

DEMONETIZATION POLICY: THE INDIAN DEBATE

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Abstract:

Indian present government took a bold and surprising decision on 8th November, 2016 to demonetize two largest denomination notes (1000 and 500 rupee) with a view to eradicate the black money from the market. The paper emphasizes on recent Indian demonetization confrontation with a brief highlight of such incidents around the world in the past. The opinions of economists, financial analysts and intellectuals have been highlighted on this paper. It is based solely on secondary information collected from previous articles, newspapers, magazines and books related to the subject matter. The paper will hopefully come to the help of those academicians seeking to investigate more and the policy makers who want some academic references.

Keywords: Demonetization, Rupee notes, Policy, Corruption, Black money, Cash, Bank, RBI, MoF.

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1. Introduction:

Demonetization can simply be termed as changing the existing (some or all) into another format. In other words, demonetization is the act of either replacing some/all the old currencies by new ones or introducing new notes/coins of the same currencies (Uke, 2017). Indian Prime Minister Narendra Modi made a very surprising and unexpected announcement to cease the specified banknotes (SBN) to be legal tender with immediate effect on November 8, 2016. According to the decree, the general public got fifty days to deposit their 1000 and 500 rupee notes into banks to remove those notes from circulation (Nageswaran and Natarajan, 2017). Instead, a redesigned 500 rupee note and a new 2000 rupee note will be circulated. According to the prime minister, the strategy involves three major goals: handling corruption, discouraging counterfeiters and punishing the hoarders of undeclared income, commonly known as “black money” (Beyes & Bhattacharya, 2017). While communications regarding the rationale behind the policy was limited to highlighting the magnitude of cash in circulation is directly linked to the corruption level and thus, reducing the cash in circulation would reduce corruption (Modi, 2016a).

The notes withdrawn made up to 86% by value of cash in circulation (MoF, 2017a). There was a big challenge that required to replace such a large amount of cash was the fact that a momentous percentage of new notes had yet to be printed at the time of announcement creating a long deficits of cash which led to significant government mandated restrictions on cash withdrawals from bank. In India, as a big country mainly relying on the agriculture and farmers especially who live in villages and do not know much about virtual currency of credit card, around 90% transactions are conducted in cash (D'Monte, 2016).

The history of demonetization in India was date back to pre-independence era in year 1946. After independence, the notes of 1000, 5000 and 10000 was demonetized to restrain counterfeit and black money in 1978.

The aim of this paper is to study the previous incidents of demonetization around the world including this one, what were the main motivation and the outcomes. For this, the authors took the opinions of economists, specialists and financial analysts.

2. History of demonetization in India and other countries:

In India, there are many examples of demonetization. Reserve Bank of India (RBI) printed the highest denomination notes of 10000 rupees in 1938. After a few years, government cancelled 1000 and 10000 rupee banknotes in 1946. Again, higher

denomination banknotes of 1000, 5000 and 10000 rupees were reintroduced in 1954 until they were demonetized in 1978 to curb unaccounted money (Jangid & Sohini, 2017).

Not only India, but also many countries in the world did the same. All the countries which had adopted such policy had some common objectives such as to hold back corruption & black money and to tackle inflation. Here is the list of countries that had adopted demonetization policy:

Table: List of countries that had demonetization with objectives and after effect (Excluding India)

Country	Year	Objective (s)	Result
Germany	1923	To prevent inflation	Inflation fell
USA	1969	To resist black money	Successful
UK	1971	To bring uniformity in currency	Successful in the UK but failed in other countries
Ghana	1982	To control black money	People turned to foreign currency
Myanmar	1987	To resist black money	Led to political dispute and thousands of people died
Nigeria	1984	To fix debt burden and inflation ridden economy	Economy collapsed
Zaire	1990	To withdraw obsolescent currency from the system	Partly successful
Former Soviet Union	1991	To fight against unearned income, smuggling and corruption	The overall economic system eventually crushed
Australia	1996	To curb black money and improve security features on the notes	Successful
North Korea	2010	To lower down the market of black money	Miserably failed
Zimbabwe	2010	Sliding out from hyperinflation	Failed
Pakistan	2015	To get rid from the black money and counterfeit currency	Messed up
Philippines	2016	To preserve the integrity of currency	Yet to be known

Source: Jangid, R. & Sohini, S. (2017)

It can be observed from the table that most of the countries adopting this policy have failed in getting success. Some countries like Nigeria, Zaire and former USSR had experience negative growth rate and a collapse in economy after demonetization was in effect (Jangid & Sohini, 2017). On the other hand, countries like USA and UK had a bit slowdown in economy while demonetization was in effect but late they grew again whereas only Australia's economy was stagnant on pre and post demonetization periods (Jangid & Sohini, 2017).

