

Why Repeat the Failed Experiment? The Logic & the Economic Cost of the Note Ban

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Abstract

Demonetization is not new in India. Though twice tried earlier and failed, it was of late attempted again for the third time to fight black money, corruption and counterfeit currency. The recent note ban was however unique and unprecedented unlike the previous experiments owing to several factors. One major difference was its devastating impact on the lives of millions of people across our country. The acute liquidity crunch literally brought the informal sector of India to a standstill position. The study tries to understand the logic of using the demonetization exercise again, and analyzes its economic cost in the light of data and evidence available. More so, the study examines the arguments of the advocates of demonetization and draws a realistic conclusion with an alternative proposal. It questions if the government could have avoided this painful exercise and done it differently to achieve the goals it desired.

Keywords: Note Ban, Black Money, Demonetization, Currency Withdrawal, Counterfeit Notes.

Introduction

The abrupt announcement on 8 November 2016 to scrap all 500 and 1000 rupee notes, more than 86% of our currency, at one go with no sign of hyperinflation or currency devaluation, or even a war like situation was quite unprecedented and shocking for millions of people across our nation. The notes on which the majority of our populace

depended on for their daily livelihood got invalid overnight. The mayhem it caused in the country was indeed immense. Though demonetization was twice experimented in the past in 1946 and later in 1978, none of them had caused so much pain to the common man. High value currency notes of 1000, 5000 and 10000 rupees were scrapped in both instances to curb black money and corruption. The history of Reserve Bank of India (RBI) and the media coverage clearly indicated that both the experiments had failed miserably to achieve the desired results (Shankaran, 2016). In fact, Sir Chintaman Deshmukh and Dr.I.G.Patel, the sitting governors of RBI during 1946 and 1978 respectively, were both skeptical of demonetization to control black money in the economy (Shankaran, 2016). Even recently, the report on measures to tackle black money (2012) by a committee of the Central Board of Direct Taxes noted the criticism of the experts on the failure of past demonetization experiments to fulfill its intended objectives. It said that currency ban could not be a solution to tackle black money menace. Less than 15% of the high value notes were only exchanged during the previous note bans and the rest never reached the banks, the report said. Interestingly, the National Institute of Public Finance and Policy (NIPFP) had estimated black money to be Rs.11870 crores in 1975-76 and post demonetization, in 1980-81, its estimation rose to Rs.23678 crores. This again indicated the utter failure of note ban to curb the black money. Unlike the recent note ban, both the earlier experiments had affected the affluent class only as the majority of the people did not have the financial capacity to have the high value

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currencies. Despite the past failures and the visible pain of the common man due to the recent note ban, we would not draw any conclusions straight away. Rather, this study will examine the logic of imposing the same experiment again and analyze its economic cost based on data and evidences available so far.

Research Methodology

This is a theoretical and descriptive type study based on the secondary data extracted from a number of published sources such as the documents and the White Papers of the government, international bodies, and think tanks; the articles and other publications of the economists, scholars, and the experts; as well as the data from both print and electronic media.

The Rationale of Demonetization

A. Preliminary Comments

India is basically a cash-based economy. The 2015 study of PricewaterhouseCoopers reported that 68% and 98% of the total transactions in India by value and volume respectively are done in cash (Jain, 2016). Therefore, the cash crunch created by demonetization, as it wiped out a substantial part of our currency, shattered the entire gamut of economic activities particularly those of the informal sector. The excessively slow supply of the new currency, the non-functional state of the automated teller machines mainly due to the smaller size of the new denominations, caused enormous pain and misery to the ordinary citizens of the country. So much so that more than 100 persons from across the country lost their precious lives. More than 93% of the workforce that worked in the informal sector was unable to receive their meager wages as their employers did not have cash to pay them and thousands among them even lost their jobs. Innumerable small businesses that bought raw materials, sold products, and did all transactions in cash faced heavy loss of revenue and virtually collapsed. Clearly, the lives of lower middle class and the poor became distressing though the upper strata of society did not face much inconvenience due to their easy access to electronic transactions. It became evident that the informal sector that contributed almost half of India's gross domestic product (GDP), along with the people employed therein suffered the most.

