# Editorial



## Demonetization and its impact

As human beings and civilizations move forward, they keep on adopting newer ways of economic transactions among themselves. For a long time, barter system was in existence. Barter means that A gives to B a part of his produce and B, in turn, gives to A a part of his produce. Of course, this transaction happened with an understanding of some sort of "equivalence" between one unit of what A gives and some units of what B gives. There is no money involved in these transactions. Bartering has some advantages as well as disadvantages. Major advantage is that it gives flexibility of items to be exchanged – both similar and dissimilar items can be exchanged. For example, an exchange of fruits and grains involves both the items coming from the food category. On the other hand, an exchange of cloth and grains involves two items from different categories. The disadvantage in the barter system can be that there is no guarantee on quality of items exchanged. A brand new product may be exchanged with an old and worn out product!

Over a period of time, these forms of transactions became less and less prevalent and were replaced by a common unit called "money." However, it must be noted that the barter system is still in use, though it is not as widely prevalent now as before. Now, all countries of the world have, each one of them, their own currencies to enable their citizens to transact among themselves. Money consists of currency and bank deposits. Larger part of money in a modern economy is in the form of bank deposits. These deposits are called either demand deposits or time deposits. Again between the two, time deposits form much bigger chunk as compared to demand deposits.

In order to hold money in cash form, notes and coins are created in different denominations. Commonly, the bigger denominations are printed as paper notes and smaller denominations are minted as coins. Once the notes or coins of whatever denominations have been created, they remain in circulation and are used as legal tenders for economic transactions.

However, once in a while, for specific reasons, the government of a country may decide that a note or a coin of a specific denomination would no longer be a legal tender. This action by the government is known as demonetization. There are many examples of this happening in the past. In 2002, many nations in the European Union demonetized all notes and coins of their currencies and adopted a new currency, called euro. Once these countries decided to make this shift, their old currencies gradually disappeared and euro came in circulation. The transition happened over a specified duration of several months. The reason for this shift was for these countries to better integrate into European Union. Prior to the demonetization, each country fixed a rate between their outgoing currency and euro, the incoming currency. For example, in France, a euro was fixed roughly equal to 6.56 units of French franc. Likewise, other countries fixed different rates for one euro. It is noteworthy that this is an example of a successful demonetization.

Amongst many instances where demonetization happened in the past for various reasons are the USA, Russia, Australia, North Korea, Ghana, Nigeria, Zimbabwe, Venezuela, etc. The most common reasons for several instances of demonetization were to curb black money and inflation.

Recently, the Government of India announced on November 8, 2016, to be precise, the demonetization of high value denominations, namely, Rs500 and 1,000. This event of demonetization is unique in many ways, particularly, if one compares it with the demonetizations undertaken in EU nations in 2002. The main reason behind

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demonetization in India is to curb corruption, reduce black money, eliminate counterfeit currency and reduce terrorist funding. At the time of the announcement, about 85 percent of total cash in circulation was in the form of notes of 500 and 1,000 rupees. All this cash was supposed to come back to banking system over a period of 50 days, between November 8 and December 30, 2016. What can be the consequences of this action?

India, being a developing country, has an economically significant informal sector where wages to employees are paid in cash and sales/purchases of product and services are made with cash. Some of these transactions remain out of the formally recorded economic system. Also, in some sectors, especially real estate, gold, etc., transactions are made in such a way that a part of payment is made in cash, which escapes formal banking system. This results into accumulation of black money. The officials who charge money to do favors also get paid in cash from those receiving favors. This kind of corrupt practice generates black money and breeds inefficiency. A part of black money finds its way to fund criminal activities and terrorism. Added to all these, there is a problem of counterfeit notes, which helped in aggravating the level of parallel economy.

All countries in the world, without exception, have a certain percentage of money in circulation in the form of cash. Cash to GDP ratio for many countries is about 10 percent. As regards this ratio, India is not vastly different from some of the developed countries like France, Germany, Italy, etc. Yet, the negative effects of cash may be quite different from one country to another.

As mentioned earlier, the informal sector of the economy has been using cash in a significant proportion and, therefore, this sector is likely to be the most affected by demonetization. Negative impact of demonetizations, at least in short run, would be reduction in employment in informal sector where the transactions are done in cash. Be that as it may, the likely positive effects of the demonization can be enumerated as follows:

(1) increase in transactions through bank cheques and digital mode will ensure tracking of transactions;

(2) as more transactions happen digitally, the potential for electronic commerce will increase;

(3) reduction in corrupt practices will lead to better governance;

(4) elimination of counterfeit notes will reduce funding of criminals and terrorists;

(5) the pricing in real estate and housing sector may attain a more "realistic" level since cash payments for sales/purchases keep the prices inflated, which induces a vast difference between the prices of primary market (at the level of construction cost) and secondary market (on a subsequent sale by the original owner);

(6) reduction in money laundering will happen; and

(7) there is a possibility of increased tax-base since, at the moment, only a very small fraction of the population is covered by tax structure due to existence of parallel, cash-based economy.

The researchers can take up studies on the impact of demonetization with the passage of time when more data will become available for analysis. The comparative effect of demonetization in different countries can also be studied and the lesson for future can be drawn.

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