

RECENT WITHDRAWAL OF RS 2000/ NOTES BY THE GOVERNMENT OF INDIA: A CRITICAL AND CONTRASTING STUDY WITH THE EARLIER DEMONETISATION OF 2016

Aanya Rastogi

Pathways World School

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ABSTRACT

Demonetisation by and large when used as a policy tool to unearth black money, stop terror funding and control inflation have been only partially successful. The demonetisation of 2016 led to more hardship and pain than fulfilment of the reasons stated above. This was because the Indian economy is largely an informal unorganised sector where most of the daily wage earners are paid in cash. The demonetisation of 2023 has been better handled as there is enough time for exchange of ₹2000 notes, and the RBI had stopped printing these notes sometime ago.

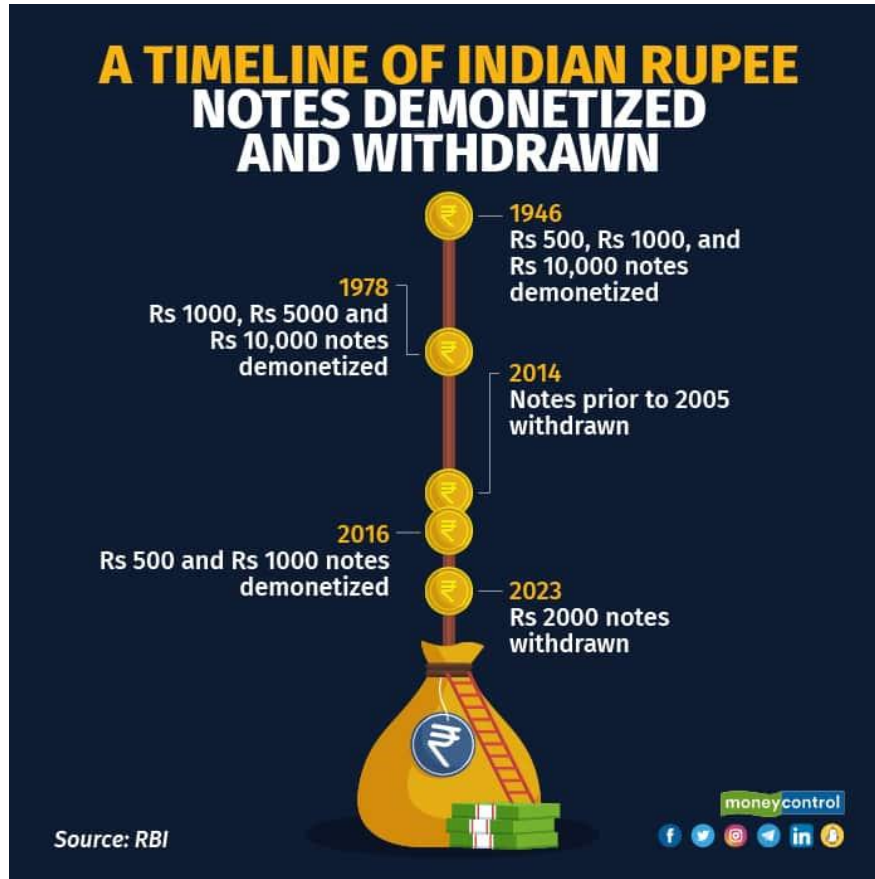
Keywords: Demonetisation, Currency, Indian economy, Hyperinflation, Counterfeit currency, Terror funding, Black money, Tax fraud, Shadow economy, Informal unorganised sector.

Research Question: The paper will attempt to understand the reasons behind the government decision in banning ₹2000 note. This analysis will be contrasted with the earlier reasoning which led to demonetisation of ₹500 and ₹1000 notes. The similarities and differences amongst the two decisions by the government would be critically studied. The impact that both have had on the economy would also be researched. In both cases are they going to achieve the required results is a moot question.

1. Introduction

The Indian government has twice under the last seven years announced demonetisation of the currency. Since independence essentially from 1947 to 2023 demonetisation was announced first in 1946, where ₹500, ₹1000 and ₹10,000 notes were demonetised, then in 1978 ₹1000, ₹5000 and ₹10,000 and in 2014 all notes prior to 2005 were withdrawn, In 2016, ₹ 500 and 1000 notes were demonetised, in 2023, ₹ 2000 were withdrawn.