Obviously, question arises if the government with all its highly qualified advisors envisaged the

magnitude of the demonetization impact on economy and the lives of common man. Quite likely, the government understood the potential difficulties as it was hinted in the Prime Minister's address to the nation. What was the logic then to take such a risky step? Well, the same old objectives were repeated. The Prime Minister stated that it was to fight against corruption and black money, and the counterfeit currency used by the terrorists. The government probably assumed to confiscate large sums of money that would justify invalidating a substantial part of our currency. The study will examine if demonetization was indeed a logical step keeping its transaction cost in view and if it fulfilled the objectives as desired.

B. Black Money & Counterfeit Currency

No one disagrees on the need to eliminate black money from our economy. The question is if demonetization was able curb the illicit money or destroyed it partly. The World Bank had estimated in 2007 the size of the black economy to be 23.2% of India's GDP. The researchers of NIPFP later estimated the unaccounted GDP (2011-12) to be of 25.4% of Indian economy (Mukherjee & Rao, 2015). So, approximate calculation of 25% of India's nominal GDP of Rs.135 lakh crores (2015-16) is about Rs.34 lakh crores that seemed to be unaccounted. Numerous studies suggest that the unaccounted wealth consisted of real estate, gold, jewellery, part of it sent out of country through illegal channels and laundered in tax free havens and some cash stored clandestinely within the country. The cash component stored in the country is however miniscule, at best about 6% of the total black money (Harriss-White, 2017). Though the exact cash percentage is unknown, there is agreement among the researchers of its small share in the black wealth. Even, a study on behalf of the Ministry of Finance (2012) found that cash is the least preferred medium of storing black money due to its negative rate of return (Rai, 2016). There is no data or evidence so far to suggest that the recent demonetization was able to drastically reduce the expanse of the unaccounted money of this enormous size or at least unearthed a sizeable part of it.

RBI's press release of 13 December 2016 stated it had received back Rs.12.44 lakh crores of the scrapped notes until 10 December. This is more than 80% of the total Rs.15.44 lakh crores of the currency ceased to be legal tender, as reported to Parliament by MoS Finance AR Meghwal. A few weeks later, in January 2017, both the Press Trust of India (Nair, 2017) and Bloomberg (Singh &

Pradhan, 2017) reported that RBI had already received back 97% of the invalidated currency by 30 December 2016. Though these media reports were never confirmed by RBI, the figures did not seem to be unbelievable as 80% of the banned notes had already been returned almost three weeks earlier. Later, the Economics Times reported on 14 January 2017 that “RBI’s Own Figures Indicate Return of 15 Lakh Crore of Banned Notes” and explained the details of its calculation. Evidently, the majority of the scrapped notes had returned back to the banking system. It at once demolished the government’s earlier proposition that a sizeable part of the black money would be smothered out of the banking system through demonetization. It also crushed the hope of the government of a windfall gain which would result from RBI’s reduction of liability on account of non-return of a good number of scrapped notes and eventual transfer of dividends to it. Ironically, while defending the government in a public interest litigation (PIL) against the note ban, the Attorney General had told Supreme Court that the government expected to unearth about Rs.4-5 lakh core of black money in the demonetization exercise (Vyas, 2016). The return of the majority of scrapped notes to the banks however did not signify that there was no black money in the deposits. It simply meant that those who hoarded it were cunning enough either to exchange it, or convert it to other assets, or even to push it into the banking system through others without getting caught. Its clear evidences are the raids and the seizure of substantial amounts of the new currency, the suspension of numerous bank officials, the large

amount of deposits in the Jan Dhan and other no-frill accounts and so on. Though the government claimed that the tax department would investigate all the suspicious deposits, yet it seemed to be extremely difficult due to the voluminous number of the transactions and the limited infrastructure of the investigating agencies. Even if it happened eventually, the demonetization drive in that case would be at best regarded as a one-time tax exercise.

The government in fact cited in its reply, the five year data from 2012-13 to 2015-16, of undisclosed assets search and seizure statistics of the Department of Revenue. The data revealed that the assets confiscated every year ranged from only 5.6% to 7.5% of the total undisclosed income of the corresponding year (Bose & Dasgupta, 2016). The cash component of the seized assets most probably would have been a miniscule percentage. However, no separate evidence was given to the court to show the proportion of seized cash or if there was any increase in cash hoardings over the years. Even if, one assumed that the unaccounted cash would have been a substantial proportion of the undisclosed assets seized, the amount would be at best in the range of a few hundred crores. In fact, the search and seizure statistics of 2006-2012 cited in the White Paper on Black Money (2012) prepared by the Finance Ministry revealed that the amount of annual cash seizures ranged from 3.7% to 7.4% of the corresponding annual undisclosed wealth. The question is how would the government justify scrapping of Rs.15.44 lakh crores to unearth the black cash of only a few hundred crores?

