in India is directly connected to corruption hence we want to reduce the cash transactions and also control corruption and thereby move towards cashless transactions.
- To counter the menace of counterfeit currency
- To prevent the cash being used for terrorist activities/terror funding
- This is the only second-time post-independence (even before Independence Demonetization was done in 1946) that the measure such as Demonetization has been announced. The last time this was done was in 1978 under the Morarji Desai government when Rs 500, Rs 1000, and Rs 10000 notes were demonetized. A CBDT report which evaluated this measure concluded that
    - It was an ineffective move as only 15% of the high denominations were exchanged
    - The rest never surfaced for the fear of stringent penalties by the government. As per the High Denomination Bank Notes (Demonetization) Act, 1978, it barred the transfer and receipt of high denomination banknotes and made any contravention including a false declaration by depositors and others punishable — with a fine or a three-year prison term
    - The report concluded that demonetization may not be a solution as black money was largely held in the form of benami properties, bullion, and jewellery. Such a measure would only increase the cost as more currency notes which have to be printed. It could also harm the

banking logistics

(In the present age the European Central Bank has announced that it would demonetize €500 note)

- India has one of the highest levels of currencies in circulation which is more than 12% of its GDP value, and the 1000 and 500 rupee notes account for 24.4% (around 2300 crore pieces) of currencies in circulation but over 85% in terms of the value of the currency in circulation Having said so it has to be kept in mind that India is not an outlier in this segment as there are various other countries such as USA's $100 note and Japan's ¥10000 account for over 80% of currencies under circulation.

Denomination	Number of Units in Circulation (in millions)	%age of units out of the total circulation	%age value out of the total value of notes
Rs 100 note	15778	17.5	09.6
Rs 500 note	15707	17.4	47.8
Rs 1000 note	06326	07.0	38.6


India has a high cash-to-GDP ratio
Sweden 1.73
South Africa 2.39
UK 3.72
Brazil 3.82
Canada 4.08
Australia 4.64
Turkey 5.37
South Korea 5.56
Mexico 6.83
US 7.9
Saudi Arabia 8.2
Singapore 9.55
Russia 10.56
Euro Zone 10.63
India* 10.86
Switzerland 11.76
Hong Kong SAR 15.51
Japan 20.66
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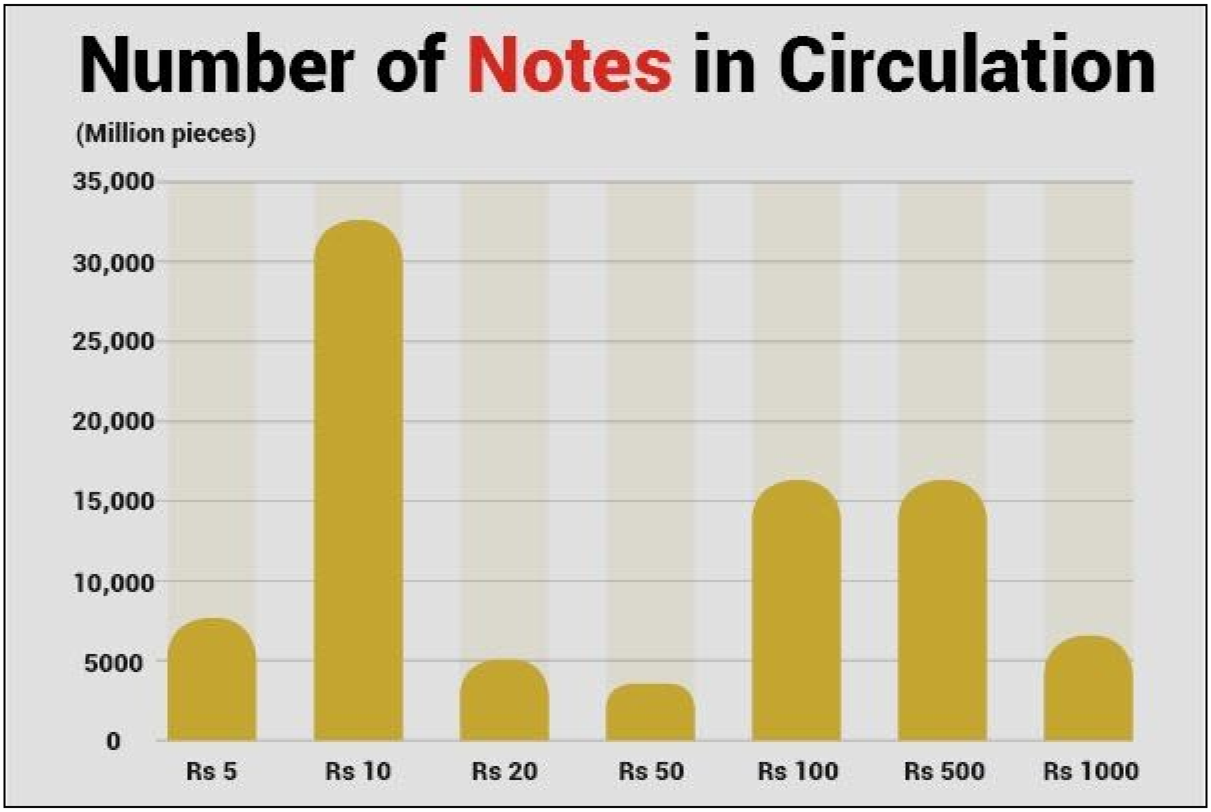
*India data for 2015-16



