

Title of the paper : History of Demonetisation-Case Studies

Details of Author:

Name: Ameya Anil Patil

Address:8,Jayraj Hsg.Socy.,Plot 72,Rambaug Colony,

Paud Road,Kothrud,

Pune 411038

Cell Phone: 8308009387

E-mail ID: amsz1234@gmail.com

Title of the paper : History of Demonetisation-Case Studies

Abstract:

The demonetization move by the Indian Prime Minister has caught the whole world's eye. Several logical views have been offered, both, for the move and against the move. In this paper, researcher has used the case study approach to find an answer. Economies of three countries, where demonetization actually took place have been examined, and the impact therein has been studied. The study finds that demonetization exercise has been a failure in major parts of the world. The researcher has tried to analyse a few reasons behind these failures and offered a few suggestions for demonetization to be successful and to attack black economy.

Keywords: Demonetisation, GDP, Inflation, IIP

History of Demonetization –Case Studies

“Study the past if you would define the future” ~Confucius

Abstract

The demonetization move by the Indian Prime Minister has caught the whole world's eye. Several logical views have been offered, both, for the move and against the move. In this paper, researcher has used the case study approach to find an answer. Economies of three countries, where demonetization actually took place have been examined, and the impact therein has been studied. The study finds that demonetization exercise has been a failure in major parts of the world. The researcher has tried to analyse a few reasons behind these failures and offered a few suggestions for demonetization to be successful and to attack black economy.

Keywords: Demonetisation, GDP, Inflation, IIP

Introduction

As per the Oxford Dictionary, The word 'demonetize' means to deprive a coin or a precious metal of its status as money. It refers to a change in currency or replacing an old currency with a new currency. The existing currency unit is stripped of its status as legal tender. In economics, it serves as one of the tools in the hand of the Government to fight black money and counterfeit currency.

On 8th November 2016, Government of India took a bold policy decision to demonetize Rs.500 and Rs. 1,000 banknotes. The public announcement was made by Prime Minister of India, Narendra Modi in an unscheduled live televised address at 20:15 Indian Standard Time (IST) on this date, and these notes were made invalid from midnight on the same day. In his words, “These notes are just papers from tomorrow”. PM also announced that new Rs.500 and Rs.2,000 banknotes will be issued. The Prime Minister cited that the move was intended to fight black money and corruption and to prevent

counterfeit or fake currency circulating in the system, which is responsible for high inflation and terrorism funding.

The move received a warm welcome from several industrialists, digital payment companies, international commentators, and public at large. However, it sought criticism from members of the opposition parties, which led to debates in both houses of parliament and triggered organised protests against the current government.

The views on demonetization move has been a mixed bag. Some call it a surgical strike, whereas, others state it as more of a collateral damage.

Though this move was bold and unusual, this is not the first time that the Government of a country has carried out the exercise of demonetization. Several precedents can be referred to this move, namely, Zimbabwe, USSR, Nigeria and others. In fact, this exercise has been carried out twice in India itself, one in 1946 and the other in 1978.

Proposed Benefits of demonetization:

Following are the expected benefits of the demonetization move:

- Demonetisation can be of a good help in Tackling the problem of Black money and parallel economy
- Money received through corruption will become worthless as such a person might not be able to explain the source.
- Demonetisation can provide a fiscal boost for Government. RBI might declare dividends to Government, for the currency that does not return into the system.
- Demonetisation can help check counterfeit or fake currency in circulation. Fake currency is responsible for terrorist funding.

- Demonetisation exercise, if successfully done, can help in mitigating inflation, and thereby bringing several goods and services within the reach of common man.

Stated limitations/concerns of demonetization:

The move however brings some concerns:

- The move can curb demand in the economy till the new currency becomes available in sufficient quantity. This can lead to economic slowdown, as pointed out by several economists. This is expected to affect several sectors such as FMCG, Real estate, Automobiles and others. Also, unorganized trade will be affected to a great extent.
- India is basically a cash-driven economy. More than 90 % transactions are settled in cash. The impact on rural economy will be huge.
- A higher denomination note (The 2000 Rupee note) can lead to more and easier collection of black money.
- More than 50 % Indians do not have bank accounts
- Inconvenience for general public, as witnessed by the long queues in front of the bank branches and the ATM's .

Review of Literature

Several economists, news media and research teams have expressed their opinion regarding the demonetization policy.

In the words of the great economist John Maynard Keynes,

“There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.”