Table 1: Search and Seizure Statistics

Year	Number of Groups Searched	Total Assets Seized (Rs. Crore)	Undisclosed Income Admitted u/s 132(4) of the Income Tax Act (Rs. Crore)	Proportion of Assets Seized to Undisclosed Income (%)
2012-13	422	575.08	10291.61	5.6
2013-14	569	807.84	10791.63	7.5
2014-15	545	761.7	10288.05	7.4
2016-16*	445	712.68	11066.24	6.4

(Taken from the Article of Bose & Dasgupta, 2016) *Provisional Figures

Original Source: Department of Revenue (Cited in Govt. Affidavit to Supreme Court)

Apart from the cash hoardings, the other important aspect to ponder is about the routine generation of black money accomplished through numerous illegal ways viz. corruption, tax evasion, fictitious transactions and assets, manipulation of accounts

etc. To understand if demonetization was effective to curb the process of generation of black money, we are inclined to float a few questions. First, could the simple note ban capture the complex loopholes in our systems that are discreetly used to generate

illicit wealth? Could this experiment seal those loopholes in the system that is constantly abused by the tax evader? Even, the hard core proponents of demonetization would admit that nothing short of comprehensive structural reforms could give a halt to the process of generation of black wealth on a long term basis.

The other objective of demonetization was to eliminate counterfeit currency used by the terrorists. Again, responding in one of the PILs against demonetization, the government affidavit before the Supreme Court cited the 2016 study of Indian Statistical Institute and declared that the value of Fake Indian Currency Notes (FICN) in circulation was about Rs.400 crores approximately

and the amount remained somewhat unchanged for the last few years (Bose & Dasgupta, 2016). Clearly, the amount of fake notes reported is a very miniscule percentage of the huge amount of currency scrapped by the government. It literally meant that the currency invalidation exercise aimed to cancel about two dozen fake ones among a lakh of currency notes. Does not it sound utterly irrational? The following diagram based on RBI annual reports portrayed clearly that there was hardly any growth of fake currency during the last few years. Surely then, demonetization could not be considered as a prudent decision nor could it be the only option to annul a meager volume of counterfeit notes.

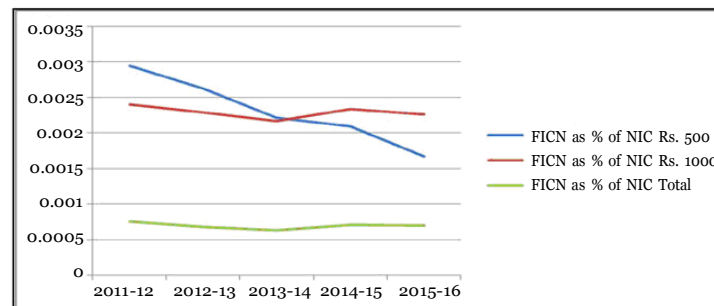


Figure 1: FICN as % of Notes in Circulation (NIC)

(Taken from the Article of Bose & Dasgupta, 2016)

Original Source: RBI Annual Reports

There has been widespread media coverage quoting the intelligence sources that the cash crunch had badly hit the operations of the hawala agents, terrorism related violence and the left-wing extremism. Though the sudden note ban crippled all these nefarious activities that thrived predominantly on dirty money and fake currency, their recommencement is only a matter of time. The criminals would be back in business with the fake version of the new currencies as soon as the masterminds get access to the new technology. In fact, the introduction of Rs.2000 note would make it rather easier for them to store high volume of cash more conveniently.

Findings

A. Growth Projections

Most of the international agencies such as the World Bank, International Monetary Fund (IMF), and the European Union initially welcomed the

demonetization initiative of our government to curb black money and corruption. However, the IMF, World Bank, and the Asian Development Bank (ADB) acknowledged the negative impact of the cash crunch though they claimed that the slowdown of the Indian economy would remain only short-lived. In October 2016, IMF had projected 7.6% GDP growth for India in 2016-17 whereas post demonetization in its dossier on "A Shifting Global Economic Landscape" it cited a lower projections of 6.6% growth for the said year due to sharp decline in business and private consumption. Similarly, both World Bank (Pasricha, 2017) and ADB (Mishra, 2016) lowered their growth projections for Indian economy in 2016-17 to 7% only. The World Bank cited decline of manufacturing, private investment, credit and consumption for cutting down the growth rate. Several other rating agencies also downgraded India's GDP growth rate for 2016-17 as shown in the graph below.

