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**DEMONETISATION IN INDIA AND ITS IMPACT ON NEPAL'S ECONOMY****Abhijit Pathak****Assistant Professor in Economics , Dhruba Chand Halder College ,  
South 24 Parganas, W.B.****ABSTRACT**

*The Government of India withdrew the legal tender status of Rs. 500 and Rs 1000 denominations of banknotes issued by the Reserve Bank of India with effect from the midnight of November 8, 2016. The demonetisation in India has not only impacted India's economic conditions but also has impacted its neighboring country Nepal where Indian currency is in circulation in large amount and also accepted along with the Nepalese currency. Moreover, most of Nepal's trade is with India and through India. It is based on Indian currency. The remittances sent back to Nepal by Nepalese workers working in India are in Indian currency. In most cases, the families of these migrant Nepalese workers depend a lot on these remittances for their living. The Nepal Rastra Bank brought these issues to the notice of the Indian Government soon after the announcement of the demonetisation in India. Efforts of coordination with the Nepalese authorities were attempted at a later stage by the Indian Government to exchange demonetised Rs.500 and Rs.1000 denominated Indian currencies held by Nepalese people. The economic problems accentuated in Nepal as the demonetised Indian currencies were held not only by the people in the urban areas but also by people living in the rural areas of Nepal which were largely unbanked. Against this backdrop, this paper has attempted to find the impact of India's demonetisation measure on Nepal's economy both in the rural and urban areas. The preliminary examination reveals that the unilateral decision by the Government of India to demonetise Rs. 500 and Rs. 1000 denominated currency notes has negatively impacted the economy of Nepal to a large extent.*

**KEY WORD:** *Demonetisation, Currency Stability, Bilateral Trade, Informal Sector.***INTRODUCTION:**

The use of a stable medium of exchange is pivotal for the existence of a market economy where the money accepted and used is fiat money and not backed by any commodity. Lenin once said that the best way to destroy the capitalist system was to debauch the currency because that will destroy the faith in business and asset holdings of the public (White and Schuler, 2009). Stability of a currency is at the core of a capitalist system and that is why many countries have adopted the dollar as their domestic currency and majority of European countries have joined Euro to have a stable medium of exchange even at the cost of their independent monetary and fiscal policy. There are examples of a large number of countries which historically accept the currency of other currencies for settling many of their regular economic transactions. There are even instances for some countries where people regularly travel to another country for their job, earn money in foreign currency and come back in the evening and can use that currency freely in their own country. This happens in small countries, or bordering states of two countries where currencies are freely exchangeable in their labour and goods market. The instability of one major currency in the region therefore has impact not only on its domestic economy but also on bordering countries.

The economic, cultural and religious relations between India and Nepal can be traced from historical times. The free movements of labour, goods and money have been taking place between the two countries from centuries. The trade and business between these two countries are dominated mainly by the Indian rupee as India is a large neighbour of Nepal in terms of both its economic capacity and geographical supremacy. When the Indian Government suddenly announced the withdrawal of Rs. 500 and Rs 1000 denominations of Indian banknotes with effect from mid-night of November 8, 2016, trade, transactions and other financial settlements between the two countries got affected. The rippling effects on the Nepalese economy in the aftermath of the demonetisation in India were expected to be felt as large numbers of Indian currency were held by Nepalese people and establishments. Against this backdrop, this paper attempts to find the impact of demonetisation in India on Nepal's economy both in the rural and urban areas and the initiatives taken by both the governments to mitigate it.

## SECTION II

In this section I shall attempt to examine Nepal as a neighbor of India and its economic relations with India. At the time of announcement of demonetisation, Nepal's \$21 billion economy was suffering with a very poor growth rate of 0.6 percent in the 2015-16 fiscal year on the backdrop of devastating earthquakes in 2015 that killed about 9,000 people. Nepal was expected to recover and rebound in 2016-17.