Cash is the king – In India majority of the transactions are done in the form of cash

- As per RBI, 87% of the transactions in India are cash transactions
- As per the RBI report, debit cards at ATMs account for 88% and 94% (by volume and value respectively) of the debit card transactions, and 12% and 6% account for POS transactions.
- The infrastructure growth is slow – The POS machines and ATMs are 1.2 million (and there are around 14 million merchants in India, in essence, more than 90% of the merchants are not using the POS machines) and 0.19 million respectively. (From 2013 to 2015, ATMs increased by 43% and POS machines by 28%)
- **Reasons**
    - ATMs and POS machines are concentrated in an urban area
    - Penetration in non-urban areas is very poor add to this, the connectivity issues
    - Even if the POS machines are installed, low-value transactions are discouraged by the merchants
- **Silver lining**
    - The number of cards issued is on the rise
    - The acceptance infrastructure has to be placed
    - Increasing trade on e-commerce (provided it promotes online payments/transactions)
    - The increasing number of digital wallets-Paytm, Pockets, etc
    - The government has implemented Jan Dhan Yojana and under this, a large population has been able to open their accounts which will be helpful (in the sense the debit cards issued have increased)
- **Menace of counterfeit currency (FICN-Fake Indian Currency Notes)**
    - As per the statements given in RS by Arjun Ram Meghawal (Minister of State for Finance), the total FICN is to the tune of Rs 400 Cr

- As per the Lok Sabha Website between 2011 and 2015, the RBI has seized around 26 lakh counterfeit notes of denomination Rs 500 and Rs 1000 amounting to Rs 167 Cr
- Amongst the two, the FICN of Rs 500 currency notes were higher (both in numbers and in value)
- As per a study done by ISI (Indian Statistical Institute), at any given point of time, the FICN is to the tune of Rs400 Cr and annually the FICN pumped into the economy is Rs 70 Cr

FICN Notes seized between 2011 and 2015

	500		1000	
S.No	Notes	Value in Crore (RS)	Notes	Value in Crore (RS)
2011	3.8 lakh	15.41	99,050	9.9
2012	5.3 lakh	26.51	1.65 lakh	16.54
2013	4.29 lakh	21.49	1.94 lakh	19.48
2014	2.9 lakh	14.52	1.46 lakh	14.69
2015	2.61 lakh	13.05	1.58 lakh	15.84
TOTAL	**18.9 lakh**	**90.98**	**7.64 lakh**	**76.47**

Measures taken

- FCORD (FICN Co-Ordination) group has been set up by MHA (Ministry of Home Affairs) to share the information with other security agencies regarding controlling FICN
- The MHA (Ministry of Home Affairs) has set up CCT Cell (Combating Financing of Terrorism Cell) to co-ordinate with FATF (Financial Action Task Force- it's an intergovernmental body has remarked that high-value bills are used in money laundering schemes, racketeering, and drug and people trafficking)
- TFFC (Terror Funding and Fake Currency Cell) has been set up under NIA (National Investigation Agency) to investigate the terror financing using FICN
- MoU (Memorandum of Understanding) has been signed between India and Bangladesh to prevent circulation and smuggling of FICN (the majority of the inflows of FICN is done through Pakistan, Nepal, and Bangladesh)
- **Less cash Vs Cashless**

The debate has been raging in India over the need for the country to become a cashless economy but the fact of the matter is that a sudden shift from cash-based to cashless will have huge repercussions and not to forget that cash facilitates trade, hence there is a need for India to first move into the less-cash economy (one of the aims in introducing Rs 2000 note) and then move towards becoming a cashless economy