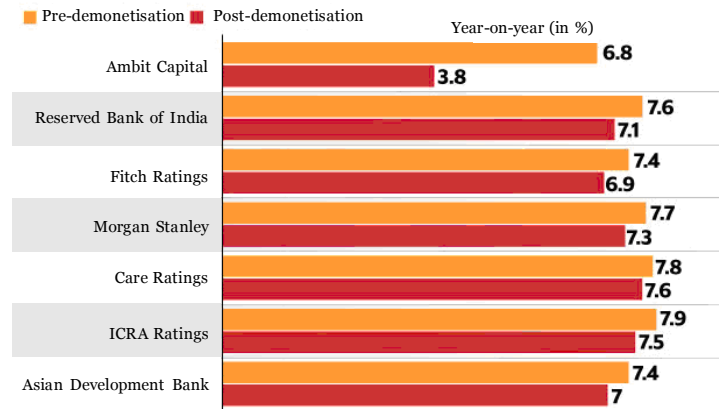


Figure 2: GDP Growth Projections for India in FY 17

(Taken from the article of Mishra, 2016)

Original Source: Live Mint Research

B. Cost & Benefit Analysis

To understand the economic implications of demonetization, it would be necessary to study both its cost and benefits to the nation. The Centre of Monitoring Indian Economy (CMIE), an Indian independent think-tank, studied the demonetization exercise and made a conservative estimation as it claimed, of its transaction cost. It estimated the loss of wages of all those who stood in queue for hours and days to get cash, the cost of printing and transportation of new currencies, the operational overheads of banks for overworking and recalibration of ATMs, the loss of business revenues based on calculation of trade bodies, and quoted the transaction cost of the 50-days demonetization exercise to be a massive 1.28 lakh crore rupees (Vyas, 2016). Mahesh Vyas, the Managing Director of CMIE, said that the study had narrowed down the calculation of the transaction cost to the 50-day period only until 30 December 2016 though the effect of the liquidity crunch, business dislocation and loss of consumer confidence would be felt for a longer period. Further, in a separate study, CMIE stated that the steep fall of automobile sales by about 18% and the statements of numerous FMCG and consumer durable companies on loss of their sales and production cuts amply testified the consumption disruptions in the economy (VyasA, 2017). It stated that since most of the cuts were in non-essential commodities, therefore it might not be easy for the consumption level to return back to normalcy unless liquidity was restored fully; and the consumers regained their confidence by beginning to spend. CMIE projected in another

study the downturn of Indian economy for a longer period, and its GDP to slide to 6% not only in 2016-17 but also to continue to remain so in the next five years (VyasB, 2017). The CMIE projection is actually much lower than those of IMF, World Bank and ADB. CMIE studies reported that the sharp reduction in private final consumption expenditure (PFCE) from 7.5% in 2015-16 to its projected estimation of 5.5% for 2016-17 and its negative impact on investments would slow down the growth of the economy for a longer period.

The advocates of demonetization have however put forth several arguments as its benefits to Indian economy. First, demonetization forced most of the banned currency that included the unaccounted cash, to return to the banking system and this would eventually broaden the tax base, improve government revenues, leading to higher allocation to social programs. Second, the cash crunch and the government incentives for digital payments inspired the people to resort to technology and electronic transactions, and the country has been gradually moving towards a formal economy which would bring about greater transparency, higher tax compliance and GDP growth. Third, the idea of demonetization was to change the mindset of people and it may succeed if followed up with other actions to fight corruption, and to promote financial inclusion (Rogoff, 2016). Fourth, India's cash in circulation (CIC) to GDP ratio is high at 12.25% (Mukherjee, 2016) as compared to many other nations and demonetization would help reduce the ratio which would be conducive for moving towards a developed economy. Though there is no dearth of publications on the benefits of demonetization

though they are less in number compared to those citing its flaws. However, since we looked for neutral and objective arguments and avoided biased and subjective opinions, therefore it became a little difficult for us to find more number of arguments. To be fair, we analyze these benefits argued before reaching to conclusions.

