A Critical Review of the Impact of Demonetization on Kenyan Economy

Article by Sahil Abrol[1], Ratemo Nyaribo Zacharia[2]
Texila American University
E-mail: abrol.sahil10@yahoo.co.in

Abstract

The study is a critical review of the impact of demonetization on Kenyan economy. The main comparisons are based on Indian economy. Theoretical literature has endeavored to define demonetization and its dimensions. Empirical literature has mainly documented the impact of demonetization in Indian economy. The study had three objectives namely: Establishing the meaning and reasons for demonetization, determining sector-wise impact of demonetization and establishing positive and negative effects of demonetization in Kenya. Research methodology was a descriptive study using secondary data. Findings indicate that demonetization in Kenya largely entailed replacement of Kes1000 note with a new one with enhanced security features, retaining of all the other old currencies and introducing other new currency notes with enhanced physical and security features as provided for by the Constitution of Kenya, 2010. Apart from fulfillment of a constitutional requirement, demonetization project in Kenya also aimed at curbing black money and corruption in the economy. Secondly, the findings indicate that demonetization project in Kenya has mainly targeted the real estate and property sector, retailing sector, banking sector and digital payment platforms. Thirdly, findings indicate that the short term impact of demonetization in Kenya is on personal finance, black money and terrorism while the long term impacts are likely to be felt in tax filing and collections, growth in GDP and expansion of MSMEs.

Keywords: *Demonetization, Impact, Kenya*

Introduction

On 1st June, 2019 during Madaraka Day Celebrations at Narok Stadium of Narok County in Kenya, the Governor of Central Bank of Kenya (CBK), Dr. Patrick Njoroge, made an announcement that the old Sh1000-note will be withdrawn from circulation effective October 1st 2019. However, the other denomination notes will continue to circulate alongside the new ones. The new notes were unveiled at the same event. There were criticism and support in equal measure. Criticism emanated from armchair academicians and politicians. Warm reception was exhibited by the business community led by Kenya Association of Manufacturers (KAM) and Kenya Private Sector Alliance (KEPSA) who lauded the move arguing that it would stamp out corruption and eliminate illicit financial inflows into the Kenyan economy. Indeed, according to a new report released by a high level panel on illicit flows commissioned by the Economic Commission for Africa Conference of African Ministers of Finance, Planning and Economic Development, Kenya lost more than Sh160 billion in illicit finance flows in eight years to 2011. Nigeria, Democratic Republic of the Congo (DRC), Algeria and Mozambique are the other African countries that have been losing billions of shillings to undeclared taxes, criminal activities and corruption. However, this is the very first attempt to demonetize in Kenya and therefore there is no empirical evidence on the impact of demonetization on Kenyan economy. This creates an urgent need for a critical review of the demonetization project in anticipation of the aftermath. Therefore, this research project will seek to address a research problem as framed in the following research topic: A Critical Review of the Impact of Demonetization Project on Kenyan Economy.

There are similarities and differences between India and Kenya's demonetization efforts. There exists empirical evidence on the impact of demonetization on Indian Economy and other African countries (Ghana, Nigeria, DRC, Algeria and Mozambique). However, there is no scientific research that has been carried out on the Kenyan case. This urgently warrants a critical review of the impact of demonetization project on Kenyan Economy with the following specific objectives

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1. To describe meaning and reasons of demonetization project in Kenya
2. To determine the sector-wise impact of demonetization project in Kenya
3. To establish the positive and negative impacts of demonetization project in Kenya

Literature review

Existing theoretical literature holds that demonetization leads to cash shortages in the country which proves detrimental to a number of small business, agriculture and transportation. The shortage of cash leads to chaos as most people face problems to exchange their banknotes due to long queues outside banks and Automated Teller Machines (ATMs) across the affected country. On the other hand, currency ban has been defined as a move to stop counterfeit bank notes, which were allegedly used for terror financing, as well as a surgical strike from finding their way to black money market and in the hands of corrupt individuals and corporate bodies in the country. Therefore, demonetization that leads to currency ban has proved to be the biggest attack on black money and corruption as well as a reliable move toward digitalization of payments. Existing evidence indicates that demonetization is advantageous in currency ban, attack on black money market, curbing corruption as well as enhancement of digital payments in the short, medium and long-term (Shanbhogue, Kumar, Bhat, & Shettigar, 2016).