Nepal is a small country with a population of around 30 million people. As Nepal is land locked from three sides by India, it depends heavily on India for its transportation of goods. It relies heavily on Indian ports, particularly Calcutta port to import various products including petroleum. All these goods are transported to Nepal through Indian roads only. Therefore, for the purpose of settlement of financial transactions, Nepal uses Indian rupee to a great extent. Accordingly, Nepal's Central Bank keeps a high stock of Indian currency in its foreign exchange reserve. The Nepal Rastra Bank (NRB), the Central Bank of Nepal has an arrangement with the Reserve Bank of India for the past few years to transfer Rs. 600 crore to NRB each year in exchange of dollars to ensure adequate supply of Indian currency in Nepal for its financial settlements. In this context it may be remembered that Nepalese Law does not permit the free usage of Indian currency in Nepal. However, anyone acquainted with the Nepalese economy is aware of how commonly the Indian rupee is transacted there at the retail level. In order to ensure a stability of exchange rate of their currency with India, the Nepalese authority is maintaining a pegged exchange rate with the Indian rupee since 1993. The change in exchange rate of Indian rupee with the dollar is accordingly adjusted in the Nepalese currency. Since 1993, 100 Indian rupees are equal to 160 Nepalese rupees in their exchange in official transactions. Therefore, in 2017, on average, \$1 = 67.49 Indian rupees and that equal 107.48 Nepalese rupees.

The economic ties between India and Nepal are historic and have gone through many phases with ups and downs. Almost all macroeconomic indicators in Nepal are influenced by the fiscal and monetary changes in India. Furthermore, the Indian market is a stable employment destination for seasonal Nepali migrant workers. Investment commitment and tourist inflows (recreational as well as religious) have also been the highest from India. The two countries have a trade and transit treaty—although it was respected during the four-and-half-month-long 'unofficial blockade' in 2015.

The data on direction of trade published by NRB periodically clearly indicates that India is the largest trading partner of Nepal for both exports and imports. The data available from Nepal Rastra Bank on its major trading partners reveals that bilateral trade between India and Nepal has grown many folds in the last two decades. Apart from its traditional exports and imports with India, Nepal is totally dependent on Indian ports for all its trade. A bilateral brief (MEA, October 2015) of India and Nepal has indicated that Nepal depends a lot on India for its foreign direct investment. According to that brief, major Indian firms have investments in Nepal. It accounts for about 38.3% of Nepal's total approved foreign direct investments in 2014-15.

Towards improvement of bilateral relations, India permitted travelers to Nepal to carry Rs 500 and Rs 1000 notes with a value limit of Rs 25,000. This new rule was notified a few weeks after Modi announced

this move during his first trip to Nepal in November 2014. This means that India had a responsibility to accept the old high-value notes that it allowed circulating within Nepal.

Against this backdrop, it is clear that a monetary policy shock as large as the current demonetisation measure taken in India is bound to have rippling effects on Nepal's economy. The impact of this policy shock was likely to be transmitted to Nepal through reduction in formal and informal trade flows reflecting uncertainty in settlement of business transactions, decline in small and medium scale business and investments, depletion of savings of unskilled and seasonal workers, reduction of earnings from remittances by Nepalese workers and lower spending by Indian tourists etc. The Nepali citizens who were visiting India during that period of demonetisation for commonplace reasons like pilgrimage and medical treatment or staying in India for studies must have faced enormous problems to exchange their currency when common Indian citizens having a bank account here were finding it difficult to exchange their old 500 and 1000 rupees notes.

### Section III

In this section we are going to analyse how demonetisation affected Nepal's economy in details based on the available information.

As Nepalese people hold a large amount of Indian currency and a sizeable transaction both in urban and rural Nepal is settled in Indian rupees, Nepalese authorities became apprehensive of the impact of demonetisation measures announced in India. The business classes in Nepal remained extremely cautious about the impact of demonetisation on Nepal's economy as most of their trade was with India and through India settled in Indian currency in cash. The data on bilateral trade from NRB indicates that with the growth of the Nepal economy, the volume of trade between these two countries has increased many folds in the last two decades. Total trade transactions between Nepal and India has increased seven times since mid 1990s. But most interestingly, from Nepal's point of view, it succeeded in increasing its export eleven times to India in the same period. The share of Nepal's bilateral trade with India increased from 29.8% in 1995-96 to 66% in 2013-14. This share declined to 61.2% in 2015-16 reflecting the impact of demonetisation; it increased back to 66% again in 2016-17 indicating the easing of situations. The share of Nepal's import to India which was 64% in 2014-15 declined to 62% in 2015-16 reflecting the impact of demonetisation and recovered to 67% in 2016-17. Imports from India by Nepal recorded a decline from Rs. 49,166 crore in 2014-15 to Rs. 47,721 crore in 2015-16 before recovering to Rs.63,367 crore in 2016-17 (NRB, 2017 a). Indian market has remained a stable destination for Nepalese goods and has provided stability to Nepal's export earnings over the years. But unlike import, share of Nepal's export to India which was 66% in 2014-15 declined to 56% in 2015-16 and remained at the same level since then. This indicates a long-term impact of demonetisation on Nepal's economy. The rapid worsening of bilateral trade balance of Nepal with India since 2015-16 is a testimony to the decline in export from Nepal to India in the post demonetisation period.