Figure 1- Timeline of India's decision on demonetisation



Source: RBI

In the last 76 years, the central bank has on several occasions demonetised or withdrawn currency notes. In 1946, the British government after consulting the Reserve Bank of India(RBI) governor Chintaman Dwarkanath Deshmukh decided to demonetise notes of ₹500 and above denominations citing World War 2 as an increasing black market operations as the prime reason.

2. Theory behind demonetisation

Demonetisation is essentially when the nation's economic unit of exchange loses its legally enforceable validity. They no longer are considered legal tender, nor have any financial value. These are defunct currency. The currency that is withdrawn is swapped with new currency.

Demonetisation per se is an exceptional decision but governments around the world have used this weapon for various reasons. Some of the oft given reason are

- Hyperinflation:

Figure 2: Impact of Hyperinflation

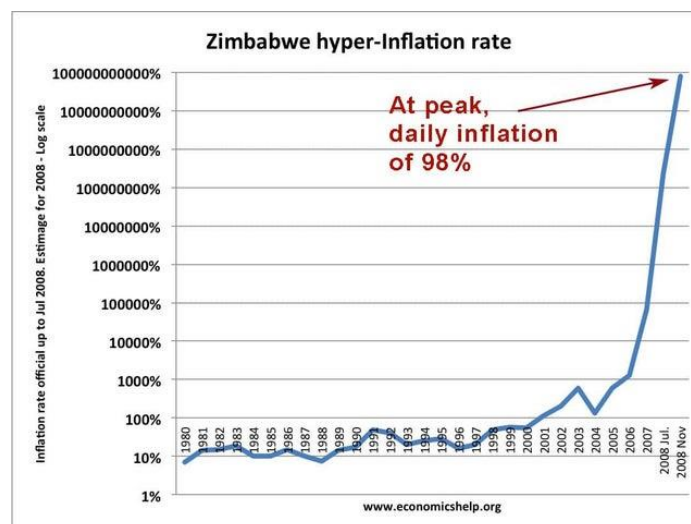
How Does Hyperinflation Works



Source: Educba

This is a situation where inflation is not coming under control in spite of various measures that the government has attempted to adopt. The inflation rates range anywhere beyond 30-40 percent. At times it is so high that when people get up in the morning, the price of most commodities have risen. This runaway inflation is extremely detrimental for the economy and needs to be addresses urgently.

Figure 3:Hyperinflation in Zimbabwe in 2008



Source: www.economicshelp.org

The above figure indicates the manner in which inflation ‘just runs away’. Demonetisation is not the only way in which one could address the above problem. The government could also initiate strict measures like control the fiscal deficit and thus the expenditure by increasing both, direct and indirect taxes. This would be difficult for the citizens but eventually the harmful impact of inflation will be countered and the economy could well be on the path of development.

- Counterfeit currency:

Figure 4: Fake ₹500 and ₹1000 notes



Source: <https://www.thehindubusinessline.com>

Counterfeit currency is an immense issue for countries especially when there are recurring incidents of officials impounding and raiding areas where there has been found to be rampant generation of such notes. The situation becomes worse when these notes enter into the mainstream economy and citizens do not have a clue on whether they are holding the real currency or a counterfeit one.

- Terror

Figure 5: Currency as a means for terror funding



Source: iStock

Real and counterfeit currency are quite often used to fund terror and create disharmony in the economy. This becomes extremely disturbing for the citizens as the frequency of such terrorist activist, it becomes imperative that the government takes a stand and addresses the issue immediately.

- Tax fraud:

Figure 6: The cost of tax fraud



Source: Researchgate

The above diagram indicates clearly that evasion and loss of taxes can create a number of issues for the government ultimately resulting in high fiscal deficit and runaway inflation.

- Adoption of a new monetary system :

Due to any one or all of the reasons above the government decides to completely do away with the existing currency and takes a decision to adopt an entirely new legal tender.

3. Reasons for demonetisation in India

Over the years, prior to the 21st century there have been number of reasons for demonetisation in India. Amongst the main reasons were the battle against ‘black money’. The reason that these numbers had increased was due to the wide scale practice of tax evasion.