Washington Post referred to PM Narendra Modi's initiative as 'ambitious' and in line with his election time vow to initiate a crackdown against black money.

A research paper published by the National Institute of Public Finance and Policy (NIPFP), a research institution under the Ministry of Finance, states that demonetization is a large shock to the economy.

"I think there are ways around demonetisation. It is not that easy to flush out the black money. Of course, a fair amount may be in the form of gold, therefore even harder to catch." –Dr.Raghuram Rajan , former RBI Governor

"The Independent" a Singapore-based paper published an article "Modi does a Lee Kuan Yew to stamp out corruption in India." Lee Kuan Yew ,a Singaporean Prime Minister for several decades and highly respected by the people there, is considered the architect of modern Singapore.

A research article by Prof. Prabhat Patnaik entitled "Prominent Citizens Question Demonetisation" has made the following pertinent points:

- i) If ,in Government's view, high value denomination currency is used to hoard black money, then the decision to issue even higher value Rs 2000 note is confusing
- ii) In the absence of steps to curb the generation of black money, demonetization is a useless exercise
- iii) Fake currency forms only .028% of total currency in circulation
- iv) demonetization has shaken the trust that the people have in India's currency,a devoid of which,can result in the currency losing its value
- v) In India,97% of the transactions are done in cash and the bank branches penetration is low in rural areas.

Surveys Carried out by various News channels have found that people in the country ,at large, are in support of demonetization, in spite of the pain incurred.

Several newspapers have reported a plunge in demand in the economy .Several news such as collapse in Mobile phone sales,low sales of vehicles, Restaurants being deserted. ,slowdown of farming economy,less amount of work for daily wage workers have been reported.

Several economists,including Dr.Manmohan Singh,the former Prime Minister of India,have pointed to reduction in GDP growth due to the demonetization policy.

Anil Bokil,the architect of the much talked about Arthakranti Proposal, who has been credited with the idea of demonetization seems to be disappointed.” This is not what we proposed”,he said.

An article by Economist Saumitra Chaudhuri in Economic Times,states that , taking into account the printing capacity of the existing mints, we will have to wait till May 2017,To get the replacenment of existing 500 Rupee notes .

Abhiroop Sarkar, Professor at Indian Statistical Institute, stated that the 1978 move had no effect on the circulation of black money because people don't stack black money in cash. Rather, they stash it in undisclosed accounts in Swiss Banks. Hence, demonetisation won't affect the big fish.

An article in HBR by Bhaskar Chakravorti called India's recent demonetization move as a case study in poor policy and even poorer execution wherein the poor had to bear the greatest burden.

Research Methodology:

The impact of demonetization has been studied using Case Study method.Effects of this move several economies ,where this move has been previously implemented ,have been studied.This includes the Zimbabwean economy(2015),USSR economy(1991),Indian economy(1946 and 1978).

Case Studies

1.Zimbabwe

Zimbabwean Government replaced the Zimbabwe dollar (Z\$) with the American dollar(US\$) in 2015.The main reason behind this move was the hyperinflation in the economy. For instance ,prices of goods was seen to be increasing three times per day. Zimbabwe used to have a one hundred trillion dollar note. The banking sector was in a state of disarray, as very few people were willing to their cash in banks. This move was aimed to stabilize this situation and for enhancing consumer and business confidence Finance and Economic Development Minister Patrick Chinamasa indicated the cost of the demonetisation exercise as \$20 million.

The Zimbabwean Government,had,even earlier,adopted multi-currency system in 2009,in response to a spiraling inflation (231% in July 2008) and since then, Zimbabwe had a basket of currencies in use, namely the US dollar, South Africa Rand, Botswana Pula, British Pound, Euro, Chinese Yuan, Japanese Yen and the Australian dollar. The press release was made on 9th June,2015. The demonetisation process ran from 15 June 2015 to 30 September 2015 .

Impact

The process was thus, carried out hurriedly ,as a result of which, wealth-holders were hurt. The speed at which Zimbabwean dollar was left valueless, even saw many of them turn their accumulated savings valueless. The value of trillion Zimbabwean dollars dropped to \$0.5.As a result, people were grossly dissatisfied. They asserted that the compensation against the loss of their earlier holdings of Zimbabwean dollars was too low.The move did brought some degree of monetary stability. In fact,the Zimbabwean economy has moved from hyperinflation to a deflationary environment. However,there was a side-effect.Zimbabwean economy witnessed a depressing economic growth, as Zimbabwean exports were hit due to a loss of competitiveness.(US \$ was now their official currency). The Government is now finding a way to reflate the economy without having to resort to money printing.

