



## Effectiveness of Demonetization in India in 2016: A Critical Analysis

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### Abstract

Demonetization policy is generally resorted to when the economy is experiencing some abnormal situations. Historically, the policy of demonetization was used when the economy suffered from hyperinflation, war, political upheavals or other extreme circumstances. The government of India announced its demonetization policy recently on the 8<sup>th</sup> November 2016 with the objectives of destroying the black money and corruption, to check the counterfeit money and terror funding by withdrawing legal status of the high currency notes of 500 and 1000 which accounted for 86 per cent of the total currencies in circulation. Here, a critical review is made to examine the rationale for the policy pursued by the government and its efficacy to address the stated objectives on the basis of the historically available information, media reports and data released by different organizations and reserve bank of India after the implementation of the policy. The paper also examines alternative options, other than the demonetization, to address the current objectives so as to minimize the pains and sufferings experienced by the common people during the window period of 50 days.

**Keywords:** Demonetization, black money, corruption, counterfeit money, hyperinflation, window period.

### Introduction

Demonetization is a policy adopted by the government of a country to check some abnormal situations prevailing in an economy like hyperinflation, wars, political upheavals or other extreme circumstances. It is a policy to withdraw the legal status of the demonetized currency notes, that is, ceasing to be legal tender. The demonetization policy was used in many countries to contain or to check the unfavourable situations in the economy for some time now. Historically, countries such as Ghana (1982), Myanmar (1985 & 1987), Brazil (1990), Soviet Union (1991), Russia (1993), Iraq (1993), North Korea (2009), Cyprus (2013), Greece (2015), Venezuela (2016) etc. employed the policy of demonetization to address the problems faced in their respective countries with partial success or without success (Govt of India:2017). In India, the first demonetization exercise was carried out before independence in 1946 and subsequently for the second time in 1978. The recent exercise announced on the 8<sup>th</sup> November 2016 is the third in the country.

### Review of Past Demonetization Policies:

The impact of the policy of demonetization varies from country to country. In some countries, the demonetization policy achieved its objectives partially and, in some countries, it ended in disruptions of the economy and failed to achieve the targeted objectives. In U.S.A. the first demonetization exercise was carried out in 1873 and was not successful. However, the 1969 exercise could be termed as successful since it could reduce the illegal cash and helped to improve

the American banking system. Likewise, the demonetization of India in 1978; Ghana in 1982; Nigeria in 1984; Myanmar in 1987; Soviet Union in 1991; North Korea in 2020 did not achieve the set objectives. The demonetization carried out in Zaire in 1993 was not only unsuccessful but also ousted its leader from office in 1997. However, the exercise carried out in Australia in 1996 was successful.

### Rationale for the Demonetization-2016:

The rationale for the demonetization policy pursued by the government of India on 8 November 2016 may be examined from the announcement of the Prime Minister on 8 November itself in the late night; from the Gazette Notification on Demonetization issued by the Ministry of Finance (Department of Economic Affairs); and a note submitted to the Parliamentary Panel by the RBI on 22 December 2016 regarding the Demonetization. In his announcement, the Prime Minister very clearly mentioned that Terrorism was a frightening threat and enemies from across the border run their operations using fake notes. Further, he mentioned that on the one hand there was the problem of Terrorism; on the other there was the challenge posed by black money through corruption. Accordingly, he announced the policy to break the grip of corruption and black money. However, both the Gazette Notification and note of the Reserve Bank of India do not mention the word corruption at all. Both the documents mentioned about fake notes, terror funding and black money. Therefore, we may conclude that the rationale behind the demonetization policy 2016 is to destroy black money and

corruption; and to eliminate the fake currency and terror funding.

### Objectives of the Paper

The objectives of the present paper are:

- i). To review the demonetization exercise undertaken by the government on the basis of the historically available information, media reports and data released by the different organizations including Reserve Bank of India against the stated objectives of the policy; and
- ii). To examine the alternative options, other than the demonetization, to address the stated objectives.