First, demonetization did force all banned notes to return to banking system and the cash-strapped banks got a relief, and even their lending interest rates got reduced. But then, the banks are unsure if the cash would remain in the system for long and if it remained, for how long? Further, the funds lying in many accounts actually do not belong to the account holders, making withdrawal a more likely possibility. Hence, with such uncertainty, the high non-performing assets (NPAs), and tepid appetite for borrowing in the market, banks would not be able to increase their lending significantly regardless of their low interest rates. As regards tax revenues, though extremely difficult, it may be possible for the tax department to penalize certain number of deposits in the time to come. However, with weak capital base of the banks, the decision to park extra funds with RBI or in government securities with low return or pursuing both partially would all depend on a host of factors including government's borrowing capacity for its social schemes and other purposes. By the way, how can the government justify the forceful capitalization of banks by the money of the people particularly the poor who struggled from dawn to dusk to meet his daily needs?

Second, the cash crunch forced the people to adopt digital payment options. As a consequence, the business of digital payment companies got multiplied by several hundred percent overnight which may be good for the economy to some extent. However, the government's vigorous push to use less cash and embrace the digital payments, though laudable, seemed to be premature due to lack of required digital infrastructure, large unbanked population, poverty and illiteracy, lack of training and awareness and many more crucial factors. Interestingly, the RBI data revealed that compared with last December, the number of digital transaction fell in January by almost 15% and continued to fall further in February. So, digital transactions of February were about 25% less than that of December 2016. This indicated that people preferred cash due to various reasons. Low cost, minimum book-keeping, swift realization, compulsion due to meager profit margins, privacy and security concerns were among the main

reasons of using cash. Therefore, to treat all cash dealings as black may be totally erroneous.

Anyway, movement towards less cash or formal economy may not reduce corruption and generation of black money automatically unless it is accompanied by reforms in taxation, cyber security, privacy protection, labour and commodity market, work contracts and other related areas especially of the informal sector. Any premature and forceful action to digitalize everything in a short span of time without preparation, training and robust supporting infrastructure for security and privacy protection of citizens would not only yield insignificant results but also take a toll on the health of our economy. Hasty actions would only make the government more vulnerable resulting in ceaseless amendments, likelihood of failure and loss of credibility.

Third, though demonetization sent a strong message to tax evaders, but the duration of its impact would depend on other supplementary measures to tackle the menace of black money generation and fake currency. Fourth, it is unclear whether low CIC to GDP ratio could really be the mark of a developed economy as there were countries like Japan, Switzerland, and Hong Kong having higher or similar ratios as India and yet scored high on World Bank rankings for ease of doing business and regulatory compliance (Mukherjee, 2016). Further, arguing that India's CIC to GDP ratio is high and then implying its impact to its black economy and corruption may also be fallacious as cash intensive economies are not necessarily corrupt. The clear evidences are again the above three countries with low corruption level as per the 2015 corruption perception index of Transparency International. The size of black economy of these countries is also much smaller than that of India. Conversely, South Africa, Brazil, and Mexico have high corruption despite their low CIC to GDP ratios and the size of their shadow economies is bigger than that of India (Kohli & Ramakumar, 2016). Further, the Deutsche Bank study of 2016 also indicated that high share of cash payments did not necessarily indicate a large shadow economy of a country (Kohli & Ramakumar, 2016).

Conclusion

Over the last few months, the print and electronic media, the newspapers, and magazines have been flooded with data related to demonetization and its impact on the economy. As observed, there are

no two opinions among the experts on the short term negative impact on the economy. The studies are unanimous that note ban caused significant damage to the informal sector which may take sometime to recover. Media is full of stories on the sad plight of small businesses, farmers, daily wagers, and small service providers. However, in the absence of precise data on the informal sector, it would not be appropriate to comment on the magnitude of damage caused to it. The views of the experts vary as regards the duration of the negative impact as well. The implications will be clearer after completion of remonetization exercise within a few months time.