3. Demonetization: The policy mechanism

The policy mechanisms of demonetization were governed by mainly two authoritative institutions: Ministry of Finance (MoF) and Reserve bank of India (RBI). In principle, demonetization referred to withdrawing the legal tender of all existing 500 and 1000 rupee notes and introduction of new 500 and 2000 rupee notes. The two notifications specified how this process was to be regulated, including over the counter exchanges of old notes and daily and weekly limits for cash withdrawals at bank counters and ATMs (Beyes & Bhattacharya, 2017).

It is noteworthy that there was a lack of insight the government bodies offered reasoning behind it. For example, the RBI notification did not provide any rational causes behind demonetization, but only as a state body, it had just officially recommended the policy (RBI, 2016a). The role of RBI in this case caused a significant after-discussion, for example, allegations that the role of RBI was in this case just to execute the order from the higher authority of the government and some practitioners have argued that such decision has damaged the image of RBI as an independent body and may further violated the law (Kapadia, 2016 and Kumar, 2016). The information provided by MoF correspondingly lacked detached remarks and obviously definite policy goals (MoF, 2016a).

One dominating issue in Indian public hot debate on this policy was its evolutionary nature was between the time period of November 8 to December 30, the last day to exchange or deposit the forfeited currency; the RBI issued 50 notifications to guide and regulate the process and to remind all the banks of their legal obligations where some of those were suggestive in nature but a large quantity was about substantive changes to the workings of the policy, while, at the same time, the MoF issues 19 notifications during the same time frame, some reflecting RBI notifications and other introducing additional policy change (Beyes & Bhattacharya, 2017). The modifications made by RBI were very large and it had to create a separate website entitled "All you want to know from RBI" referring 57 notifications and 27 press releases (March 1, 2017) issues by the central bank on demonetization (RBI, 2017).

From the public view, the most observable changes to the policy mechanisms of demonetization was the concern of exchanging and depositing of old notes, as well as caps on the availability of new notes (Beyes & Bhattacharya, 2017). By the end of 2016, the RBI had issued 9 notifications on the exchange and deposit process and five on cash withdrawal limits. A noteworthy set of RBI and MoF notifications alarmed the agricultural sector where near about half of India population is employed (World Bank, 2013), addressing complains that farmers were incapable to buy the supplies for the ongoing sowing season.

4. Linking cash and corruption?

The announcement of demonetization in early November involved three primary goals: dropping corruption, punishing hoarders of “black money” and discouraging counterfeits. Early communications by the RBI and the MoF echoed these goals but did not provide detail on the rationale behind them (Beyes & Bhattacharya, 2017). As an example, it was just stated that such policy had been taken for the above reasons, but notably, in any discussion, the relationship between cash and corruption and consecutively, the anti-corruption credentials of demonetization were absent.

When asked regarding reasoning behind demonetization, the present Prime Minister quoted four economists: James Henry, the former chief economist of the consulting firm McKinsey; Kenneth Rogoff, a professor at Harvard university and the author of the book “The Curse of Cash”, a 2016 book arguing that in advanced economies like US, a large proportion of high denomination notes is used in illegal transactions; Larry Summers, the Harvard professor and the former World Bank chief economist; and the former HSBC CEO Peter Sands (Chengappa, 2016). He also cited the European Central Bank’s decision, in 2016, to stage out 500 Euro notes, relating to that those notes were primarily facilitating illegal activities and also, an Indian government report from 1971, by the Wanchoo Committee arguing that experts across the world have advocated demonetization over the years (Beyes & Bhattacharya, 2017).

Another paper that provides some insights into the observation of Indian government’s relationship between cash and corruption is the Economic Survey, an annual document issued by the Ministry of Finance (MoF), India that

provides a summary of the status of the Indian economy and discusses relevant government programs (Beyes & Bhattacharya, 2017). Published in February, 2017, the survey dedicated a full chapter quoting “Demonetization: To Deify or to Demonetize”, again took the pre-assumption as the initial point that the higher amount of cash in the flow, the larger amount of corruption (MoF, 2017a). Apart from quoting the same four economists mentioned in Prime Minister’s interview in December, 2016, the survey revealed the observation that 11% of 1000 and 22% of 500 rupee note are returned to the RBI every year as damaged while the corresponding rate for lower denomination notes is 33% acknowledging the lower “soil rate” may be the result of the fact that there are more lower value than higher value transactions among which, a fraction of the notes are not being used for transactions are being used for storing black money (Beyes & Bhattacharya, 2017).