Muthulakshmi (2017) holds the view that when money is withdrawn from the economy, the affected country will not benefit in short term but when the money paves its way into the economy it would have a positive and meaningful impact. This view supports the contention that demonetization project, on one hand, is a serious attack on black money, corruption, hawala transaction, counterfeit currency and terror financing but on the other hand, it has a negative impact on various sectors like commodities and real estate. Shah (2017) states that demonetization is one of the major steps in fighting against corruption, black money and terror funding. However, sudden announcement of demonetization and failing to plan properly creates chaos among the general public and adversely impacts the public when common people face problems buying with no money in their hands and in wasting their time standing in endless queues. In the case of India where 86% of the currency notes were withdrawn with an intention to rid the country of black money and dig out tax defaulters and black money holders, the government could have easily avoided thrashing all market transactions with advance planning. Sudden announcement of demonetization of some denominations of currency by the government is usually a big shock to the citizens but where the highest currency notes are withdrawn from the economy, it is an effective way of countering the problem of tax evasion, counterfeit currency and financing of terror activities. Nonetheless, demonetization is not a sure safeguard against huge money, more than specified limits, being deposited into the bank accounts unless penalties and punitive taxes are introduced. Indeed, usage of e-wallets, debit and credit card usually increases tremendously to circumvent the brick and mortar deposits thus circumventing the intended safeguards. Suffice to say that demonetization actually leads to creation of a better cashless infrastructure (Veerakumar, 2017).

Abhani (2017) posits that enlisting the support of bank employees, business men and other citizens is one sure way of ensuring that demonetization project will be successful. In the modern era where people are using online banking as a mode of payment, it is important for bank employees to give their best if demonetization is to be successful. In addition, demonetization may not grab all monies in black money economy, but it should at least create fear in the minds of people who are fond of holding black money. This contention emphasizes the importance of public support if demonetization is to tackle the problem of black money, terrorism and corruption in an economy. Shukla & Gupta (2018) hold the view that the people actively support any initiatives taken by the government especially if targeted at eradicating corruption, black money, and any other threats like terrorism and naxalism in the country.

The CBK holds that the reason for the demonetization project in Kenya is to counter the rising cases of illicit financial transactions and the emerging counterfeit notes. There have been reports of odd transactions in the banking sector which have raised concern among Kenyans and therefore CBK had to act quickly to stop the illegal transactions. The Governor of CBK, Dr. Patrick Njoroge is quoted as saying

"You don't wait until the house is already burning before you use the fire extinguisher. When you smell smoke, grab the extinguisher and begin to deal with it,"

Additionally, the Kenyan Shilling is widely used in the East African Community (EAC) region and beyond. Therefore, Kenya's financial regulator took the arduous task of demonetization to ensure the currency is not tainted by the illegal transactions and counterfeits. CBK must have borrowed important lessons from India on the demonetization process. First, CBK announced withdrawal of ne denomination of Ksh 1000 note and also gave four months for people to exchange the Ksh1000 notes. This was in a bid to avoid the Indian scenario of 2016 where long queues and a decline in economic growth were witnessed after abrupt withdrawal of the 500 and 1,000 banknotes from circulation (CBK, 2019).

Nonetheless, other players in the Economy hold a contrary view to CBK in regard to the impact of currency withdrawal in the fight against corruption. Reginald Kadzutu, the Chief Investment Officer of Nairobi based Fund manager at Amana Capital is quoted as saying

"We might see an increase in the velocity of money as corruption money can't just be taken to the bank they will have to spend it, that would lead to demand induced inflation. Increase in velocity will mean an oversupply of Shilling in the market so it will add downward pressure on the Kenyan currency"

Two petitions were filed in court challenging the new generation currency. The petitioners were arguing that there was no public participation in the process and that the inclusion of the image of Jomo Kenyatta (First President of the Republic of Kenya) on the new currency notes violates Kenya Constitution, 2010. However, CBK has dismissed the challenge saying due process was followed in the design and printing of the same. People who want to exchange amounts between Sh 1million and Sh 5million are expected to go to their own commercial banks. Those who do not have bank accounts and want to exchange this amount will need to contact the CBK for endorsement and referral to a designated bank branch. People who want to exchange amounts above Sh 5 million will have to contact the CBK. At the end of the exercise on midnight of 30th September 2019; CBK targets to demonetize 217.6 million pieces of the KSh1,000 old series note. This means the notes will cease being legal tender on the 1st of October 2019 and Kenya demonetization project would have mopped up KSh 217 Billion in circulation (Mbatau, 2019).