### Methodology of the Study:

The present study is the review of the demonetization exercise undertaken by the Government of India on the 16<sup>th</sup> November 2016. It is, therefore, used the secondary sources of information like the daily newspapers, commentary of different experts and economists, books by economists and reports of Reserve Bank of India, Ministry of Finance etc.

### Review of the Demonetization 2016:

Many economists and commentators started discussing the likely impacts of the demonetization exercise from the day one itself on the Indian economy, on the lives of the common people, on the unorganized workers, farmers, peasants, migrant workers etc. over and above the likely impacts on the stated objectives. They predicted that it would affect all sections of the society who live on cash. The sudden withdrawal of cash from the economy is something like the withdrawal of blood from the human body which ultimately leads to death. Thus, there appeared to be complete breakdown in the economy due to the exercise.

This is one side of the story. The real problem is its efficacy to contain the stated objectives of black money and corruption; and to check the counterfeit notes and terror funding. The speech of the Prime Minister, the Gazette Notification and the Note submitted by the RBI to the government assumed that high currency notes were responsible for the generation and hoarding of black money and therefore corruption. Counterfeit high currency notes of Rs 500 and Rs 1000 were printed from across the border and used for terror funding. Thus, it led to the demonetization exercise of the government.

Demonetization is the withdrawal of the legal status from the specified currencies in circulation. Demonetization of Rupees 500 and Rupees 1000 notes means they cease to be legal tender money. The size of the total currency in circulation as on 8 November 2016 was Rs 16.41 lakh crore out of which Rs 14.18 lakh crore, that is, 86 per cent were in Rs 500(47.6%) and Rs 1000(38.4%) notes. Hence, at one stroke such a huge amount of money in circulation became invalidate as legal tender money. With the invalidation of the currencies, as per the assumption of the government, around 25-30 per cent of these could not be presented to the banking system which would have made it the black money unearthed by the exercise.

But the reality is quite the opposite. As per the data released by the Reserve Bank of India on 12 December 2016, of the Rs 14.18 lakh crore, as much as Rs 12.44 lakh crore, i.e. 88 per cent had been deposited to the banks as on 10 December 2016 (Reddy, 2017:12). That is, during the 30 days of the 50 days window period announced by the government, 88 per cent of the Rs 14.18 lakh crore have already been returned to the banking system. The final numbers revealed that 99.30 per

cent of the demonetized money back into the banking system (Economic Times. 30 August 2018). The present outcome of the demonetization exercise is more or less similar to the outcomes of the two past exercises in the country in 1946 and 1978. In the first instance of 1946, Rs 134.9 crores out of the total Rs 143.97 crores in circulation were exchanged up to the end of 1947 and therefore only Rs 9.07 crores were demonetized (Reddy, 2017:43). Likewise, in the second instance of 1978, Rs 20 crores out of Rs 144 crores were demonetized (Gupta, 1992:171). On the whole, there were partial successes of the demonetization exercise to unearth the black money. The recent exercise also faced the same consequences. Except demonetizing a few crores of rupees i.e. hardly 1 per cent of the Rs 14.18 lakh crore, outcome is quite disappointing. Evidence of terror funding even with the genuine new currencies is available.

There are many reasons why demonetization as a policy fails to curb the black money and corruption, and to check the fake currencies and terror funding. Most commonly cited reasons are the followings;

- i). Black money held in cash is very small. It might be around 5-6 per cent of the entire black money, according to experts;
- ii). The total black money in the economy is estimated to be around 25-62 per cent of the GDP;
- iii). Most of the black money are held in real estate, land, jewellery and gold;
- iv). Black money is stashed away in tax havens (in foreign countries);
- v). Only 3 per cent of the population holds black money;
- vi). Only 1 per cent of the population controls 58 per cent of wealth in the country;
- vii). Size of the fake currencies was estimated at around 0.000007 per cent of all notes in circulation in 2015-16 (RBI, 29 August 2016);
- viii). Genuine Indian currency notes (new Rs 2000 note) recovered from the dead body of Terrorist in Kashmir proves the ineffectiveness of the policy to check terror funding (Hindustan Times, 22 Nov.2016);
- ix). Corruption is a larger issue. Black money is one of the causes of petty corruption. But large-scale corruption takes place somewhere else. Nexus between politicians, bureaucracy and businessmen is generally mentioned for the large-scale corruption.