- Views of Raghuram Rajan (again many economists have the same viewpoint)
    - The intelligent always find a way around when the currency is demonetized
    - It becomes much more difficult if they have stored the black money in other forms-gold, asset, etc
    - So the way out is that rather than running behind these measures, we must implement the systems, procedures which will bring all those who are supposed to pay the tax, under the tax bracket and we can collect the appropriate taxes from them (as in India, the highest rate of taxation is around 33%, whereas in America, after including the federal and state taxes the tax rates are around 50% and in case of UK it is hovering around 45%)

Analysis of Demonetisation in India

- **Pros of Demonetization**
    - The menace of black money can be controlled to some extent
    - Terror financing, using black money for illegal activities, etc will all take a hit
    - The counterfeit currencies which have an impact on the real economy will be rooted out
    - The mobilization of deposits in the banks will increase, which may lead to increased credit flow and lowering of lending rates
    - The black money adds to the inconspicuous demand and hence the inflation to some extent will be under control
    - The government is also aiming to raise its revenue collection (eg- by taxing exorbitant IT rates over certain deposits, the tax collection in other forms will also increase, etc)
    - Real estate is one of the major sources of black money generation. With this move, it is expected that the property market rates may bottom out or moderate
    - It's a major step by the government towards forming a cashless economy
    - The honest workers will be rewarded under such a scenario
    - The elections are usually associated with black money generation and circulation, with this scheme the funding of elections through nefarious ways will be hit
    - It is expected that with this move the Fiscal Deficit of the government may come down
- **Cons of Demonetization**
    - For one all the black money is not stored in the form of cash only and secondly, the measure takes care of the result but not the cause-black money is generated mainly because of corruption and tax evasion. This measure controls the usage of black money but cannot control the causes
    - Sudden and huge demand for the new currencies
    - Panic amongst the common man (already we have seen the case wherein people have looted fair price shop in MP, Cash Carrying companies seeking higher insurance, etc). already the panic has led to people hoarding currencies which have further reduced the liquidity in the market
    - The small trade/shopkeepers are facing difficulties
    - Black marketing of the new notes/currencies is on the rise
    - The establishments such as banks, hospitals, etc are under a lot of stress
    - Another area that is a cause of worry is the likely drop in the rural demand as the cash usage will become restricted. Apart from this, the experts are also expecting an impact on the SME sector, agricultural production (the economy was expected to perform well as there was an expectation of a good rabi crop after two bad monsoons but a prominent economist, Pronab Sen has said that demonetization is akin to third bad monsoon year as it will have an impact

on agricultural production, but the more dangerous situation is this having a spillover effect on to fertilizer, tractor sectors)

- **Challenges**
    - The coverage of the banking sector-
        - Only 27% of the villages have a bank within 5 Kms (as per Economic Survey 2015-16)
        - Despite recording breaking implementation of JDY, the banking penetration is low-on an average 46% in all the states (as per Economic Survey 2015-16)
    - Another challenge in implementing and eradicating black money would be the presence of the informal economy. It accounts for 45% of GDP and 80% of employment hence this move may have a greater impact on the informal economy
    - Logistics and cost challenges of replacing all the Rs 500 and Rs 1000 notes – as per the RBI documents this measure would cost at least Rs 12000 crore as it has to replace over 2300 crore pieces of these currencies
    - The decision to issue Rs 2000 denomination currency and withdrawal of Rs 500 and Rs 1000 currency will lead to huge challenge as most of the day to day transactions in India are centered around Rs 500 note (more than 47% of the value of notes in circulation is in Rs 500 note form)
    - The availability of Rs 500 and Rs 1000 notes will be the biggest challenge as both of them covered over 85% in terms of the value of total currencies issued
    - The process has led to huge rush and long queues of the people in front of ATMs and as per the statement of the finance minister the ATM recalibration would take around 2 to 3 weeks
    - As per data furnished by the Finance Ministry, Rs 17,50,000 crore worth of currency notes were in circulation in October-end, out of which over 85% percent or Rs 14,50,000 crore is in the now-defunct Rs 500 and Rs 1,000 notes. So far for the first four days, the government has been able to pump in Rs 50000 cr (on an average 12500 Cr). Going by these numbers it would take around 4 months to replace these notes as against the 50 days promised by the PM