Thus,this demonetization move failed leading to unintended consequences such as resentment among people,slowdown in economy and loss of export competitiveness. The general public in Zimbabwe has seemed to lost their trust in the banking system.

2.Russia-1991

On 22nd January, 1991, Russian president, Mikhail Gorbachev declared 50-ruble and 100-ruble notes invalid as of midnight that very day. (Ruble). These currency denominations accounted for one-third of the money in circulation. A period of only three days was given to citizens to exchange their old notes for new ones. After this period, note holders would have to appear before special commissions to get their worthless currency replaced. The objective stated behind this policy was to combat the parallel economy and shore up the currency's value. Extremely restrictive conditions were imposed on the withdrawal of currency, very much, like the ones, seen in India now as regards to limits.

Impact

This reform failed to restrict inflation. Within three months of the move, inflation rose to as high as 300%. However, it had unintended side-effects as, loss of public confidence in the government and a blow to economic activity. The economic collapse, was combined with political infighting. In August 1991, President Gorbachev faced a coup attempt which destroyed his authority and led to the Soviet break-up the following year.

Several Soviet republics such as Kazakhstan, Ukraine, Azerbaijan, Turkmenistan, and Moldova were severely affected by this move which eventually led to dis-integration of Soviet Union.

1998

Russia tried demonetisation again in 1998, and removed three zeroes from its currency. This time, the process went on smoothly as they had learnt the lessons of the past failure.

3. India-1946

On 12 January 1946, Government banned Rs 500, Rs 1000 and Rs 10,000 notes. The government came out with 2 ordinances on this day, which was declared a holiday. The purpose of this move was to curb black economy.

First ordinance asked banks to furnish info about currency holdings of various denominations (Rs. 100, Rs. 500, Rs. 1,000 and Rs. 10,000). Second was about informing public that denominations of Rs. 500 and above were demonetized. A similar action was taken in India's colonial master Britain as well as in France, Belgium and some other countries. People were given 10 days for exchange (23 January), which was extended to 9 February, wherein the people had to give explanations on why they could not exchange their currency in first ten days.

The then RBI Governor, Chintaman Deshmukh, was not happy in going ahead with this move for the following reasons:

- i) These scheme would be launched only when there were signs of the onset of an inflationary spiral and there were no signs of such a situation.
- ii) The Governor wanted Government to be satisfied that there was no harassment to honest persons.
- iii) As a currency authority, RBI could not endorse any measure likely to undermine the confidence in the country's currency.
- iv) He was of the view that the Government will not even get Rs. 10 crores as additional tax revenue from tax evasion
- v) This measure had no precedent or parallel

Impact

As stated by the then RBI Governor, though the measure was a revolutionary one, the purpose for punishing black money hoarders was not achieved. This was because no fool-proof administrative method by which a particular note brought by an individual could be proved as the life-savings of the hard-working man or established as the sordid gains of a black-marketer was available. Another loophole of which considerable advantage was taken was the exemption of the princely States from scrutiny or questioning when such notes were presented by them. By the end of 1947., out of a total issue of Rs. 143.97 crores of the high denomination notes, notes of the value of Rs. 134.9 crores were exchanged, leaving only RS. 9.07 crore for demonetization.

This indicates that the exercise was more of "conversion", not 'demonetization'

India-1978

On 16 January 1978, Janata Government led by Morarji Desai banned Rs 500, Rs 1000 and Rs 10,000 notes. The banks and treasuries were closed on 17th January. This Government had a reasoning that high-denomination notes were used for illegal transfer of money meant financing transactions which are harmful to the national economy or which are for illegal purposes. Moreover, the Government had a feeling that a considerable amount of black money has gone to finance hoarding and speculation. This has been giving rise to high inflation, as witnessed then via increasing agricultural prices, particularly of edible oils. Hence, the purpose of this move was to combat corruption and black money and to fight the rising threat of food inflation. As per the then RBI Governor, I.G. Patel, this exercise was one against the corrupt

predecessor governments .A time period of 3 days was provided for people to exchange Rs 1000, Rs 5000 and Rs 10000 notes.