Table 2.1 below shows the denomination, pieces in circulation and the total value of legal tender in Kenya

Table 2.1 Currency circulating in Kenyan economy

Denomination	Pieces in Circulation (millions)	Value (millions)
1000	217.6	217,600.00
500	30.8	15,400.00
200	54.8	10,960.00
100	126.4	12,640.00
50	100.5	5,025.00
20	9.9	198.00
Total	**540**	**261,823.00**

Source. CBK (2019)

CBK (2019) has enumerated four Challenges in Implementation of the demonetization project in Kenya: First is legality of the new notes: The legality of adoption of the new generation bank notes by the CBK has already been thrown to doubt with two petitions already launched at the High Court based on the protocol followed to adopt the policy and usage of the image of Kenya's first President in the note, against the constitution. Second, is the long transition period likely to erode objective of curbing illicit financial flows: The long grace period provided by the regulator to convert the old Kshs 1,000 bank notes to the new currency is likely to erode the intended objectives of the demonetization policy especially in regard to curbing illicit financial flows. CBK expects that perpetrators of illicit transactions will have enough time to integrate their monies into the financial system.

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Third, is the cost to the tax payer and banks: The currency demonetization move will force banking institutions to incur costs associated with replacing of old bank notes such as the recalibration of Automatic Teller Machines (ATMs). The taxpayer is also expected to incur the cost of printing the new notes and fourthly, is the risk of counterfeiting of new notes: Many Kenyans remain largely uneducated on the new notes and failure of the CBK to conduct comprehensive and intensive public awareness of the demonetization move, due to budgetary constraints, is likely to open an avenue for the introduction of counterfeit new currency.

In the case of India, demonetization was aimed at finding a solution to black money market economy and fake notes for the betterment of the country. The government of India did an abrupt demonetization project targeting two highest denominations so as to catch tax evaders and corrupt individuals off their feet. On the contrary, Kenya has chosen to embark on a four months' demonetization exercise targeting only one highest denomination but with similar main objectives of eradicating corruption and fake currency. Existing empirical evidence on three African countries (Ghana, Nigeria and DRC) demonstrate that demonetization alone cannot be expected to achieve the desired objectives as other players in the economy; particularly the law enforcement agencies and the judiciary would need to do their part. So far, in Kenya, there is a mixed reception of the demonetization project. Empirical evidence on the Indian demonetization project attempted to understand meaning and reasons of demonetization, the sector-wise impact of demonetization and the positive and negative impact of demonetization on Indian economy. Findings of the study established the key reasons for demonetization to be management of the black money economy and eradication of fake currency. The main sectors of the economy that were impacted include real estate and property, and gems and jewellery sectors. The positive impact was elimination of black money and improved economy of India. The main negative impacts were liquidity crisis and loss of well-being. The Indian case study was descriptive in nature such that all the required and relevant data was taken up from various journals, magazines for published papers and websites while text books were also referred to for theoretical information as required (Kushwaha, Kumar & Abbas, 2017). So far, no similar research has been carried out for the Kenyan case. This study will seek to fill the identified research gap by replicating the research objectives and research methodology of the Indian Economy on the Kenyan Economy in furtherance of existing knowledge.

Research methodology

This study is of descriptive nature and tells about the meaning and reasons of demonetization along with the sector-wise impact of demonetization and positive and negative impacts of demonetization on Kenyan economy. Therefore, the study area and study population will be Kenyan economy. The study will be carried out for a period of four months starting 1st June, 2019 and ending 30th September, 2019. The study will make use of secondary data from Research Papers, Journals, & Publications, websites and Text Books for theoretical information on the topic as required. The main sources of data will be Journals. The entire study will be based only on observation and documentary analysis. Findings will be presented mainly in prose and tables where applicable.

Observations and findings

In Kenya it has been observed that CBK Governor Dr. Patrick Njoroge announced a 4-month long notice to withdraw Kenya's Sh1,000 bank note and to replace it with a new generation one. Kenyans were given up to October 1st 2019, to trade in old notes for new, after which the old will cease to be legal tender. The unveiling of new generation currency notes on May 31, 2019 marked major milestones in Kenya's banking sector and the wider economy. First, it marked a fundamental fulfillment of Article 231 sections (2) and (4) of the Constitution of Kenya 2010. Besides, the features of the new notes also enhance inclusivity as majority of persons, including the visually impaired can knowingly transact. Second, the new currencies embody enhanced security features which can effectively deter if not minimize illicit financial transactions in counterfeits and laundering. Thirdly, and equally important was the move to purge "black money" from mainstream economy or demonetization of the Kenya shilling. According to the Central Bank of Kenya, the Sh1, 000 notes, which is the largest currency bill, are widely being used for illicit financial transactions and forgery in domestic market and the neighboring countries of South Sudan, Uganda, Tanzania, Rwanda and Burundi. The last two motives are ostensibly geared towards curtailing further expansion of the underground or parallel economy in Kenya and by extension the East African Community (EAC).

