

POTENTIAL ECONOMIC AND BANKING IMPLICATIONS OF PHASING OUT ₹2000 BANKNOTES IN INDIA

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ABSTRACT

As part of its "Clean Note Policy," the Reserve Bank of India (RBI) has announced the withdrawal of banknotes with the denomination of 2000, with a goal of a gradual transition until September 30, 2023. The withdrawal of the note, even though it will continue to be legal tender, is reminiscent of the 2016 demonetization, which was intended to fight black money. Its political ramifications are highlighted by the timing, which comes before state and federal elections. The 2000 note was created after demonetization to replace the gap in the money supply, however it is currently viewed as unneeded. This emphasizes monetary debasement and parallels the short life of the note. The action, in keeping with the RBI's approach, raises concerns about the morality of manipulating national currencies. The decision's impacts on the economy and banking industry may have an influence on illicit financial activity, industries relying on cash, the informal economy, digital transactions, economic growth, the banking system, counterfeiting, and public confidence. Demonetization's success depends on how well the government plans and implements it.

Keywords: Demonetization, RBI, Economy, Liquidity

1- Introduction

The Reserve Bank of India (RBI) has announced its decision to withdraw the ₹2000 denomination banknotes from circulation as part of its 'Clean Note Policy.' Despite this withdrawal, the note will continue to be legal tender. Banks have been advised to continue providing deposit and exchange services through September 30, 2023 in order to ensure a smooth transition. This gradual procedure tries to let people transfer their genuine assets into currency notes with lesser denominations. This action differs from the demonetization in 2016 where 86% of the money in use in India was destroyed.

The recent decision to phase out the 2000 notes is thought to have been made with the state and federal elections—periods known for higher cash usage—in mind. The note's distinctive pink tint distinguishes it from others that were released after the abrupt elimination of the 500 and 1000 notes in 2016. The demonetization of 2016 is still having an impact on certain people, as the RBI's notification about the withdrawal of the 2000 note serves as a reminder. The RBI admits that the purpose of introducing the note was to quickly raise the value of money in circulation after the demonetization event.

Intriguingly, the RBI's decision suggests that the denomination no longer serves its intended objective of increasing money circulation. This emphasizes the 2016 currency debasement and underlines the 2000 note's brief useful life. Notably, by March 2017, the value of the currency in circulation was 50% represented by the 2000 note, demonstrating the skewed denominational structure brought on by the demonetization.

Concerns over the most recent choice were addressed by RBI Governor Shaktikanta Das, who worked in the economic affairs division during the 2016 demonetization. He acknowledged that the main goal of the 2000 note was to fill the gap left by the withdrawal of the 500 and 1000 notes as quickly as possible. This admission calls into doubt the national currency's sacredness and the appropriateness of such manipulation. The 2000 note's acceptance in regular transactions is still up in the air, despite the fact that it is still legal money.

2- Impacts on the Economy and Banking System

If the Indian government were to decide to phase out or scrap the ₹2000 banknotes, it could have several effects on the economy and the banking sector:

Impact on Black Money and Corruption: Demonetization is often touted as a means to curb black money and corruption. If ₹2000 notes were demonetized, people holding large amounts of unaccounted cash might be deterred from keeping it in such high-denomination notes, as the notes could potentially lose their value suddenly. This could lead to a reduction in illegal activities and unaccounted cash.

Short-Term Disruptions: The sudden withdrawal of a high-denomination currency could lead to short-term disruptions in cash-dependent sectors of the economy. This might impact sectors like agriculture, where cash transactions are prevalent.

Impact on Informal Sector: The informal sector, which heavily relies on cash transactions, could be adversely affected in the short term. Many small businesses and daily wage workers might face challenges if adequate measures aren't in place to manage the transition.

Cashless Transactions: Demonetization tends to encourage digital and cashless transactions as people seek alternative ways to make payments. If ₹2000 notes were demonetized, people might rely more on electronic payment methods, leading to a boost in digital transactions and formalization of the economy.

Impact on Cash-Intensive Sectors: Certain sectors of the economy that heavily rely on cash transactions, such as agriculture and small businesses, could face short-term disruptions due to a shortage of currency. However, in the long term, this could push these sectors toward more transparent financial practices.

Economic Slowdown: If demonetization is not managed well, it can lead to a temporary economic slowdown. Cash shortages can impact consumer spending and business operations, which might affect GDP growth for a limited period.

