

DEMONETIZATION AND ITS IMPACT ON INDIAN ECONOMY – A COMPARATIVE STUDY

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Abstract: Demonetization is the process of disavowal of respective currency from circulation in a nation. Demonetization becomes imperative whenever it requires changing the national currency due to any specific reason. It includes either to introduce new currency of the same denomination or to replace the old denominations with the new one completely. The main reasons for a nation to demonetize its local unit of currency are – to combat inflation, corruption, counterfeiting and tax evasion, to inhibit cash-dependent economy and to facilitate the trade. The purpose of this research paper is to correlate and evaluate the impacts of demonetization and its significance in fiscal evolution in India by comparing it with other countries. This research paper attempts to throw some light on the historical importance of the demonetizations and its positive and negative repercussion. This study also provides an insight to the process of demonetization and its impact on the development of different countries.

Introduction: Demonetization is the act of stripping a currency unit of its status as legal tender, such legal tender being money. It means putting a bar to the usual medium of exchange in a country which primarily is cash. This may sometimes include other negotiable instruments as well. Demonetization occurs whenever there is a change of national currency: The current form of money is pulled from circulation and retired, which is then replaced with new notes or coins. Nations may opt to demonetize their currency for multiple reasons varying from combating inflation, corruption and crime to eradicating counterfeit currency and black money. Another major motive could be promoting a cashless economy and fighting tax evasion, which was the rationale behind India's demonetization. The abrupt announcement of demonetization by the government was aimed to combat India's thriving underground economy on several such fronts.

On November 8, 2016, the two biggest denominations of the Indian currency system were demonetized which accounted for 86% of the country's circulating cash. The demonetization making notes of such denomination worthless was announced with little warning, by India's Prime Minister Narendra Modi. Citizens then had the option of depositing their old notes or exchanging them for the newly introduced bills of Rs 500 and Rs 2000. But such deposition and exchange was in every way restricted to be done until the end of the year. As a result of this sudden economical action, individuals who secured huge sums of black money were forced to take such sums to a bank, where it was mandatory to provide the tax information on such money. If the owner could not provide proof of making any tax payments on the cash, a penalty of 200% of the owed amount was imposed.

Statistics show that right in the first week after demonetization, over 3 trillion rupees, or over \$44 billion in old currency, was deposited with Indian banks. Although it succeeded in serving its purpose to a great extent, but this move by the government is believed to have shook the momentum of the fastest growing economy in the world as it brought about a lot of chaos in an economy which was completely cash dependent, leaving the citizens struggling for cash outside ATMs and banks.

History of Demonetization in India: Paper Money was introduced for the first time in the late eighteenth century as a legal tender. The Victoria portrait series was issued in few denominations of 10, 20, 50, and 100. Rs.1000 and Rs.10, 000 currency notes were also issued between 1938 and 1946. For the

first time notes of Rs.10 with Ashoka Pillar watermark series was circulated between the year 1967 and 1992 time, Rs 20 in 1972 and in 1975, Rs 50 in 1975 and 1981 and Rs 100 was issued during 1967-1979. In 1980, the slogan of Satyameva Jayate — ‘truth alone shall prevail’ — was incorporated under the national emblem for the first time.

10,000 rupee note was the highest value of denomination which was issued by the Reserve Bank of India (RBI) in 1938 and in 1954. The currency with the picture of Mahatma Gandhi on it was introduced in 1996 “in the denominations of Rs 5, (introduced in November 2001), Rs 10 (June 1996), Rs 20 (in August 2001), Rs 50 (March 1997), Rs 100 (in June 1996), Rs 500 (in October 1997) and Rs 1,000 (in November 2000). The Mahatma Gandhi Series – 2005 bank notes were issued in the denomination of Rs 10, Rs 20, Rs 50, Rs 100, Rs 500 and Rs 1,000 and carried some additional/extra security features as compared to the 1996 MG series. A new redesigned series of Rs500 banknotes and a new denomination of Rs 2000 banknote are added and are in circulation since 10th of November 2016.”¹

Demonetization around the World:

- **United States:** Due to the enforcement of The Coinage Act of 1873, silver coins along with two-cent piece, three-cent piece, and half dime were removed as the legal tender of the United States and adopted the gold standard which resulted in a contraction of the money supply and subsequently led to a five-year economic depression. To handle this critical situation and huge pressure from farmers, silver miners and refiners, the Bland-Allison Act was passed which remonetized silver as the legal tender of US in 1878.
- **Australia:** In 1996, Australia became the first country to issue a full series of polymer currency notes to replace paper-based notes to stop counterfeiting. This currency was more durable than paper currency. Later on plastic currency was launched in 1992 and by 1996; all the currency notes produced were made of polymer. Reserve Bank of Australia issued the world’s first long-lasting currency notes with the additional benefit of the polymer base as it is counterfeit-resistant
- **European Union:** Nations of the European Union introduced euro as their currency in 2002. At that time, the previous national currencies, such as the German mark, the French franc and the Italian lira were demonetized and the euro bills and coins were introduced. However, the various currencies of EU nations remained exchangeable into Euros at fixed exchange rates for a while to assure a steady transition.
- **Zimbabwe:** The Zimbabwean government demonetized its dollar as to combat the country’s hyperinflation in 2015 which was recorded at 231,000,000%. It was a three-month process which involved abolishing the Zimbabwean dollar and accepting the U.S. dollar, the Botswana pula and the South African rand as the country’s legal tender in an attempt to uphold the economy.