Though the Prime Minister Modi and the Economic Survey both properly identified the relationship between cash and corruption has attracted attention over the last few decades and possibly more and more in recent years, both were unsuccessful in addressing the issue that cash is widely perceived as making up only a small part of Indian shadow economy, which includes, but not limited to, income from corrupt practices (Beyes & Bhattacharya, 2017). Kohli and Ramakumar (2016) argued citing the former RBI governor Patel that the idea that black money or wealth is held in the form of notes tucked away in boxes or pillow is a naive, rather, they estimated that the majority of unaccounted income in India is held and transferred using real estate, stocks, gold and other form of undeclared investments in home and abroad.

Therefore, the lack of references to any of these modes of corruption within government communication and demonetization indicates that present government represents corruption primarily as a cash based issue. By creating a storyline that emphasizes the role of cash, demonetization may switch attention from future anti-corruption strategies that take a wider approach, such as strengthening the legislation, building and empowering the capacities of anti-corruption tools more and more; and above all, creating public awareness through print, electronic and social media.

5. Challenges and responses:

There were some obvious challenges and responses from different areas to this policy. In this section, we have tried to highlight some of the notable ones based on newspapers, articles and academicians.

5.1 Sufferings of rural banking:

The decision of RBI to restrict District Cooperative Central Bank (DCCB) and Primary Agricultural Credit Society (PACS) from accepting or exchanging the old notes was perhaps the most controversial one as these two institutions only provide the access to banking service for an vast majority of India's rural population, including small farmers and lower income groups (ADB, 2013). While farmers in general depend on DCCB and PACS a lot to purchase seeds and fertilizers, suddenly, a large proportion of rural population was required to move to larger villages or cities to exchange or deposit the old notes.

Although, RBI did not present any formal reasons for putting these restrictions in place, it was speculated that the government was apprehensive with what was apparent to be abnormally huge cash deposits at DCCB and PACS right away after the announcement. Between the period of 8 to 14 November, DCCB in 17 Indian states received approximately 90 billion rupees as deposits (Fernandes & Sukhi, 2016). The RBI unreservedly questioned the source of wealth of depositors belonging primarily to the marginal agricultural sector, allegedly raising concerns that DCCBs were used to park unaccounted funds and launder undeclared income (The Economic Times, 2016a).

Based on the circular of RBI, operations at 372 DCCBs and over 93000 PACS were reported to come to a virtual standstill (Beyes & Bhattacharya, 2017). A lot of such institutions provisionally suspended operations as they were unable to carry out banking activities vital to the rural sector, including loan payment collections, disbursing cash, paying interests and dividends, distributing fertilizers and running public distribution shops for the poor (Matthew, 2016).

Unfortunately, the timing of this decision coincided with the peak agricultural season of harvesting summer crops and sowing winter crops disrupting cultivation and severely affecting the sale and marketing of agro products as

traders were unable to pay in cash. There were particularly acute problems for the produces to perishable products like vegetables and fishes. Further, many farmer were unable to buy seeds and other inputs or to pay agricultural workers for farming activities (Alliance for Sustainable and Holistic Agriculture, 2017).

The decision triggered intense agitation of rural banks and prominent farmer groups representing over 20 million farmers around the country. The protests were severe in the states like Maharashtra, Kerala, Uttar Pradesh, Gujarat, Tamil Nadu, Karnataka and West Bengal led by Krishi Swaraj, an alliance of 400 farmer groups drawn from more than 20 states across India; Bharatiya Kisan Union (BKU) and the Consortium of Indian Farmers' Association (CIFA); All India Kisan Sabha (AIKS) and All India Agricultural Workers' Union (AIAWU) (Beyes & Bhattacharya, 2017). Protests and demonstrations lasted from mid-November to January and were well supported in the southern states of Kerala and Tamil Nadu in particular, where the largest cooperative banking system is in operation (National Federation of State Cooperative Banks, 2016).

Cooperative banks moved to regional high courts and later to the Supreme Court of India challenging the government order and the protesting farmer groups appealed to the Prime Minister for exempting the farming transitions, particularly sale of harvested crops and purchase of agricultural input from demonetization policy (National Seed Association of India, 2016). The level of agitation in some state was so intense that the key BJP representatives at the local level were allegedly isolating themselves from demonetization amid fears that the policy move would destabilize their political campaigns ahead of the state elections in 2017 (The Economic Times, 2016b).