The people who were settled along the long open border with India and were dependent mostly for works and small businesses with India were the worst sufferers. The fate of a large number of workers from remote villages from Nepal mostly employed in seasonal works were expected to be hit and thereby not only the people in Kathmandu but people from villages of Nepal were also expected to be impacted by the demonetisation in India. Therefore, the fall in remittances received by Nepal was expected. Every household in Nepal and even in rural Nepal was holding some old Indian currency notes of Rs. 500 and Rs. 1000 which was no more a legal tender after the RBI announcement of demonetisation of November 8, 2016 (Rajbhandary, 2016). Nepal had an arrangement with the RBI that against the US dollar, the Nepal Rastra Bank used to take Rs 600 crore from RBI in each fiscal year. This was effectively drawn down to nil after demonetisation causing a lot of inconvenience to get Indian rupee in Nepal. There were media reports of sharp rise in gold smuggling along the India Nepal porous border, which Nepal authorities claimed was a side-effect of Indian demonetisation (Giri, 2016).

Nepalese people hold Indian currency for retail transactions, trade, pilgrimage, health care and other purposes. As there is always a shortage of Indian currency in Nepal, whoever gets Indian currency keeps it

aside for safety and security purposes. Therefore, it was a problem for local people, common people especially labourers who worked in India and visited Nepal during Dussehra and left currency with their families once Rs.500 and Rs. 1000 denominated Indian currency ceased to be a legal tender from the mid-night of 8<sup>th</sup> October 2016 through notification by Government of India. In the absence of a proper exchange of currency notes, people were exploited by mediators. A lack of information has added to concerns among Nepalese citizens, particularly in the southern towns bordering India. Many people were forced to exchange their currency at a high cost and black-marketing in currency exchange became rampant. Traders operating between Nepal and India are also reported to have had challenges, with some transactions coming to a halt amid the cash shortage and uncertainty over the use of old currency notes. Procurement of petroleum from Indian traders became a major challenge given the uncertainty of settlement of transactions through old 500 and 1000 rupees Indian notes.

Nepal Rastra Bank attempted to estimate how much Indian Rs 500 and Rs 1,000 notes were lying in the banking channels of Nepal in November 2016. It found that Indian currency worth Rs 33.6 million in 500 and 1000 rupee notes were stacked in the banking channels of Nepal. There are no official figures or estimation on the number and value of banned Indian notes actually held by Nepalese traders, migrant workers or general public at that time. According to the report published in India Today on December 14, 2016, the Federation of Nepalese Chambers of Commerce and Industry estimated that INR 10 billion (US\$146 million) in defunct notes were held by the informal sector and private individuals. Considering that nominal GDP per capita in Nepal was US \$837, this represents a significant loss of private savings.

Nepal is one of the favourite destinations of the Indian tourists. Around 8 lakhs Indians visit Nepal for the purpose of tourism. The decline in number of tourists during the months of demonetisation adversely affected the tourism industry in Nepal. Demonetisation has obviously resulted in the decline in Indian tourists in Nepal and affected the tourism in Nepal as most of the Indian tourists purchased Nepalese goods and made their required payments in cash with Indian currency. The cash crunch in India affected the demand in major cities of Nepal especially Kathmandu. The reduction in tourists from India negatively affected the handicraft and cottage industries in Nepal along with the small hotels.

