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Demonetisation in India and its Effect in Nepal

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Abstract

Demonetisation of Indian Currency of Rs 500 and Rs 1000 notes was taken as an important tool to fight against crime, tax evasion, corruption and other activities held in underground economy in India. Demonetisation in India directly affected the Nepali economy as India is the largest trading partner with common cultural relationship and open-border. The objective of the study was to examine the effect of recent demonetisation (November. 8, 2016) of India to Nepal. The study used the systematic review to find the effect of Indian demonetisation to the Nepali economy. The study found that it has paved the way for digital payments and supported the process of financial inclusion. The overall transformation in the economy translates into long-term benefit for the industry in India. But, the informal firms faced the liquidity crunch to pay their suppliers and workers without the standard access to cash in India. However, business sector and general people of Nepal are hard hit by the demonetisation because India is not making adjustments to take back demonetised IRs 500 and IRs 1000 notes estimated to be over Rs. 100 million, more than it the Indian policy departure has direct effect in Nepal. The demonetisation policy has created negative effect in Nepal to the greater extent from migrant labours to big business houses.

Keywords: Black money, underground economy, shadow economy, liquidity, currency

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Introduction

Demonetisation is the process of banding a currency unit of its status as a legal tender. It is a monetary step where a currency unit taken as a legal tender is declared invalid. If a current form of money is pulled from circulation and retired, often to be replaced with new notes it is known as demonetisation. Demonetisation is a sudden withdrawal of one particular form of currency from circulation. It can be defined as the completely replacement of old currency with new currency. Demonetisation is taken as an important tool to fight against crime, tax evasion, corruption and other activities held in underground economy. Nepal has not been deployed this important economic tool for its development, but used by its neighbouring country, India. The great Indian demonetization of 2016 (Lahiri, 2020) has been burdening to Nepal.

Since the Second World War, demonetisation has been implemented three times in India, for reducing corruption and converting black money into white money in India. The first and second demonetisation was held in Jan. 12, 1946 and Jan. 16, 1978 respectively. The third and latest demonetisation was announced in Nov. 8, 2016 by the Modi Government (Dash, 2017). The Prime Minister of India; Narendra Modi announced demonetisation of Rs 500 and Rs 1000 currency bills and the cash holders of demonetized currency were given till 31 December, 2016 to exchange their demonetised bills for newly issued currency of Rs 500 and Rs 2000 notes. There were mainly two ways for converting demonetised currency like changed the old currency for new currency with daily limits and deposited the cash in their bank accounts.

Nepal is landlocked as well as India locked as it is bounded on three sides by India. There is open-border between these two countries and every factor of production like labor-force, capital, technology, goods, services etc. are moving freely from one country to another and there is no visa system. Due to the unregulated flow of people between the two countries, large numbers of Nepali workers are working in India. India is the largest trade partner of Nepal. There is huge volume of accounted as well as unaccounted trade between these two countries. In this context, any one economic event held in India affects the economic activities of Nepal. Therefore, the effort of demonetization in India directly affects the economic activities of Nepal as Nepalese people are commonly using Indian currency without any hesitation. However, the absent of required amicable behavior of Modi government in exchange of the demonetized Indian currency of Rs 500 and Rs 1000 has been burdening to Nepal.

The government of India took the bold decision of demonetization of all Rs 500 and Rs 1000 bank notes in 8 Nov. 2016 and with the sudden decision of the government, 86 percent of all the currency circulation becomes just a piece of paper. This step was taken to control the black money and parallel economy. Initially demonetization created some positive and negative impacts on the Indian economy. In fact, this step was not success for controlling black money as more than 99 percent currency of Rs 500 and Rs 1000 returned back to the banking system and exchanged with newly issued currency of Rs 500 and Rs 2000. Due to

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open boarder and free flow of all factors between India and Nepal, the step of demonetization taken by India also affects the Nepalese economy. The interesting and important part of this step for Nepal is that the Indian government was not ready to exchange the Indian currency notes of Rs 500 and Rs 1000 hold legally by Central Bank of Nepal i.e., Nepal Rastra Bank (NRB). According to the NRB, Nepal still has Rs.33.6 million Indian legal currencies. At the same time, there is the possibility of large amount of Indian currency of Rs 500 and Rs 1000 with individuals and informal sectors (The Kathmandu Post, 2018). The holding of Indian currency of Rs 500 and Rs 1000 is completely loss for Nepalese economy and it created negative economic as well as political and cultural impact to the Nepalese economy.