Impact of
Demonetization
Tectonic impact on parallel economy
Indian Government's move on demonetization of Rs.500 and Rs 1,000 currency notes will curb unaccounted for cash in the economy
Boost Savings
Large amount of cash in circulation is likely to brought within the purview of formal banking system in the form of deposits thus boosting deposit base as well as financial savings
GDP Growth
Short term implications in cash-intensive sectors like real estate, consumer discretionary and informal sectors. Decline in money supply will directly impact growth.
Real Estate
Limited impact in Tier I cities than the Tier II and Tier III cities where cash components have been a factor even in primary sales, will see a business crunch.
FMCG
Discretionary consumption may see some impact as consumers with a liquidity crunch may become choosy on where the spend.
Gold
Demand for gems and jewelry likely to decline in the short term and impacts both the wholesale and retail markets for bullion. Sales are likely to go down until the public is comfortable with this change.
Automobile
Two-wheeler sales in the rural market are likely to come down as known to be driven by cash transactions. And luxury car segment, which may see a slowdown as it is largely driven by unaccounted money.
Payment Banks
Demonetization will give a major push to e-wallets and the recently launched Unified Payment Interface(UPI), an inter-operable system launched by the Reserve Bank of India(RBI) and the National Payment Corporation of India (NPCI), which will allow peer-to-peer and peer-to-entity payments.
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- **Worries**

    - The rural demand even after a good monsoon is unlikely to pick up and agriculture production is unlikely to achieve a 3.5 to 4% GDP growth rate
    - As per Prof Bhanumurthy (NIPFP), all the black money may not find its way to the banks hence GDP growth rate may come down by 1.1% (the professor has also remarked that the money which was not there in the system is being pumped in and add to this if the online transactions are promoted then the GDP growth may pick up rather than declining)
    - As per economist Pronab Sen, this may lead to a lowering of GDP by 0.2 to 0.3%, and in extreme cases, we may end up achieving 7% (targeted is 8%)
- **The opportunists**

The online service providers have up their ante when there is a shortage of currency notes, pushing their products/services by providing discounts, coupons, credit, etc. For example, Paytm, which is the largest mobile wallet company, has said that it (since the ban kicked in)

- Has seen a 700% increase in overall traffic on the platform
- 1000% growth in the value of money added to the Paytm accounts
- The average transaction value has increased by 200%
- Mobile app downloads have increased by 300%
- Has processed around 5 million transactions each on 12th and 13th (Saturday and Sunday respectively) of this month

The future

There is no doubt that the coming months will be painful for the common man, small businesses, housewives, etc as there will be some shortage of legal tender/currency that will have an impact on them. Another rising issue will be that the demand for POS machines, Debit Cards which has to be resolved lest the measures will become an obstacle rather than the solution.

If these measures are implemented efficiently then we can expect a higher collection of taxes, higher investments in the market, price corrections, improvement of India in some of the international rankings, prevent corruption practices, etc and these are some of the reasons why people, although are going through difficulties, are lauding this measure of the government

But after having discussed so much, will this measure eliminate all the black money in the economy? The answer simply would be a confirmative NO as it has been seen that the black money is stored in various forms other than cash (such as gold, jewellery, assets, etc) and as per A 2012 report prepared by the National Institute of Financial Management – on unaccounted income – found that cash was the least preferred option for storing unaccounted wealth

Measures by the Government to control black money

- One of the first cabinet decisions taken by the government was to set up SIT (Special Investigation Team) on Black Money
- The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, came into force on July 1, 2015, under which the tax rate imposed was 60%
- Further upon the leaks of the Panama Papers, the government constituted a Multi-Agency Group (MAG) comprising officers of the Central Board of Direct Taxes, Reserve Bank of India, Enforcement Directorate, and Financial Intelligence Unit.
- Lok Sabha recently has passed the Benami Transaction Bill, 2015 which is an anti-black money measure that aims to seize unknown property and prosecute those indulging in such activities.
- This year the government has amended its DTAA's and is in negotiations with some other countries
- It is also under negotiations with the authorities in Switzerland in signing Automatic Exchange of

Information (AEOI)

- In this year's budget government had announced IDS (Income Declaration Scheme) under which it has successfully collected Rs 65,250 crore in the form of taxes.

The topic ' Demonetisation' can be asked in either prelims or in Mains (GS 3, or Essay) exams. It makes a good topic for Indian Economy preparation that comes under Mains GS III. Aspirants can refer to UPSC Mains GS 3 Strategy and Syllabus article for more information on GS III preparation.