Nearly 10 lakh Nepalese were working in India and sending back their remittances regularly to Nepal in high denomination currency. Nepal is heavily dependent on remittances from workers working in India, having received US \$640 million in remittances from India in 2016. Thus demonetisation was expected to lead to a deceleration growth in remittances. The NRB data has clearly indicated that remittances that grew on an average 15 per cent per year during 2012-13 to 2015-16 registered a mere growth of only around 4 per cent in 2016-17. This clearly reflects a genuine loss of income of Nepal from remittances sent by Nepalese workers staying abroad in the fiscal year 2016-17. A quarterly data comparison of remittances of 2016-17 and earlier years vindicate that most of the loss of remittances took place in the period from October 2016 to March 2017 i.e. the period of demonetisation and its immediate aftermath (NRB, 2017b). In this context it may be noted that according to World Bank data on 'Migration and Remittances' (World Bank, 2017), Nepal is one of the small countries which figures in the list of top receivers remittances from abroad. The dependence of Nepal on remittances is crucial and its decline hurts the economy of Nepal to a large extent.

The impact of demonetisation on Nepal was expected by many as short lived while some people believed it would be gradual and persistent. In the first place, from the employment side, India is a popular employment destination for seasonal workers for the busy agricultural season. Survey estimates has indicated that over 41 percent of the total Nepali overseas migrants get employed in India and account for around 20 percent of total remittance inflows to Nepal. Moreover, for the Nepalese migrants, India is preferred to other destinations for its capacity to absorb unskilled migrants in a large amount. India's large and open market, low cost of migration, language and social familiarities, low cost of living has made it a preferred destination for migrant labourers in comparison to the Middle East and many East Asian countries. The poor migrants even come over to India for short-term to medium term work and use the Indian currency earned in Nepal.

Banking penetration in Nepal is poor and the unskilled migrants from remote villages from Nepal in most cases did not have any bank accounts in Nepal and whatever money they earned in India they used to take back home in high denomination Indian currency which was easy to carry there. Moreover, as these workers used to get their daily wages in cash and as their employers were also cash crunched during the period of demonetisation, many of them actually received their payment with much delay or lost their jobs. The remittance income of this group of migrant workers constitutes the major part of the consumption demand in the rural villages of Nepal and thereby supports the local economic activities of interior Nepal. This may reduce the rural demand in the economy resulting in a deceleration in economic growth.

As many agricultural products and merchandise trade of Nepal with India are through informal channels and settled in cash to avoid taxes and other legal hassles, the demonetisation measure became a nightmare to many small and medium scale traders in Nepal. Their business came to a standstill and on many occasions resulted in a huge loss of money. This loss of capital for small and medium traders may have downward pressure on Nepal's economic growth in the short run and generate persistent impact on Nepal's economy in the medium-term.

#### Section IV

This section attempts to examine the initiatives taken by government authorities of both Nepal and India. Immediately after the announcement of demonetisation in India on November 8, 2016, the authorities of Nepal started consultation amongst themselves as 30% of all financial transactions in Nepal are denominated in Indian currency and it has impact on trade, tourism, employment and economic growth of Nepal. The authorities of Nepal contacted the Indian authorities to take up the issue. Accordingly, the Nepal Rastra Bank on November 14, 2016 prohibited exchange of Indian Rs.1000 and Rs.500 notes by banks and financial institutions in Nepal. However, the modalities to exchange the possessed Indian Rs.1000 and Rs.500 notes by Nepalese financial institutions and public was not finalized between the authorities of the two countries. Thus, Nepalese authorities waited for further directions from the RBI in this regard.

The Reserve Bank of India formed a task force on November 17, 2016 (The Financial Express, 2016) to ease currency exchange facility in Nepal for non-Indians who possessed the now-defunct notes of 500 and 1,000 denominations. The RBI informed the Nepalese authorities that it will be possible by the apex bank in India to look into the issues raised by the Nepalese authorities once the liquidity conditions eased in India. It was almost made clear that the RBI will be able to provide fresh notes for exchange only after the period of demonetisation is over in India. Taking into consideration the shortage of Rs. 100 denominated notes in Nepal, RBI announced to provide Rs 1 billion to the NRB on January 7, 2017 (Business Standard, 2017). These notes were shifted to Nepal in January itself to ease the liquidity conditions in Nepal.