3.1 The specific reasons for taking this step in 2016 were the following.

The Modi government had just come to power with a majority in 2014. The reasons stated for demonetisation on 8th November 2016 was same as stated earlier, namely

- Eradication of black money
- Getting rid of benami transactions
- Corruption
- To promote digital payments
- Prevent terror financing
- Reduction in inequalities of India

The government announced that ₹500 and ₹1000 notes would no longer be legal tender. Reserve Bank of India announced that as the above notes are being banned, there would be a simultaneous issue of new ₹500 and ₹2000 notes.

Given the list above, the main aim seem to be the same as what was stated earlier as the reason for demonetisation.

The black money economy, also known as the parallel economy is expanding at a very rapid rate since the 1960s. The basic reason for the growth of this system has been primarily tax evasion. The reasons for tax evasion have been

- Lack of simplicity and accuracy of the tax legislation
- High rates of taxation
- Significant informal economy

The format to fill up tax returns since the 1960s has been extremely cumbersome. An individual who wants to pay direct tax needs help to fill up the form. The tax payer has to a pay for the services of a chartered accountant to help him file his returns. This issue has been subsequently addressed and in recent times, the tax authorities have brought out a simplified system which can be filled by a layman. The government has brought out various videos and articles specifying the method in which such forms could be filled.

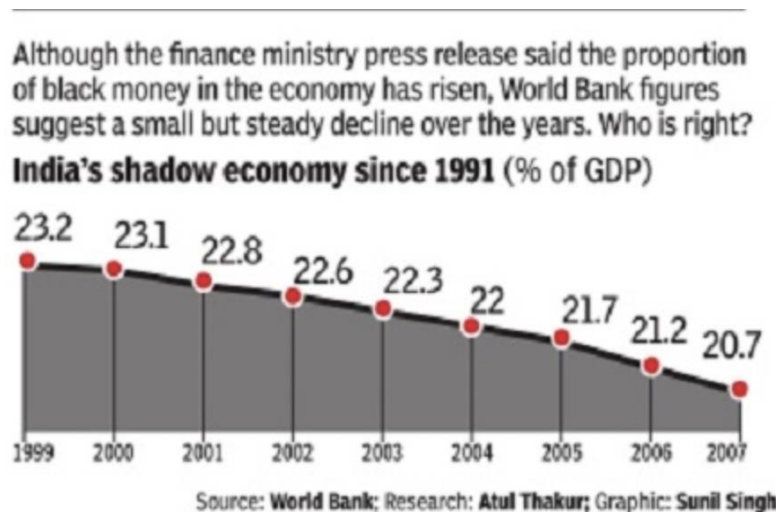
Figure 7: Lengthy Tax forms



Source: Business standard

High rates of taxation were the norm in the 1970s, 80s and partly the 90s. The reason being the government wanted to earn revenue and as other sources were not accessible, the only option for them was revenue from (both direct and indirect) taxation. At one point in time, the rates were as high as 70% on the highest slab. This meant that every ₹100 earned, ₹70 would go to the government and ₹30 would stay with the individual. This was just not accepted by the earner and he/she started looking for ways in which to evade taxation leading to rampant tax evasion. This issue was addressed to a large extent in the 1990s, but there still seems to be a large amount of ‘black money’ circulation.

Figure 8: India’s shadow economy since 1991



Source: World Bank

The growth of the informal and unorganised setup has led to a huge generation of black money in the economy. This leads to loss of revenue for the government as they do not enter the banking system. Corrupt practices such as taking or giving bribes generally take place in cash (this is part of the black money economy). These transactions are rarely caught. Large amount of this money is parked in safety lockers in foreign banks for example Swiss banks which do not disclose the identity of the operator. Elections to a large extent may be funded by cash.

As these sums are not part of the taxation process, the actual GDP may be underestimated due to the existence of a parallel economy, resulting in a decrease in the quality of public goods and services for the marginalised section of the country. The existence of this economy undermines the impact of the monetary policy of the government. It could also lead to increase in terrorist activity. These were the reasons that led to demonetisation of ₹500 and ₹1000 notes in the year 2016.