Demonetization in India: The Indian government’s stated objectives behind the demonetization policy as discussed earlier were: first, it was an attempt to make India corruption free. Second it was done to curb black money, third to control escalating price rise, fourth to stop flowing of funds to illegal activity, fifth to make people accountable for every rupee they possess and pay income tax return. Finally, it was an attempt to make a cashless society and create a Digital India. But to what extent these attempts were successful is what determines whether the idea turned to be a boon or not. The demonetization policy is being seen as a financial reform in the country but this decision is fraught with its own merits and demerits.

Advantages of Demonetization:

- **Black Money Tracking:** Fighting black money was one of the foremost objectives of this entire exercise. Various reports show that most of the black income was converted into white by various means such as by depositing it in Jan Dhan accounts or in individual’s own accounts by breaking into smaller chunks, by exchanging for new currency notes through hawala dealers, by buying last-minute luxury items, by paying advance wages to employees etc. Even after applying the above mentioned rescue methods, a total of Rs 3185 crores has been seized by the Income Tax authorities since the launch of the demonetization drive. This move has helped the government to track unaccounted black money.

- **Reduction in Illegal Activity:** Banning high-value currency has halted illegal activity. Black money is usually used to fund the illegal activity, terrorism, and money laundering. The move has barred funding to the unlawful activities that flourished due to unaccounted cash flow. It has also curbed the menace of money laundering, making it easily track-able. Fake currency circulation has also come to halt in a single shot. The Income Tax department is now regularly taking all the measures to track corrupt officers, money launderers and other such people.
- **Tax Payment:** India's tax-to-GDP ratio is quite low as compared to other emerging economies. The individuals who had unaccounted cash now have to show income and submit PAN for every valid financial transaction. Individuals making any deposit of Rs 50,000 or above in cash are required to submit PAN. This helps the income tax department to track individuals with high denominations currency. The demonetization policy has forced people to pay income tax returns. Most of the people who have been hiding their income are now forced to come forward to declare their income and pay tax on the same. Moreover businesses that under-reported their revenue earlier, now have to make proper disclosure, especially, of revenue received through digital or cashless means. Also tax rates have lowered as the tax base has widened because more people have started paying taxes
- **Jan Dhan Yojana:** The people who had opened Jan Dhan accounts realized its benefits. They can now deposit their cash under this scheme and this money can be used for carrying out various developmental activities in the country. This is why individuals now are depositing enough cash in their Jan Dhan accounts which they were reluctant to do so a few days back because they understand that the amount deposited can be used for the betterment of the country.

Demonetization lead to all the monetary transaction being made through the banking methods and individuals now has to be accountable for each penny they possess. It is a giant step towards the dream of making a digital India.

Disadvantages of Demonetization:

- **Inconvenience to the Citizens:** The demonetization of the currency caused huge inconvenience to the people for the initial few days. They rushed to the banks to exchange notes, deposit amounts or withdraw money. Delay in the circulation of new currency lead to further problems. Individuals who had an upcoming wedding had to make alternative arrangements to make payments. However, the government permitted higher withdrawal limit in such cases.
- **On Small And Medium Sized Enterprises:** The labor wages in this sector were paid in cash and were adversely affected by the drive. Other sectors like restaurants and transport operators have also suffered a loss since economic activity deteriorated and also as there is high tendency in these segments to accept payments through cash only. Many poor daily wage workers were left with no jobs and their daily income stopped because employers were unable to pay their daily wage.
- **Cost of Currency Destruction:** After the drive, many individuals have burnt and discarded their currency notes, which is a loss to the economy of the country. The government has to bear the cost of new currency and its circulation.
- **On The Functioning of Banks:** Indian economy is largely cash driven with more than 90% transactions taking place in cash. During the demonetization drive the banks have just been focusing on the single task of deposit and withdrawals neglecting their core function of issuing loans which has been adversely affected. This in turn lead to people suffering agony as they could not have their loans sanctioned.
- **On Agriculture:** Farmers had problems in selling their produce as both the parties had to agree on the mode of payment. Also change for the high denomination Rs 2000 notes was not readily available. This defracted the buyers to big retail markets thus impacting the livelihood of the unorganized sector.

Conclusion: Demonetization of old currency notes surely has had some positive impact like reducing the cash flow to terror organizations, dismantling of counterfeit currency structure, better income tax and indirect taxation, boost to digital economy. However, it has come at a huge social and economic cost.

Many learned economists opines the demonetization move as an 'organized loot and legalized plunder' and believe that demonetization was a one-time event and will not have much long term effect.

During this entire exercise the vast majority of honest and innocent citizens had to undergo terrible hardships in order to catch the few people who did not abide by the law. It has deeply affected various spheres of operation. Due to the cash crunch, the entire economy has been made to come to a standstill.

However, if we compare the merits verses demerits, it will be safe to conclude that the former outweighs the latter. Even though the citizens had to face a lot of chaos and trouble at that moment but the forecast is that its benefits will be seen in the long run.

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