After demonetisation in India, the Nepal Rastra Bank had also lowered exchange limit of Indian banknotes in Nepal. NRB was providing an exchange facility of up to Rs 2,000 from the stock of Indian currency from its exchequer. Similarly, it was providing Rs 10,000 to those who submitted a copy of air or train ticket to travel to India and Rs 25,000 for those travelling to India for medical check-up. As per agreement with Nepal, RBI was extending Rs 6 billion exchange facility to Nepal every year (based on Indian fiscal year calendar) but in this fiscal year 2016-17, Nepal is unlikely to get this facility due to the demonetisation move of the Indian Government. NRB had brought only Rs 1.20 billion this year. In the beginning of January 2017, the NRB had around Rs 3.5 billion in its coffers and after bringing another Rs 1 billion, NRB will be able to provide exchange facility for the next eight to nine months. This was the estimate that Indian and Nepalese authorities planned for the smooth exchange of Nepalese currency with Indian currency in the post demonetisation period.

However, the issue of exchange of demonetised Indian currency notes held by the Nepalese is still not over even after 20 months of demonetisation. The latest available information indicates that there are a lot of technical issues that need to be resolved before the exchange of notes with Nepal can actually happen. The central banks of both the countries are still consulting to sort out the issues (TOI, 2018). As demonetisation is a complex issue and a lot of time has already passed since November 2016, the prospect

of exchange of demonetised Indian currency held by Nepal is not so bright. Moreover, it is already mentioned in the Indian media that around 99 per cent of the demonetised currency in India has come back to the banking system. Now, if we add the demonetised Indian currency held in Nepal to that figure, then the total may exceed 100 per cent. This may also have domestic political implications in India.

Nepal is a close neighbor of India and shares a historic relationship of friendship and co-operation with India. The religious and cultural exchanges over the periods have made the relations deep-rooted. Historically, the border between these two countries has remained open and free movements of people are accepted mutually. According to the Indo-Nepal Treaty of Peace and Friendship of 1950 Nepalese citizens enjoy facilities and opportunities at par with Indian citizens. Nepal faced devastating earthquakes of magnitude 7.8 on 25 April 2015 and its aftershock of 7.4 magnitudes on 12 May 2015. India immediately extended its support to its neighbor by dispatching its National Disaster Response Force (NDRF) teams and relief materials to Nepal. The total Indian relief assistance to Nepal amounted to US\$ 67 million approximately.

But given the emerging importance of Maoists in Nepal politics and its ideological and political affinity towards China, the relation with this small country has become all the more important. Certain political lobbies within Nepal are involved in anti-India propaganda which India will have to deal with more delicately and diplomatically. Nepal is economically dependent on India and any economic policy taken by the Indian Government whether monetary policy or fiscal policy has its impact on Nepal's economy. It is true that India will have to make its macroeconomic policies based on its own economic necessities and compulsions but at the same time it will have to take into consideration its ramifications on its neighbours as far as possible. After the announcement of demonetisation on November 8, 2016 initiatives could have been taken by the Government of India at political, diplomatic and institutional levels to mitigate the expected monetary and exchange problems in Nepal as Indian currency is widely used in Nepal. India should deal with the issue more sensitively by taking a few proactive measures.

## CONCLUSION

The demonetisation initiatives taken by the Government of India with its domestic objectives have cross border implications for its neighbouring country Nepal. The impact on Nepal was through direct and indirect channels. The direct channel is like problems of exchange of Indian currency by Nepalese financial institutions, informal sectors and people of both rural and urban areas and problems of wholesale and retail trade with India. The indirect effects were impact on Nepal's tourism, employment of unskilled migrant labourers in India from Nepal and their remittances, small scale investments on agro and manufacturing units of Nepal and problems faced by Nepalese students and patients in India. The possibility of a wealth loss by remote rural Nepalese people, even not having a bank account who were holding old Indian currency of Rs. 500 and Rs. 1000 earned by their migrant family members working in India cannot be ignored and this may have damaged the demand generation in the rural economy of Nepal. Though steps were taken by the authorities of both the Governments to mitigate the crisis but given the importance of the diplomatic relations with Nepal, India should have handled the issue more carefully and by taking a few proactive measures in coordination with the Nepalese authorities.

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**Abhijit Pathak**

Assistant Professor in Economics , Dhruba Chand Halder College , South 24 Parganas , W.B.