It is rather strange that RBI has not yet disclosed the final amount of the scrapped currency deposited in the banks during demonetization. It has asked for more time to provide the information in response to the query of Public Accounts Committee. However, it is likely that total deposits were close to Rs.15 lakh crores as calculated by the analysts based on RBI's own figures released periodically. If this is the case, then where is the large amount of black cash that was claimed to be smothered out of banking system? Though it is wrong to argue that there was no black cash in these deposits, yet the truth is there is no data so far as to how much black cash was unearthed and wiped out finally. What looks clear however is that the government machinery was either ill prepared or under equipped to detect the wrongdoings swiftly. Whatever is the case, given this experience of unpreparedness, the limited infrastructure of the tax department, and the humongous number of banking transactions, time will only tell us the amount of tax revenue collected finally on the unaccounted wealth. With regard to counterfeit currency, post demonetization a positive scenario emerged and that touched the heart of every Indian. Due to cash crunch, there was a massive downturn in violence and the activities of terrorists and the naxalites. However, as discussed, it is a matter of time for the business these criminals to be as usual.

The argument that demonetization relieved the banks from their difficult cash-strapped position does not hold much ground. As the deposits are involuntary, they may not remain for long in the banks after removal of the withdrawal cap. Further, keeping the cash requirements of the economy in view, it is only logical to assume that a reasonable size of deposits would be withdrawn for use in business and other purposes though no one can predict its scale as of now. Though lending rates

are reduced due to surplus funds, yet no substantial benefits are noticed so far in terms of credit expansion.

The government's push for formalization of the economy should not just mean digital transactions and tax. It has to be accompanied with comprehensive reforms covering all crucial issues for the economy particularly for the huge informal sector. However, to be fair, whatever progress is achieved with regard to formalization of economy, no matter how minuscule, should be considered as plus and the sign of an evolving economy. As regards the argument to lower the CIC to GDP ratio, it may be imprudent to act in this direction hastily without understanding how it would affect our cash dominated economy. Besides, there are other macro economic concerns that are more crucial to look into than the CIC to GDP ratio.

As regards the long term impact of demonetization, though opinion is divided among the experts, there is clearly a tilt towards positive effect but noted mostly with the condition that it was dependent on the introduction of supplementary reforms. Most of the international monetary and rating agencies have made positive comments that the Indian economy would bounce back as a result of the reforms initiated by the government. The IMF, World Bank, and the ADB have projected India's GDP growth rate as 7.2%, 7.6% and 7.8% respectively for the year 2017-18. However, since no bigger economy has undertaken demonetization of this magnitude, therefore long term impact seemed to be largely speculative. The government has already taken certain initiatives for disclosure of black money stashed abroad, voluntary declaration of unaccounted money, curbing of fictitious transactions, and for mutual sharing of banking information with various countries. We are hopeful that the government will undertake other required reforms as discussed to effectively fulfill the same objectives it cited, as the goals of demonetization.

Finally, under the above said backdrop, it is apparent that demonetization did not fulfill any of the objectives assigned to it nor was it logical to undertake the failed experiment again in this indiscreet manner. Even for an honest observer, it would be hard to justify the sudden clampdown. Keeping the pain and the misery of the citizens as well as its massive transaction cost in view, can the government claim assertively that invalidating the colossal amount of Rs.15.44 lakh crore was the only way to destroy the limited black money and the meager volume of counterfeit

currency? Did it justify the cost it entailed on the economy? Clearly, the answer is no. As some economists commented, how justifiable is it to use a sledgehammer to kill the rats in the house or to close down the banks for preventing robberies? So, did the government have other options to achieve the objectives it desired? Yes, the government with well thought-out preparation could phase out the old currencies gradually by providing sufficient time to the citizens somewhat like the discontinuation of 500 Euro bill by the European Central Bank. There was absolutely no need of any secrecy. The government could easily scrutinize the suspicious transactions as it is doing right now. In fact, the additional advantage in this case would be the extra time for the tax department to introduce probably some kind of robust mechanism to detect and scrutinize the transactions. Even, the routine unaccounted wealth search and seizure operations of the department of revenue could have been fine-tuned to do the job. How apt is the statement of Prof. Kenneth Rogoff to cite here that the long-term gain of demonetization depended on its implementation not on government's intentions (Karuturi, 2016). Nevertheless, no action engenders only negative outcomes. It is undeniable that demonetization did create some amount of fear in the minds of black money hoarders and could possibly become a deterrent (Chakraborty, 2016) at least on a short term basis. The biggest contribution of demonetization is the bold message it conveyed to the tax evaders that their business will not remain as usual in the time to come and it is now for the government to expedite comprehensive reforms for effective realization of the objectives it originally desired to accomplish.

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