Banking System Strain: Demonetization can lead to a surge in people depositing their old notes in banks, potentially straining the banking system's capacity to manage the sudden influx of deposits. This could lead to long queues at banks and ATMs.

Counterfeit and Terrorism Financing: High-denomination notes are often used for counterfeit activities and funding terrorism due to their intrinsic value. Demonetization can disrupt these illicit activities by rendering counterfeit notes worthless.

Monetary Policy and Inflation: Demonetization can impact the money supply and monetary policy. It might lead to a temporary reduction in money circulation, affecting interest rates and inflation dynamics.

Public Perception and Trust: How well the demonetization process is executed can influence public trust in the government and the banking system. Poorly executed demonetization can erode public confidence and lead to social and political unrest.

Informal Sector and Job Losses: The informal sector, which relies heavily on cash transactions, could witness disruptions, potentially leading to temporary job losses and economic dislocation for workers in this sector.

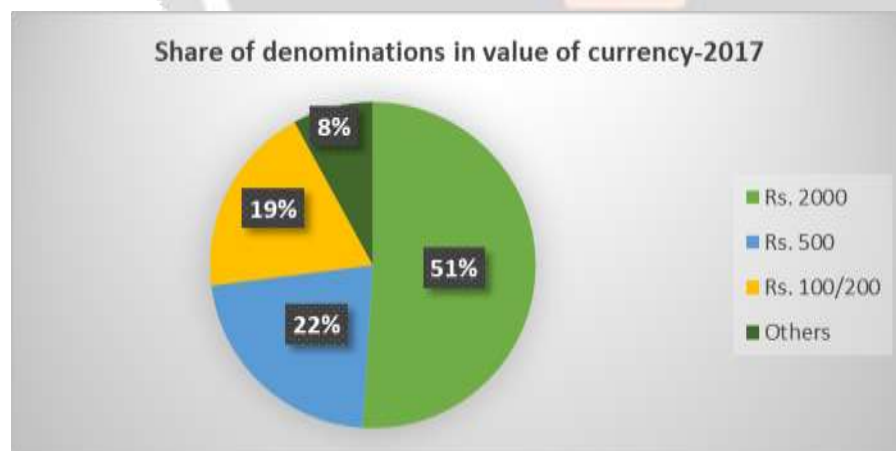
Shift to Digital Economy: A demonetization move could accelerate the shift towards a digital economy, which might lead to increased financial inclusion and formalization of the informal sector.

Demonetization will be successful if it is carefully planned, skillfully carried out, and the government takes strong action to deal with any potential problems. Demonetization has both short-term and long-term effects, and its outcomes depend on a variety of factors. These include the scale of the demonetization project, the government's communication plan, and the plans made to support the economy throughout the transitional period.

A significant perspective on the effects of demonetization may be gained from looking at how different denominations are distributed within the total amount of cash in circulation in 2017.

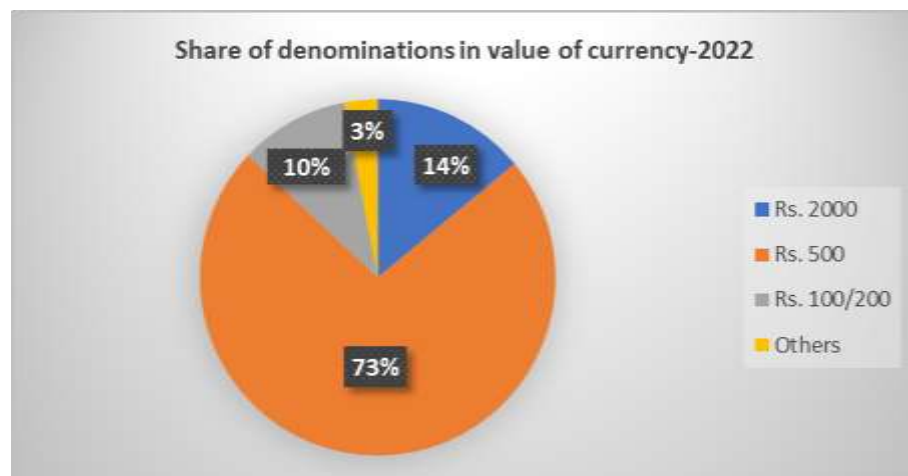
It's crucial to remember that the government's preparation, implementation, and mitigation actions for anticipated disruptions will have a significant impact on how successfully demonetization goes. The magnitude of the demonetization, the government's communication plan, and the steps taken to support the economy during the transition are just a few of the many variables that may have an impact on the economy's short- and long-term outcomes.