Hence, the policy of demonetization could not be used as an instrument to check the black money and corruption; and to check the fake currencies and terror funding is evidenced from the outcome. Here, in this connection, the statement given by the former Governor of the Reserve Bank of India Mr Y V Reddy may be mentioned. According to him, demonetization has negligible impact on black money and corruption (Indian Express-22 April, 2017).

**Alternative Options to the Demonetization:** Economists and commentators predicted from the day one of the demonetization that it would not be successful. For whatever reasons best known to them, their predictions seem to be correct as of now. Instead of the current policy, they have suggested many alternative options available in the hands of the government so that disruption in the economy, distress, hardships, pains and inconveniences on the part of the common and honest citizens could be minimized on the one hand and expected gains could be achieved on the other. In fact, the issue of black money and corruption has become focus of attention among all sections of the society including

the policy makers of the present dispensation for some time now. Some of the alternative options may be outlined to address specific problems.

**To Check Fake Currencies:** Even though the number of fake currencies to the total currencies in circulation is very small, the issue becomes very critical is evidenced from the statement of Prime Minister, Gazette notification and Note of the Reserve Bank of India. However, to check the problem, use of the demonetization policy is not advisable. Without resorting to such policy, it can be removed gradually by withdrawing the fake currencies in a phased manner without any hardships to the common people. In the past, RBI adopted this policy. In January 2014 RBI announced that all pre-2005 currency notes started withdrawn and ceased to be legal tender money from the 31<sup>st</sup> March 2014 which was extended up to June 2016. The process was conducted in an orderly fashion without any panic to the people (Reddy, 2017:64).

**To Check the Terror Funding:** One of the main objectives of the demonetization policy is to check the terror funding with fake currencies from across the border especially from Pakistan. However, evidence shows otherwise. From the day one of the demonetization announcement till the end of the April 2017, there is no report of fake currencies recovered from the terrorist killed or arrested so far in the country. This was confirmed by the Finance Ministry in its reply to Public Account Committee that during the period from the 8<sup>th</sup> Nov. 2016 to 30<sup>th</sup> December 2016 no case of seizure of fake currency was available. Instead of fake currency, genuine new Currency Notes were recovered from the terrorist killed in Kashmir. Hence, the theory of funding of terror with fake currencies is inconclusive. Thus, the problem of terror funding can be addressed with the strengthening of law enforcing agencies and other associated actions.

**To Destroy Black Money:** The problem of black money in the country is not new. It became a problem even during the British era. That was why the first demonetization exercise was undertaken in 1946 in the country. The second such exercise was performed in 1978. This proves the gravity of the problem in the economy. But the basic question remained is how successful the demonetization policy was to address the problem of black money. If the outcomes of both the exercises are reviewed, it is more or less similar as the demonetization exercise of 2016. The difference was the pains and sufferings of the common people which are more in the present case. The black money act imposes a 30 per cent tax on undisclosed foreign income, a 90 per cent penalty and potential imprisonment of up to seven years. As of March 2025, this has resulted in 1021 assessments; Rs 21,719 crore in tax demands; Rs 13,385 crore in penalties and 163 prosecution complaints (Policy Circle:2025). In August 2023, the income Tax Department detected black income of Rs 150 crores after it raided several business groups in Haryana and NCR Delhi. Similarly, the département detected undisclosed income of Rs 250 crore during searches against two business groups (Unnakrishnan:2023).