Kushwaha et al (2017) established that the reasons for domonetisation in India included to curb black money, to hit fake currency rackets, to encourage the cashless(digital) economy, to hit maoists (hoarders of currency) and to grow the long term Gross Domestic Product (GDP). Therefore, in Kenya, the demonetization project was not only a constitutional requirement but a means to curbing black money, fake currency rackets and hitting at maoists. Unlike India, Kenya did not use the demonetization project for the purpose of encouraging cashless economy and grow the long term GDP though these outcomes may emanate after as a natural consequence of the other objectives more especially after the demonetization deadline of 30th September, 2019.

Sector wise impact of demonetization in Kenya can be grouped into two main categories: Immediate effects and long term effects. The immediate effects include limited effect on liquidity of money markets: Given the ample time provided by the CBK to exchange old notes with the new generation notes, demonetization move in Kenya has little or no effect on market liquidity based on the following reasons: The long transition period (approximately 4 months) grants market players enough time to restock their capital balances, The phased issuance of new generation notes by first demonetizing the Kshs 1,000 bank notes, and the indefinite timelines to phase out bank notes of other denominations will give market players room to adjust to the new currency with minimal disruption to the markets, and, the large population of banked Kenyans, estimated at 75.0% of the bankable population as per the Global Findex Report 2017, portrays a high rate of financial penetration and therefore many people have access to the formal financial sector.

The second short term effect is on illegal financial activities: Demonetization policies, if carried out within short timelines, are likely to greatly aid in curbing financial flows in the black market. However, a demonetization policy that gives a long transition period, as in Kenya’s case, is likely to have little or no effect on the black market since the market has time to conform to the new currency. Measures that black market players and perpetrators of corruption are using to circumvent the demonetization policy include: Use of multiple depositors through mobile money and banking agents, purchase of valuable commodities such as precious metals and gems in the highly unregulated market and conversion of cash held in Kshs 1,000 notes into the lesser notes given failure of the CBK to give timelines for demonetization of the other denominations.

The third short term effect is on Small and Medium Business Enterprises (SMEs): SMEs in developing countries are heavily reliant on cash transactions, and sudden currency demonetization has been shown to have severe effects on the sector. Case in point is in India where SMEs faced cash shortages resulting in employee layoffs and business closures. The move to demonetize the Kenyan currency is likely to force many SMEs to adopt digital infrastructure for cashless transactions to avert the danger of cash-shortages that would be brought about by such policies in the future. This would not only result in a more resilient SME sector but contribute to the growth of these firms as a result of implementation of enhanced financial management systems.

Long-term effects of demonetization in Kenya have been observed to include financial deepening and inclusivity: Demonetization policies force the population to deposit old currency with banking institutions, consequently resulting in enhanced financial inclusion especially in rural areas like in India, where up to 1.9 million new bank accounts were opened in the period after the announcement of demonetization. Noting the high rate of financial inclusivity in Kenya, the move by the CBK is expected to prompt a slight growth in total accounts. The second-long term effect is on monetary control and financial stability: Demonetization of the currency is expected to lead to more consumer spending as holders of money look to put it back into circulation. Increased consumer spending would likely result in higher inflation levels in the country. However, we do not expect a depreciation of the currency owing to the efficiency of the Monetary Policy Committee to regulate the highly formalized market.

Kushwaha et al (2017) established that in India, real estate and property sector was the most affected by the note ban due to high involvement of cash component in payment in the sector. Other sectors affected in India were gems and jewellery where reduced demand was witnessed, banks sector

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where both lending and deposit rates were cut by banks, media and entertainment industry suffered reduced number of viewers and reduction in film production, hospitality and tourism industry also suffered reduction in number of luxurious foreign trips, reduced local tourism and a cut in revenues of restaurants. Other sectors that were adversely affected include automobile, retail, agriculture and labour-intensive sectors like mining, textile and leather industries. However, similar cases have hardly been reported in Kenya most likely due to the short duration of the demonetization exercise (4 months) and the fact that only the Kes1000 note was targeted for demonetization. Nonetheless, the aftermath and long term effects of the demonetization project will be reported clearly long after the expiry of the deadline on 30 September, 2019.