Share of denominations in value of currency in circulation (2017)



Source: Reserve Bank of India

Share of denominations in value of currency in circulation (2022)



Source: Reserve Bank of India

3- The Role of Currency as a Facilitator of Transactions

The importance of denominational structure within a monetary regime stems from its function as an exchange facilitator. Understanding the fundamental function of money in a modern economy is essential to understanding how the prestige of the national currency is eroding. Money functions as a store of value and a means of exchange, as stated by fundamental economic concepts. It also serves as an accounting unit, enabling market participants to compare prices. The importance of this latter component resides in its role as a trade medium, even though it is not immediately relevant to arguments about demonetization.

Alternative methods, such as credit cards or the widely used Unified Payment Interface (UPI), may appear to be available to simplify transactions, but they are unable to act as trustworthy stores of value. Fundamentally, transactions demand mutual consent on reasonable terms, generally mediated by a globally accepted currency or payment method. Situations frequently occur when one party declines to accept particular monetary denominations or payment methods. When this situation is scaled up, as it did after November 8, 2016, it leads to severe economic turbulence on a national level.

Money must exhibit stability and predictability in order to efficiently promote trades, especially when it takes the form of tangible currency. For transactions to go smoothly, acceptance must be universal and assured. Failure to achieve this results in chaos, stalling economic gears. The impact goes beyond annoyance; it seriously jeopardizes a currency's function as a reliable means of exchange, which has a negative effect on the economy and people's quality of life. After November 2016, this lesson was sadly realized. A system that is unconcerned about payment methods is good since it encourages easy transactions while reducing obstacles and rigidity.

If economic actors believe the Reserve Bank of India's (RBI) claim that the 2000 note continues to be "legal tender" is inaccurate, it loses its validity. With regard to the time up until September, distrust brought on by events from after 2016 makes such claims meaningless. Concerns right now center on the pink note's acceptance by counterparties.

Further aggravating matters, the awareness that these notes can be exchanged or deposited in banks only until September 30, 2023, deters holders from surrendering them prematurely. Instead, they might decline transactions involving these notes, while the impractical 10-note per visit limit adds to the deterrents. This futile restriction merely creates an avoidable obstruction hindering the circulation of goods and services.

The 2016 fiasco is still being felt in the present situation. Customers did not need to fill up deposit papers, according to banks, including the illustrious State Bank of India, even before the 2000 note deposits began on May 23. Surprisingly, the central bank, which is in charge of the country's currency, said nothing. The arbitrary 10-note cap every bank visit is still in place, though. It defies logic to claim that making several trips will relieve bank strain, burdening bank employees who have already been through a great deal of stress since November 2016, some of whom have even lost their lives while on the job.

4- The Brief and Eventful Journey of the ₹2000 Banknote

The maximization of liquidity is the underlying idea behind the international hierarchy of currency denominations. The foundation of India's monetary system before demonetization was the 500 note, which was comparable to the 100 note about 20 years earlier. The lower total price level in the economy at the time was reflected in this hierarchy. When the 500 and 1000 notes were added together, they made up 86.4% of the total value of the notes, making up nearly half of them. Together with the \$100 note, these two notes represented 96% of the total value. However, the share of the 2000 note in the total value of the currency has decreased to 10.8%, but the share of the 500 note is still significant.

This hierarchy followed a sane reasoning. Surprisingly, before demonetization, there was an exact 2:1 value differential between the highest and lowest denominations. This gap was tripled by the introduction of the 2000 note and the abolition of the 1000 note. As a result, even though the 2000 note was a larger value store, its liquidity significantly decreased. Its widespread avoidance as a result during its limited existence. During the 2016 crisis, there was a famous incident where a van driver in Bengaluru abandoned his kidnapped vehicle after finding it only had the unpopular pink 2000 notes.

The strain on the 500 note was made worse by the growing value differential between the top two denominations because a sizable share of these notes were practically supporting the less liquid 2000 notes. In reality, these 500-dollar notes were kept on hand to help the 2000-dollar note circulate rather than for direct transactions. The main cause of the reluctance to hold the new highest denomination note was this dynamic.

The 500 note played a crucial role in the pre-demonetization plan for rapid liquidity and functioned as a store of value. The 1000 note, meantime, made transactions of comparatively bigger value possible. The phrase "relatively high-value" does not, however, imply wealthy currency holders. Such transactions are not always associated with big revenues, especially given that almost half of India's national GDP comes from unregulated businesses.