The demonetization of India directly affected the Nepalese economy as India is the largest trading partner with common cultural relationship and open border. There is frequent use of Indian currency in Nepal without any restriction. As a result, Nepalese economy was negatively affected by demonetization in India and its behavior after demonetization in 2016. The government of India is not ready to exchange the legal Indian currency that are even kept for maintaining foreign exchange reserve by NRB up to now. There is the possibility of large amount of demonetized Indian currency with business men, households and common citizens basically in the border area. In this context, it is necessary to analyze the effect of demonetization of Indian currency of Rs 500 and Rs 1000 in Nepal.

This study explored the causes and consequences of the 2016's demonetization policy of Indian government in Indian economy as the source of lesson learn for Nepalese economy. The specific objective of the study was to examine the effect of recent demonetization of India in Nepal.

Literature Review

A literature review is a scholarly paper, which provides an overview of current knowledge about a topic. It will typically include substantive findings, as well as theoretical and methodological contributions to a particular topic (Hart 2018). This study explored the previous studies about the demonetization and impacts in the local as well as global economy. Nerkar (2016) concluded that demonetization has positive and negative impact on Indian economy. The followings are the advantages and disadvantages of demonetization found by Nerkar (1016).

Similarly, Uke (2017) used secondary data and analyzed that either the note ban decision actually eradicate the black money or not. He concluded that India was success to some extent. The financial system of India became strong. However, it also created many problems for the citizens of India like queue problem in ATM and banks, decreased the consumption with liquidity problem. Further, Kose et al. (2017) has presented "Spillovers from India to Nepal and Bhutan, through trade and remittances channels, could negatively impact growth in India's neighborhood".

Potnuru (2017) concluded that the supporter of demonetization quickly articulated this as a big-bang step to convert black money to white money. However, the opposition has

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criticized it as an organized loot. He analyzed that the political parties which are in power were positively affected and the opposition political parties were negatively affected. Similarly, this paper also concluded from the review of literatures that demonetization has separate effects on political leaders. The leaders who were supported by cash money from informal sectors were negatively affected and vice-versa.

In addition, Sabitha (2019) used the descriptive research methodology with secondary data for analyzing the impact of demonetization in India. This paper highlighted the impact of demonetization like non-availability of cash, negative impact on rural people and daily wage workers. Similarly, there was decrease in demand and supply goods and consumption due to lack of cash money. He analyzed the various positive and negative impact of demonetization on various sectors. According to Chanda and Cook (2019) most of the black money of India has been invested in real estate, gold, invest in abroad, and deposit in Swiss bank. Thereafter, they have studied the medium-term effects of demonetization policy of 2016 in India. They used night-light data and found that districts which experienced higher deposit growth during the demonetization period, recorded higher levels of economic activity in the year and a half that followed. They found large regional variations in deposit growth as a result of demonetization. Furthermore, they have estimated that a one standard deviation increase in deposits is associated with a 5% increase in district GDP per capita.

Lahira (2020) analyzed the reasons behind the demonetization in India using time series data of tax and GDP ratio in India before and after demonetization and number of tax payers before and after the demonetization as:

The first reason is to grab the wealth of an economy that was not accumulated in national income. The second reason is to eliminate the scourge of counterfeit currency that was circulated in the economy. Another reason for demonetization was to push India towards a modern digitized and cash less economy. Similarly, another important reason was to force the people to convert their old cash into new currency through the banking system. This objective was almost fulfilled as more than 99 percent of demonetized currency had been returned to the central bank through the commercial banks. Moreover, there was decreased in unemployment. However, there was reduction of output and employment after demonetization. The step of demonetization was failed on the basis of cost benefit analysis for public. It was unable to control the black money and parallel economy. The Diplomat (August 28, 2019) explored as:

Nepali banks, financial institutions and individuals holds more than 7 billion rupees i.e., about US\$108 worth of banded Indian notes. Due to the open-border with India and does most of its trade with India has contributed to wide acceptability of Indian currency in Nepal. Nepal has demanded with India to allow for exchange of demonetized Indian currencies. However, India has not shown any signs that it will entertain Nepal's request. Indian officials have blamed fake notes and have used the prospects of Indian "black money" coming back into India through Nepal as reasons for their unwillingness. The Indian government's unwillingness to exchange banned notes from Nepal has more to do with Indian domestic politics than anything else does.