Previous studies on impact of demonetization on economies have indicated that demonetization is a double edged sword: It has both positive and negative effects. The major difference on the impact of demonetization is brought by the timing, implementation and scale of the demonetization exercise. For instance, in the case of Kenya and India the former introduced demonetization after weeks of preparation and public knowledge while the later did it as a surprise. Secondly, Kenya implemented the demonetization as not only a tool for fighting black money and corruption but also as a constitutional requirement to change the pictorials on the legal tender notes. Thirdly, India withdrew two large denominations (1000 and 500 currency notes) across the country while Kenya only withdrew the 1000 currency note.

Discussion, conclusion and recommendations

Findings from the Indian case indicate that the positive impact of demonetization included: Curbing of black money where huge deposits were collected into the banks with heavy penalty or simply destroyed. Secondly, the demonetization project increased the GDP of India due to increased borrowings from the treasury and improved inflation outlook. Thirdly, demonetization reduced the flow of unaccounted money into real estate sector and resulted in the reduction in the prices of land and property. Fourthly, the sudden withdrawal of black money economy was a surgical strike to hawala operations which effectively curtailed money laundering, maoism in states like Andhra Pradesh Odisha, Telangana and Chhattisgarh, terror funding and Kashmir violence. Fifthly, the banning of old currency of Rs500 and Rs1000 notes and replacing them with new ones with highly advanced security features, completely sucked the circulation of fake currency. Nonetheless, demonetization in India had a few negative effects: Firstly, demonetization gave rise to liquidity problem as people found it difficult to get sufficient amount of cash to fulfil their basic needs. Secondly, the cash crunch made labour intensive firms to cut their labour costs and thus reduced the income of the lower middle class. Thirdly, cash shortage severely affected the consumption behaviour of the people in India thus reduced volume of trade among retailers. Lastly, the black money in form of land, gold and buildings was untouched by the demonetization project (Kushwaha et al, 2017). In Kenya, short term impact of demonetization has been felt in personal finance, black money economy and terror funding. Firstly, savings accounts of individuals have received huge deposits thus leading to increased commercial banks' balances. The increased deposits are associated with awakening among mattress savers who have been compelled to deposit their savings in mainstream commercial banks and digital money channels. Secondly, the reduced cases of terrorism during the 4-month period of demonetization sends a signal that black money economy suffered a big blow and therefore leads to a conclusion that demonetization project has contributed positively to curbing of terrorism. The long term effects of demonetization project in Kenya have not been documented but experts postulate that positive effects will include increased tax payments, growth in GDP and expansion of MSMEs (Mbatau, 2019; CBK, 2019).

In India, currency demonetization was aimed at curbing illicit activities especially operations of the black market as well as enhancement of financial inclusion. However, recent studies in India have failed to prove the effectiveness of these policy moves to curb illicit financial flows. Sudden implementation of demonetization policy in India led to market illiquidity, traders freezing sale of commodities due to uncertainty, and general investor panic in the short term. However, in the long term the policies led to more enhanced financial inclusion and higher economic growth. In the case of Kenya, it has been established that the long grace period granted by the CBK to withdraw the old

Kshs 1,000 bank notes as legal tender, and the indefinite timelines to demonetize other denominations of bank notes, is likely to erode the effectiveness of the policy in tackling illicit financial flows, as intended by the regulator. However, in the long term, it is expected that the demonetization policy will have a positive impact on economic growth due to enhanced financial inclusion of the informal sector, transition to a more cash-less economy, enhanced revenue collection by the government, increased savings by the population in formal institutions and reduced lending rates.

The study generates two-fold recommendations: Recommendations to policy makers and recommendations to practitioners, academia and research institutions for further studies. Firstly, there is need for the regulator, Central Bank of Kenya, to hold firm on the deadline of 30th September, 2019 for withdrawal of old currency of Kes1000 note if the short term and long term impact of the demonetization project are to be sustained in Kenya. Any extension of the deadline will most likely thwart the short term positive effects and compound the short term negative effects. In addition, extension of the deadline might jeopardize the envisioned positive long term effects. Secondly, the academia, practitioners and research institutions need to invest in research on best international practices of demonetization so as to inform future policy makers and regulators on how to maximize benefits and mitigate negative effects of demonetization in an economy.

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