By March 2017, the value of 2000 notes accounted for more than half of the overall currency value as a result of the currency press's frenzied efforts. With the 200 note, a comparable tendency was seen, but to a lower degree. The 200 note was introduced with the intention of quickly increasing liquidity and supporting the burdened 500 note. The peak circulation of 2000-yen notes was in 2018, when there were over 3.363 billion notes in circulation. However, more than one-third of these notes had been taken out of circulation by March 2022.

Distribution of Currency Denominations as a Percentage of Total Circulation Value

Year	Rs. 100/200	Rs.500	Rs. 1000	Rs. 2000	Others
Mar-15	11.5	44.4	39.6	—	4.5
Mar-15	10.5	46	39.3	—	4.2
Mar-16	9.6	47.8	38.6	—	4
Mar-17	19.3	22.5	0.7	50.2	7.3

Mar-18	14.4	42.9	0.4	37.3	5
Mar-19	13.3	51	—	31.2	4.5
Mar-20	12.4	60.8	—	22.6	4.2
Mar-21	10.8	68.4	—	17.3	3.5
Mar-22	9.7	73.3	—	13.8	3.3

Source: Reserve Bank of India Annual Report, various issues • Note: The 200-rupee was introduced after demonetisation.

In a recent statement, the Reserve Bank of India defended the termination of the Rs. 2,000 note by referencing its Clean Notes Policy, which calls for the removal of notes after four to five years. This justification, however, calls into doubt the necessity of retiring a sizeable portion of these notes far earlier than anticipated. Furthermore, rather than focusing on the usefulness of the denomination, the Clean Notes Policy is more concerned with the notes' appearance. The RBI might have achieved its goal by simply exchanging the old notes for new ones if the policy had a goal in the first place.

5- An Internally Induced Liquidity Dilemma

In November 2016, the world was surprised by an unexpected decline in currency value that led to an unprecedented liquidity collapse and self-inflicted crisis of unimaginable proportions. The Reserve Bank of India (RBI) was forced to run its currency printing equipment at full capacity in order to meet this emergency. However, the printers' inability to handle such a severe liquidity reduction made this effort ineffective. The manufacture of the eye-catching pink 2000 note was given priority; in the immediate aftermath of demonetization, the 500 note was glaringly absent. Given that the value of the currency in circulation was 20% lower at the end of March 2017 than it was at the same time last year, the magnitude of the liquidity reduction becomes clear. Surprisingly, the value had climbed by a by end-March 2018

The withdrawal of the 2,000 note was expected and serves as a warning that demonetization's effects are still being felt. In reality, there is a case to be made for the return of the \$1,000 bill. Support for the 500 note, especially in very high-value transactions, becomes essential given the rising price level and some, if flimsy, economic expansion. However, it feels like a losing battle trying to convince people that high-value transactions don't always include affluent people participating in shady business. The stubborn contempt for logic and reason is demonstrated by the failure to reinstate the \$1,000 note. Furthermore, even if the idea that high-value notes are associated with illicit funds were to be accepted, the introduction of a note with an even greater denomination in 2016 contradicts logic.

Demonetization facilitated the movement of money from the less wealthy to the wealthy, an outcome not usually possible. This is a factor that is frequently overlooked. The effect was uneven; the weak were disproportionately affected, which resulted in significant losses and even disaster for many. In retrospect, a string of negative events aimed at India's most vulnerable groups began with the demonetization in 2016.

Demonetization has previously been used in countries dealing with hyperinflation. Demonetization has never been approved as an efficient economic policy instrument by any nation that aspires to international significance and certainly not by any nation that claims to be a serious participant.

6-Conclusion

The Reserve Bank of India's decision to withdraw the ₹2000 denomination banknotes marks a significant step within its 'Clean Note Policy'. While the note remains legal tender, its gradual withdrawal through deposit and exchange services until September 30, 2023, signifies a move distinct from the drastic demonetization of 2016. The timing of this decision, just ahead of state and general elections, raises strategic considerations, underlining

the enduring legacy of the 2016 event. The RBI acknowledges the note's initial purpose in swiftly boosting currency circulation post-demonetization, now deeming it no longer necessary. This episode underscores the currency debasement encountered in 2016. The decision's implications on black money, the informal sector, digital transactions, and economic growth highlight the intricate interplay of policy decisions and their cascading effects. The ₹2000 note's brief journey serves as a reminder of the complex dynamics that envelop currency management and its far-reaching consequences on the economy and society.

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