



Demonetization and Cash Fungibility

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Abstract:

Estimates suggest that the black money in India before demonetization was around Rs 3.5 lakh crores, while the amount in the form of fake currency was around Rs 400 crores. Following announcement, the total of demonetized was Rs 15.44 lakh crores. The exact amount of deposited money into the formal banking channels would reveal the effectiveness of demonetization and the amount of black money that has been recovered, but the RBI is yet to release the respective statements. Since the estimates suggest approximately five percent of the total population holds black money in cash, it was evident that the inculcable majority would have to bear the burden of the demonetization exercise. The paper is an attempt to discuss the proposed effect on black money post demonetization

Keywords: Demonetization, Reserve Bank of India (RBI), Currency.

Introduction

Paper money as legal tender was first issued in late 18th century. Indian government's first set of currency notes were the Victoria's portrait series issued in denomination of 10, 20, 50, 100. This was replaced by under print series in 1867. Rs. 500, Rs. 1000 and Rs. 10000 notes were in circulation between 1938 to 1946 and were then demonetized. The currency with same denominations were re-introduced in 1954. This was again demonetized in 1978 by then Prime Minister Late. Sh. Morarji Desai government. Mahatma Gandhi series notes were introduced in 1996. These series of notes were replaced by MG series 2005 currency notes but in a more orderly and sensible manner. The shock and astonishment approach that has triggered hardships to a vast

majority of citizens for the restricted benefit this may deliver. The buildup and hyperbole that the action will give a death blow to corruption and black money, is certainly not sufficient to deal with the problem of corruption and unaccounted wealth which is much bigger and is certainly not limited to hoarding of cash only, as it is anything less than 5% of total black money. Hence, overly proclaimed statements by the government that this will curb the menace of black money and corruption are simply bizarre. Also, the immediate introduction of Rs.2, 000 notes weakens their claim and it simply does not fit the narrative of an attack on black money and corruption. This paper discusses the goals demonetization has been said to achieve especially black money.

Objective

The main objective of the paper is to analyze the extent to which demonetization can help curb black money and find if the move is significant in dealing with the subject matter.

Research Methodology

The paper is based on secondary data from RBI and other research work. Use of statistical tools like percentage has been used to reach a conclusion.

Discussion

1. Cash is neither permanently black nor white. It is fungible

We withdraw cash from a bank and buy a durable product without a bill to tax or bribe for any approval needed, the white cash from bank becomes black. Now, if the same recipient goes to a supermarket or a hotel and spends the money received from the person who withdrew it from bank, and gets a bill, it becomes white. So not all cash is white and not all cash is black. Hence, the remedy is not attacking the cash. Requirement is for incentives that drive formation of black money need to be addressed. Quashing cash is like treating the symptom than the underlying problem!

2. A view of the possible real benefits of Demonetization

To say that demonetization will deliver a death knell to black money and corruption is an overstretched and an exaggerated remark. The historic experiences from various countries which have experimented with the concept tell us that demonetization has a very limited effect unless backed with several other measures of surveillance. This is simply due of the fact that substantial amount of black money is held in offshore real assets and via overseas bank accounts or through a web of shell companies, a fact earlier and the fact has been

acknowledged by the ruling parties prior to general elections. Equally undeniable is that a portion of it is also held locally but bulk of it is in the form of financial assets through trusts, real estate, gold and some amount of it is in cash also.

The benefits case:

- **Cash back into the formal banking system**

Irrespective of having a bank account, people hold cash for their routine and emergency requirements. This move resulted in this cash flowing back into the banks, only to be withdrawn within limits. This will temporarily improve the liquidity of banks till the new notes are fully available and withdrawal limits are lifted. So the real advantage is questionable. However, the cash that was earlier not within the formal banking system will flow in, for the first time, leading to an increase in deposits and to the extent of stability these deposits show, it may comfort the credit creation process. However, the PSU banks weighed down by non-performing assets have to be recapitalized for credit creation process. So, no concrete benefit to the economy till the banks are recapitalized.

- **Fake Currency Menace**

The matter of fake currencies was becoming a thoughtful menace and demonetization clearly stamps it out. However, the instant adverse influence of this will be felt in the form of sluggish GDP growth and lower consumer expenditure. The positive impact may be in the form of Inflation trending down.

- **Unaccounted Cash**

This is actually what the government is targeting. If some part of unaccounted money finds its way into the formal system, this will improve the tax take and the government finances. Given the ingenuity of people in protecting their cash, it remains to be seen whether this yields a huge tax collection or results in just a rise in number of bank accounts and balances as hoarders always find means to split the amounts. It has to be noted that the recently established Income declaration scheme in September 2016, lead to income disclosure of Rs 65,000 crores and netted a tax take of Rs 29,000 Crores, much less than the expected hundreds of billions of dollars.

- **Unclaimed balances**

Any unclaimed notes in circulation, a highly unlikely scenario, as individuals will find methods to recycle, will result in a strong benefit to the RBI and the government, as RBI can extinguish its liabilities to this degree. The gain would be used by the RBI to pay dividend to the government which

will reduce the fiscal deficit in turn. But this process cannot begin until following fiscal year, when the aggregate of unclaimed balances will be calculated as RBIs window for accepting notes extends to 31st March 2017.