Impact

The ordinance had a ripple effect on other markets such as gold and diamond where prices slumped by 5 to 10% within a week.. On the contrary, the old notes were going at 70% discount in Bombay's Zaveri Bazar. Just like this time, Long winding queues begin to form in front of the Reserve Bank office right from the morning as also at the main office of the State Bank of India, to collect declaration forms. Public and foreign tourists raised considerable hue and cry .

Surprisingly, the amount of currency actually rose..It rose from Rs.9170 crore in 1977-78 to Rs.1699 crore in 1978-79.crore So, the impact was neither a conversion nor demon.'Cumulation' can be the word used here .Although, Around 73.1 crore of Rs.500,1000 and 10000 notes were demonetized, 1067 crores were added by Rs 100 denominations and the smaller denominations made up another 650 crores. The money stock was not destroyed at all, but increased.

As written by Jay Dubhashi in his article for ,India Today , "Politics apart, the demonetization is unlikely to curb black money in circulation, for the simple reason that no one really knows how much black money there is in circulation and, even more important, whether black money can really be defined in precise terms in all its shades."

I.G.Patel, the then RBI Governor was not happy with this exercise and quoted,

"Such an exercise seldom produces striking results. Most people who accept illegal gratification or are otherwise the recipients of black money do not keep their ill-gotten earnings in the form of currency for long. The idea that black money or wealth is held in the form of notes tucked away in suit cases or pillow cases is naïve. And in any case, even those who are caught napping—or waiting—will have the chance to convert the notes through paid agents as some provision has to be made to convert at par notes tendered in small amounts for which explanations cannot be reasonably sought. But the gesture had to be made, and produced much work and little gain."

Conclusion

History serves to learn from the mistakes in the past. Demonetisation has earlier taken place in several parts of the world, including India. However, they have failed. Even if some have been able to achieve their objective to a certain degree, there have been

several unintended effects on those economies. Interestingly, Russia presents a case, wherein their demonetization drive was a failure in 1991. They, however, learnt the lesson, and made their demonetization move of 1998 a success.

People's trust in an economy's monetary and financial architecture is the very foundation of a modern economy, and policies such as demonetization can destroy that trust. So, such exercise has to be carefully crafted and implemented, and must be resorted to, only in extreme cases.

Suggestions

As an immediate action, remonetisation should be done as fast as possible. The more the time taken to remonetise the currency, higher is a negative impact on productivity and economic growth. This is also essential to prevent people's inconvenience and restore demand in the economy.

Generation of black money, itself, should be attacked. As stated by Dr. Raghuram Rajan, former RBI Governor, "I would focus more on tracking data and better tax administration to get at where money is not being declared." Extensive financial literacy programmes educating people about the harmful effects of unaccounted money should be carried out. Implementation of GST must take place as soon as possible.

Limitation

The demonetization cases in the past have been mainly carried out by dictatorial Governments, unlike the democratically elected Government in India. So, the result for India can vary. On the other hand, information technology has progressed rapidly over the years, which can enable Government to trace illegal transactions in a better manner.

Further research

A further quantitative research can be carried out to study the impact of demonetization on various economic indicators such as GDP growth, exports, Index of Industrial Production (IIP) and Inflation.

References

RBI Website

<http://www.forbes.com/sites/timworstall/2016/11/19/effects-of-demonetisation-on-indias-gdp-difficult-to-calculate-we-dont-even-know-the-sign/#459d2f1a4a1a>

<http://www.epw.in/journal/2016/48/commentary/demonetisation-1978-present-and-aftermath.html>

<http://www.countercurrents.org/2016/11/16/prominent-citizens-question-demonetisation/>

<http://www.globalresearch.ca/black-money-and-indias-demonetization-project/5557384>

<http://scroll.in/article/822661/zimbabwe-myanmar-and-ussr-tried-demonetisation-and-burnt-their-fingers>

<http://www.thehindubusinessline.com/opinion/how-demonetisation-will-benefit-india/article9382602.ece>

<http://www.herald.co.zw/president-calls-for-demonetisation/>

<http://www.rbz.co.zw/assets/demonetisation-press-statement-9-june-2015.pdf>

<http://www.chronicle.co.zw/us-for-old-zim-bank-notes-rbz-plan-to-finalise-local-currency-demonetisation/>

https://hbr.org/2016/12/indias-botched-war-uncash?utm_source=twitter&utm_medium=social&utm_campaign=harvardbiz

Times of India

Mumbai Mirror

Business Standard

The Economic Times

The Hindu Business Line

Livemint