Finally, as criticism from the rural sector mounted, the government launched a series of policy tweaks to ease the pressing situation on the rural economy (Beyes & Bhattacharya, 2017). On November 2016, just 9 days after the announcement of demonetization policy and mere 3 days after the government had disallowed DCCB and PACS to exchange or take old notes, the MoF issued a further notification allowing the RBI to modify the cash withdrawal limit for farmers (MoF, 2016b). After 4 days of this instruction, farmers were allowed to withdraw up to 25000 rupees from loan or deposit accounts (RBI, 2016b). On

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November 20, 2016, in response to the second major point of protesters, passed another notification that added the purchase of seeds from government-affiliated bodies to the growing list of activities (such as payments to government hospitals; purchases of railway, bus and plane tickets; and settling of bills issued by central, state, local and municipal bodies) for which old 500 rupee notes could be used (MoF, 2016c).

Ministers of government (Agriculture & Farmers' Welfare and Finance) appeared to have relieved after those revising notifications and thanked the Prime Minister for taking steps to alleviate difficulties in farming and rural banking sectors (Press Information Bureau, 2016).

5.2 Disturbance in small and medium businesses:

Besides the severe impact on the agricultural sector, demonetization also had a momentous consequence on the informal business sector, currently employing more than 80% of the workforce, through micro, small and medium enterprises (MSME). Such businesses are heavily cash dependent, often managed by individual (normally one or two) proprietors, small turnovers, limited reserve and limited access to financial sectors. The policy caused severe disruptions to such enterprises many of which were already in trouble due to the stable decline in credit flows and a rise in non-performing assets in rural banking system (Beyes & Bhattacharya, 2017). The consequence was the reported substantial decline in production capacity, loss in earnings, wages and lastly, unemployment (India Today, 2017).

The long term consequences of demonetization on the MSME sector have not be fully revealed yet, although, a number of independent studies and industry surveys identified and captured some of the immediate economic challenges. An opinion survey by the Indian Development Foundation, a private, non-profit research organization estimated that more than 74% of the temporary jobs in urban small scale industries across 9 northern states were lost and evident reverse migration to the villages (India Today, 2017). Another study by the All India Manufacturers' Organization found a loss of 53% of temporary jobs in MSMEs across the country and 50% decline in revenue during the first 34 days of demonetization declaration (Business Standard, 2017). Edelweiss (2017), a

diversified financial services firm, made similar remarks, estimating a more than 70% decline in MSME business operation during the first few weeks. The same report further estimated a lasting negative impact on 20% to 30% MSME businesses and a momentous reduction in employment growth for non-skilled workers in the near term. Finally, the Associated Chambers of Commerce and Industry of India, one of the India's primary trade organizations, stated that the policy had a negative impact on rural consumption and job creation in the MSMEs in the immediate run in a national survey on the impact of demonetization on small enterprises in January, 2016.

All the above reference lauded demonetization and appreciated the necessity to move away from cash economy to more transparent one. They also highlighted that considering the poor financial infrastructure of India; the result cannot be expected in a very shorter period. Instead, they rather argued for a more incremental and steady approach towards creating a digital transformation.

After understanding the momentum pressure on MSMEs, the Modi administration decided to make this sector a priority in the budgetary allocations for 2017-18. Keeping the consistency with that decision, it introduced a number of tax brackets, including the reduction in corporate tax and presumptive tax for companies with an annual turnover of less than half a billion rupees and business entities with a turnover of less than 20 million rupees respectively (MoF, 2017a). Also, credit guarantees to MSMEs increased from 10 million to 20 million rupees and significantly amplified investment support to enhance digital infrastructure in this sector.

The budgetary announcements made by government were generally welcomed by MSMEs, hoping to lead to better infrastructure and a formalization of financial service sector. However, there are still some critics who view that the government did not introduce any objective measures that could address more fundamental microeconomic challenges affecting the sector (Beyes & Bhattacharya, 2017).

5.3 Allegations of political nepotism:

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In Indian political economy, nepotism, clientelism, corrupt electoral funding quite a common phenomenon (Beyes & Bhattacharya, 2017). As a result, as soon as the demonetization announcement was made in public, it did not take time to become one regarding political debate and hot issue about electoral advantages.

Many opposition parties, central and regional, specifically targeted the ruling party alleging that the policy was primarily aimed at undermining opposition funding and in turn, benefitting the ruling party in upcoming state level elections. They also brought the allegation that the information regarding this upcoming policy had been leaked selectively to the key members of BJP and also their affiliates in the corporate sector (Gupta, 2016; The Hindu, 2016).