The data below compares the magnitude of black money and the extent to which this action is going to address the problem. **Total money in circulation according RBI statistics is Rs 16.4 lacs crores** (\$250bn), of which nearly 86% i.e. Rs 14.2 lacs crores (\$ 215bn) is represented by Rs 500 and Rs 1,000 notes.

Rs 500 and Rs 1,000 banknotes in circulation						
	Volume (crore pieces)			Value (Rs lakh crore)		
Denomination (Rs)	Mar-14	Mar-15	Mar-16	Mar-14	Mar-15	Mar-16
500	1141	1313	1571	5.7	6.6	7.9
(% share)	14.7	15.7	17.4	44.4	45.9	47.8
1,000	508	561	633	5.1	5.6	6.3
(% share)	6.6	6.7	7.0	39.6	39.3	38.5
500 and 1000 together	1649	1874	2203	10.8	12.2	14.2
(% share)	21.3	22.4	24.4	84.1	85.2	86.4
Total of all notes	7733	8358	9027	12.8	14.3	16.4
Source: RBI						

According to the RBI's statistics, the banks of India hold about Rs.6 lacs Crores (\$91bn) in Rs 500/Rs 1000 notes after applying the eighty six percent on their total cash holdings to estimate the amount held in Rs 500 and Rs1,000 notes, in their branches and ATMs. Organizations like the Railways, Hospitals ,Post offices, PSUs, Corporate, Petrol Pumps, government offices and traders etc. hold cash as part of their legitimate daily activities. Assuming that the legitimate portion of the cash holdings to be 2/3rd levels of banks, based on an estimate that the number of corporates, traders, organizations significantly outnumber the banks by hundreds of folds, it comes to Rs 4 lacs crore (\$60bn), then the residual cash amount cuts to less than half of the total. So that leaves the balance cash to Rs 4.2 lacs Crores (or \$64bn). The table below shows the estimates:

Details	Rs (Crores)	USD billions	Percentage to total cash in circulation
Aggregate Money in movement (RBI statistics)	1,640,000	250	100%
Aggregate Money in denomination of Rs 500 and Rs 1,000 (86% of total as per RBI Statistics)	1,420,000	215	86%
Money held by Scheduled Commercial Banks and other Financial Institutions including CRR of Rs .5lacs Cr. with RBI (Branches and ATMs) (estimated at 86% of total cash in Rs. 500/1000 notes)	6,00,000	91	36%
Estimate cash with Traders, Post Office, Railways, Corporates, Petrol Pumps, Govt. etc.	4,00,000	45	18%
Estimated Balance left with individuals (a number associated with fraud)	4,20,000	64	26%

Source: Sridhar Raman BlogSpot

Out of the predictable amount of cash held by individuals, we can make a rational split of cash held by urban and rural population. For urban India, assuming an average of Rs. 2,500 per person for 400 million of urban population, justifiably held cash for routine and crisis expenses Rs 1 lac crore (\$15bn). On the other hand, rural and semi urban who are mainly cash users and not majorly into the banking system, say an average of Rs 500 per person as the cash held by the 800 million, the total approximately amounts to Rs 40,000 crores (\$6bn). So, if we adjust the amounts held by people of Rs 1.4 lacs Crores (\$21bn) from the aggregate Rs 4.2 lacs Crores (\$64bn) of balances with people, the net estimated total of unaccounted cash would be Rs 2.8 lacs crores (\$43bn), which is just about 2% of our GDP. Now cutting all the noise, comparing this to the total of unaccounted money which was estimated to be \$1 trillion, we can very easily see that it represents less than 5% of the black money problem. Even if, we made an exaggeratedly optimistic assumption that the whole amount of \$43bn can be recognized as an achievement either through tax or unclaimed balances, this would still be only 4.3 percent of the total black money problem. While this development still needs to be applauded, it is much needed to keep it in the framework of the magnitude of the overall problem. So, all that screaming that demonetization will end black money, we need to realize that the black money problem is far from over. It is mere scratching the surface. Moreover, in long run, re-monetization of higher denomination notes will only worsen the problem unless further measures to control and check the cash transactions are introduced.

Conclusion

Demonetization should be welcomed as there will be some benefit from this exercise but the justification behind sudden withdrawal is questionable. If the government is truly minded to challenge black money menace, it has to focus on the 96 percent of the problem and work with other G20 members on transparent information sharing and needs to take prompt action. So far the government has been unable to share any facts and figures as to how much black money it has recovered. The hype and hyperbole associated, only seems to exploit the monetary and economic illiteracy that is prevalent even amongst the educated classes of the nation who have not realized the issue, let alone the rural illiterate. While there are some gains for the government in the form of potential tax and unclaimed balances that will help to reduce the fiscal deficit, but to assert that demonetization is going to end corruption and black money is far away from reality and the speechmaking does not gel with the instantaneous introduction of the higher denomination notes. The approach does not justify the hardship imposed on millions of ordinary citizens.

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