3.2 Reasons for demonetisation in 2023

The government decided to demonetise ₹2000 notes on 19th May 2023. The reasons stated by the government was based on the reason that it was issued in the first place. These notes were issued in 2016 as at that time 86% of the total currency in the system was being withdrawn and ₹2000 notes helped in pushing more currency in the system to support the economy. These notes, according to the government has encouraged storage, and they found that these notes had started disappearing from the market. The banks complained that there were not enough ₹2000 notes to be stored in ATMs. The ATMs had to be recalibrated to accommodate ₹2000 notes. The other reason was an alarming number of fake and counterfeit notes in this category, as well as illicit activities that were functioning with the use of this denomination. To address the above issues as well as to increase the reach of digitalisation, the government decided to ban this currency.

The modus operandi in this ban is different from the others as the government has given time till September 2023 to exchange these notes into legal tender. Anyone can go to the bank without answering any questions and can change this currency. As it is not an immediate ban, it definitely allows enough time to convert the now illegal tender into legal tender.

4. Repercussions of this decision on the economy

Demonetisation most of the time does not achieve what it is set out to do. Every time that demonetisation as a policy measure been implemented, there have been various views on whether it has achieved all the issues that it wanted to. The demonetisation in 2016 and 2023 are entirely different. The one in 2016 had far reaching consequences than the recent one.

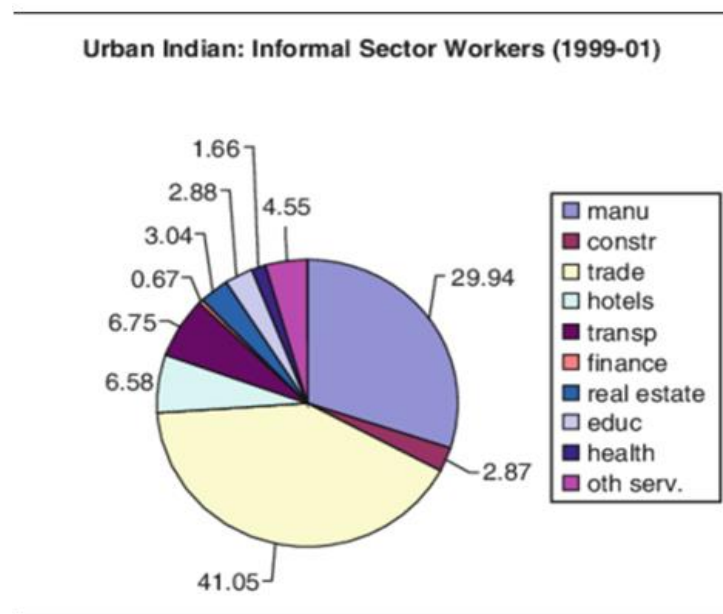
4.1 In 2016

As per statistics, India’s attempt to flush out undeclared wealth did not work. According to some economists who have based their analysis on RBI data have claimed that, demonetisation of 2016 has been one of complete failure. The aim at that time was that illegal black money would be flushed out of the system. It has been stated that illegal notes worth ₹15.28 trillion had been deposited in banks up to June 2017 which meant that 99% of the currency was backed with the bank, indicating that all the black money had been converted into white money and had entered into circulation. People managed to find a whole lot of citizens who may not have been recipients of black money, but accepted the excess money in the system for a price and deposited it in their account, thus making the conversion complete.

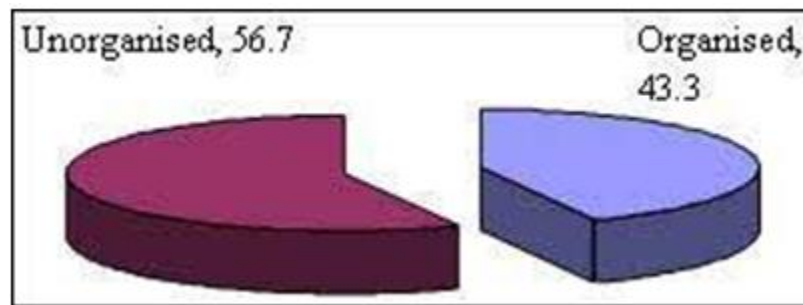
India being an economy with a huge informal sector where the main medium of dispersal of salary is cash led to a large decline in the availability of disposable income of such people resulting in impacting their spending patterns and consumption in the short run.

The Indian economy consists of a huge informal setup, the informal setup is defined as one, which is neither taxed or monitored by any form of government be it Central, State, Local and District. Most of the people involved in this sector are self-employed, or else work for people who are self-employed. They are not taxed nor do they pay tax. There are no formal arrangements, laws or regulations that are applicable to this sector.