The government has been trying to eliminate the black money is evidenced from the many policies and schemes announced from time to time in the past with partial successes. Some recent steps may be mentioned to substantiate the reality/argument. For example, during the United Progressive Alliance Government led by Dr Manmohan Singh, a white paper on Black Money was presented in 2012. Before such step, many amnesty schemes were also announced which included 1) the National Housing Bank (Voluntary Deposit) Scheme, 1991, 2) the Remittances in Foreign Exchange

(Immunities) Scheme, 1991, and India Development Bonds Scheme, 1991, and 3) the Voluntary Disclosure of Income Scheme, 1997 (Reddy, 2017:51-52). Even, during the present dispensation, the Special Investigation Team formed during the UPA regime became operational in 2015; the Prevention of Money Laundering Act, 2002 was amended in 2015; the Benami Property Transaction Act, 1988 was amended in 2016; a Protocol was signed to amend the Double Taxation Avoidance Agreement (DTAA) in May 2016; Income Declaration Scheme, 2016 (Reddy, 2017:48-51). All these exercises point to the fact that the government in the past as well as the present did not remain silent on the issue of black money in the country. But the problem lies in the seriousness, honesty, sincerity and will of the government. Without seriousness, commitment and will, no scheme can success. Here, an order of the Hon'ble Supreme Court of India in 2011 following the hearings on the writ petition which dealt with a couple of high-profile cases alleged illegal holding of deposits in foreign banks may be noted. The court saw the lack of seriousness on the part of the government to carry out necessary investigations. It also saw the absence of satisfactory explanation for the slowness of investigations and lack of credible answers as to why the respondents did not act with respect to these actions that were feasible to bring back the money stashed away in the foreign banks (Reddy, 2017:47).

Some of the outcomes of the amnesty schemes may be highlighted so that they can be alternative to the highly painful and distress demonetization policy to unearth the black money. The sums disclosed under the National Housing Bank (Voluntary Deposits) Scheme, 1991 was Rs 154 crore; under the Remittances in Foreign Exchange (Immunities) Scheme, 1991 and the India Development Bonds Scheme, 1991 was Rs 6,400 crore; under the Voluntary Disclosure of Income Scheme, 1997 was Rs 33,289 crore and in today's prices this would amount to Rs 82,550 crore; and under Income Declaration Scheme, 2016, the disclosure was Rs 65,250 crore (Reddy, 2017:51-52). In his address to the nation on 8 Nov. 2016, the Prime Minister mentioned that during the two and half years of his government, a sum of Rs 1.25 lakh crore has been brought under the various schemes. Hence, it can be concluded that, if used with great heart, the schemes are more fruitful and less painful than the demonetization policy.

**To Demolish Corruption:** Though corruption becomes a household word in the country, yet its incidence cannot be measured very easily. The Transparency International, an NGO uses the Corruption Perception Index which implies that it is a measure of perceptions from individuals and select organizations and it does not measure the magnitude of corruption in each country. According to this measure, India was ranked in the 76<sup>th</sup> position out of the total of 168 countries in 2015 and was ranked 96<sup>th</sup> position out of the 180 countries (Policy Circle:2025). The experts are of the opinion that corruption cannot be checked unless the nexus between politician, bureaucracy and businessman are broken. The root cause of all corruptions lies in political corruption. In an analysis of the 2009 Lok Sabha Election by Gowda and Sridharan, it was found that the chances of winning in the election are higher in the case of richer candidates than poor candidates. For example, 106 out of the 322 candidates whose incomes of Rs 50 million and above won the election i.e. 33% won the election, but 15 out of the 3,437 candidates whose income less than 1 million i.e. 0.44% won the election. They, therefore, wrote a very nice statement, "Political Party

preference for wealthy candidates can give rise to a new breed of 'Political Entrepreneur' who are ready to invest in running for office in the hope of controlling the levers of government to further enhance their personal wealth". Therefore, electoral reforms and political party funding reforms are the need of the hour, other than the demonetization, to address the corruption in the country.

### Conclusion

From the foregoing discussions, it can be concluded that the demonetization 2016 turns out to be a great failure. None of the stated objectives, that is, to destroy the black money and corruption; and to eliminate the counterfeit currency and terror funding in the country could be achieved with this exercise in a satisfactory manner. Not only the exercise became a partial success, it disrupted the economy; it caused a lot of distress and hardships to the common and honest citizens. To achieve the stated objectives, instead of employing such a highly painful but fruitless instrument to tackle the problems, government could have resorted to the less painful but effective alternative available options.

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