The proof that was brought forward by the opposition parties to hold the above allegations in parliamentary debate was principally subjective and seemed to aimed at gaining political advantage rather than making a reasonable argument regarding political integrity in formulating policy and good governance (Beyes & Bhattacharya, 2017). For instance, a number of political parties quoted one regional daily where an article was published on demonetization six months before it was actually announced. Later, the newspaper clarified that the report that was published on April 1, 2016 had been April Fool's Day prank (ABP, 2016). Another example is Ganashakti Patrika, a local newspaper affiliated with Communist Party in West Bengal, published another report claiming to have evidence of bank deposits and transfers of 10 million rupees in old currency made by the local BJP unit on November 8, just hours before the demonetization announcement (Gupta, 2016). Later, local BJP unit stated that the transaction was legitimate and claimed they had donation receipts and others proofs. Similar allegations of a political conspiracy theory dominated in Indian social media even months after the announcement though none of them have been verifies so far (Beyes & Bhattacharya, 2017).

The Modi administration was mainly silent on this issue. Even demands for parliamentary investigation into stubborn defaulters and momentous purchases of gold and foreign exchange in last six months before demonetization had been dismissed by the ruling party. However, in the long run, it seems that the government actually put some attention to such

allegations and demands and made an announcement on electoral funding reform, including a reduction in allowable amounts of unspecified political offerings by a factor of ten, from 20000 rupees to 2000 rupees (MoF, 2017b).

Such measures to institutionalize the political funding were long outstanding recommendations of the Indian Election Commission (EC) to address corruption in the electoral process. Although, the government did not accept all the recommendations made by EC, the announcement at least sent a positive message as well as the integrity of demonetization its commitment to root out the corruption.

5.4 An independent decision?

Roughly a month after demonetization was in effect, public opinion on this policy became increasingly reversed. While in the beginning, a large part of the common people supported the initiative, with a hope that it would punish the rich criminals and the owners of illegitimate cash, intellectuals, academicians, economists, industrialists and the opposition parties banded the policy as ill-timed, ill-conceived, badly implemented and miserably failed unleashing economic chaos and terrific hardships for rural India (Iyengar, 2016). One extreme criticism was that the Prime Minister had acted on his own regarding taking this decision without sufficient consultation with all stakeholders and did not consider the gap between urban financial system and agro-economy, reflecting a lack of proper knowledge and understanding about the life of rural India (Beyes & Bhattacharya, 2017).

The civil society groups also commented the issue “war on black money” was being used to forcibly and prematurely integrating rural India into techno-financial systems, not to fight corruption (Pandit, 2016). Others raised their doubts on the effectiveness of the policy, stating demonetization would not touch the holdings those assets residing in tax heaven, gold or real estate (Iyengar, 2016).

The allegations put its fingers to also RBI, the custodian of Indian monetary policy, stating that a very small group of people were involved in planning where procedural clearances from the ministry of law were obtained just the night before and the formal approval by the board of governors of RBI was reportedly obtained in a short session on the day before announcement.

The President and cabinet ministers were also kept uninformed until shortly before Prime Minister's speech (Kapoor, 2016).

In response, the government representatives argued that such policy had to be planned on a need to know basis to keep secrecy and avoid leaks. The Prime Minister also argued that secrecy and the decisiveness were the key to success of such policy and he is a strong leader to take bold and courageous decisions aimed at societal change. He even put a further powerful argument appealing to patriotic sentiment, highlighting that the people of India had made the whole world stand up and notice the historically inherent qualities of sacrifice, discipline, understanding, and commitment to the nation (Chengappa, 2016)

6. Conclusion:

By taking such a courageous and bold decision, the Prime Minister Narendra Modi portrayed himself as a leader willing to take decisive, and if necessary, drastic measures to tackle bribery, money laundering and leasing the hoarding of unaccounted money by passing the formal mechanisms. Although, the long term impact is yet to be revealed, the policy illustrates that the government presented the corruption as a cash based issue. The demonetization policy launched by the present government did not explicitly target non cash corrupt activities like illegal property transfers, hoarding of gold or other precious metals or money laundering outside India. By creating more controversial narrative on corruption that emphasizes only on cash, demonetization might divert attention from future attempts at anti bribery and corruption policies taking a more holistic approach. The policy may be seen as the continuation of larger steps towards the hard stand against anti-corruption of the government. At least, it has put some lights into corruption, political bribery, hoarding undeclared money and money laundering.

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