Figure 9: Extent of informal and unorganised sector in India



Source: Research gate



Source: Arc journals

The initial impact of demonetisation in 2016 significantly affected the poor population as they depended largely on cash transactions and were very much a part of the informal unorganised sector.

The daily wage workers were compelled to spend much of their time in long serpentine queues before banks and before ATMs which finished their funds before the queue could get over, all of this at the expense of using their daily wage. Entire families suffered for days and people had to walk long distances to convert the money. The limit for conversion was only ₹4000 per day.

Figure 10 : Serpentine queues to convert cash during 2016 demonetisation



Source: NDTV

The second reason of detecting counterfeit currency also seemed not being fulfilled as data from RBI annual report has stated that the total number of ₹500 and ₹1000 old series detected from April 2016 and March 2017 was ₹5,73,891. The total number of notes withdrawn stood at ₹24.02 billion indicating that the counterfeit notes identified between April 2016 and March 2017 is 0% of the withdrawn notes. Without demonetisation, the extent of counterfeit notes that were seized was ₹40,474 (this occurred without demonetisation).

Agriculture is another sector, like the informal economy operates on cash and was adversely impacted by the demonetisation. Farmers were not being paid enough for vegetables and pulses that they had grown.

Most studies have indicated that the reasons stated for the 2016 demonetisation was not at all fulfilled, infact what it did lead to was immense suffering to almost all the citizens. Infact, what did occur was a slowing down of economy and a dip in the GDP in the subsequent years. An economy that was cruising at quite a decent rate was suddenly halted in its track due to the twin reasons of demonetisation in 2016 and the faulty implementation of goods and services tax (GST) in the subsequent years.

4.2 In 2023

The ₹2000 notes were withdrawn from the economy. It is still considered legal tender till September 2023. The current decision to withdraw ₹2000 notes will have less impact than the move in 2016. The notes are being phased out gradually over a longer period of time and it is hoped that it would result in a smoother transition with minimal destructions to the Indian economy.

The reason to withdraw these notes is based on the decision to reintroduce them in 2016. At that time the purpose of this denomination was to quickly replenish currency in the economy due to the withdrawal of ₹500 and ₹1000 notes. In the last 4 years, the RBI has desired to reduce these notes and in fact has already stopped printing them. The RBI states that this denomination is not commonly used for everyday transactions.

The timing of the withdrawal maybe due to the upcoming state and general elections where the quantum of cash increases and withdrawing of such denomination may affect the misuse of cash and promote transparency in transactions. It is stated that close to 76% of these notes have been deposited or exchanged.

As the reason for this withdrawal is to prevent hoarding of black money and the process of not printing them had started some time ago. The adverse impact that was experienced in 2016, is unlikely to occur this time around.

5. Conclusion

Demonetisation at any point in time, in any country is not a measure which is considered an effective one. The reasons that economies undertake this decision are normally not fulfilled. In spite of this, it has been noticed that economies around the world, still attempt to use this as a policy measure for various reasons. In the case of the Indian economy, the hardship that was

experienced by its citizens has been etched in the minds of the people. Hundreds and thousands of daily wage workers were seen trudging along with their families in tow to their hometown, which could be as far as Bihar, Jharkhand, Chhattisgarh from places like Delhi.

The policy makers should have been aware of the fact that the Indian economy is primarily an unorganised, informal one and that most of the labourers are paid in cash. The sudden withdrawal led to complete mayhem, hunger, disaster and discomfort of hundreds and thousands of daily wage workers. The time and the amount one could exchange in 2016 was also limited to a measly ₹4000 . The banks themselves were not ready for this massive operation and thus could not replenish the ATMs at the rate that people were demanding money.

The policy of digitalisation, though had started at that time, had not effectively spread throughout the country. It is after 2016 that UPI payment, Paytm etc became extremely important in the scheme of things. This time around, in 2023, the impact is much less and in fact one could say negligible as there is a long window whereby one can exchange and deposit money. The preparation for this had started years ago when the central bank, had stopped printing these notes. The reason in 2023 is also to control the 'black economy' but the method is different and stories of hardships have not emerged as yet.

To ensure an effective demonetisation policy, it is essential to understand what the ground situation is and then decide and follow a policy to achieve one's goals.

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