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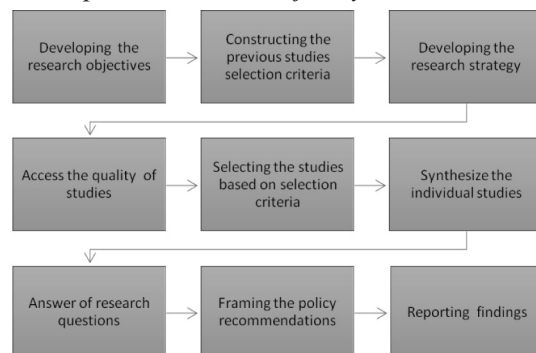
In March 2017, a high-level delegation from the RBI visited Kathmandu to discuss the exchange facility with Nepali counterparts. As late as March 2018, then-Finance Minister Arun Jaitley was still assuming Nepal that it would soon get exchange facilities for the demonetized Indian notes. However, India shut off the prospect of exchanging banned Indian notes from Nepal by removing the part from it's the RBI report, 2016-2017 report. The RBI (2018) has stated,

The banned Indian notes from Nepal had not yet been returned yet. The report states that 99.3percent of demonetized notes returned to the formal banking system, indicating that almost all money came back, and that demonetization was virtually unsuccessful in freezing out black money. As a result, Nepal has pushed furthermore more toward China due to unamicable behavior of India and the anti-India sentiment in Nepal has been developed.

Methods and Procedures

Research methodology is a way to systematically solve the research problem in which it depends on the types of research. The research design follows from the scope and objective(s) as reflected in the expected outcomes and gives out procedures to be followed for establishing the validity and generalizability of the research findings and rolls out a comprehensive guideline for various activities to be performed (Zawacki-Richter et. al., 2020). This study has used the desk research methodology based on the systematic review. It involves the collection of data from existing sources and reviews of the journal articles, reports and other literature. Systematic review is defined as “a review of existing research using explicit, accountable rigorous research methods” (Gough et al., 2017). The systematic reviews help to find out what is already known from pre-existing research about a phenomenon, subject or topic; new primary research to provide answers to questions about which existing research does not provide clear and/or complete answers. Therefore, the systematic review research method is used in this study; a form of secondary level analysis that brings together the findings of primary and secondary research to answer an objective set-forth in study. The conceptual framework of this study is as presented in the Figure 1.

Figure 1
Conceptual Framework for Systematic Review of This Study



Results and Discussion

Need for Demonetisation in India

Governments of many countries across the world have taken this extreme measure to control black money and stop the counterfeiting of currency notes. The Prime Minister of India, Mr. Narendra Modi has clearly stated objectives of the policy as to target black money, reduce corruption, and remove fake currency notes. Therefore, the government of India identified that demonetization would help to tackle the menace of black money/parallel economy/shadow economy. The cash circulation in India is directly connected to corruption and black economy hence government of India wanted to reduce cash transactions and also to control corruption and thereby move towards cashless transactions (thefinancialexpress.com). Similarly, Indian government encouraged to use this policy to counter the menace of counterfeit currency and prevent the cash being used for terrorist activities/terror funding. In developing countries like India and Nepal majority of the transactions are done in the form of cash. As per RBI (2018), 87% of the transactions in India are cash transactions. The menace of fake Indian currency notes was increasing alarmingly in such situation. The RBI has seized around 26 lakh counterfeit notes of denomination Rs 500 and Rs 1000 amounting to Rs 167 Crore in which Rs 500 notes were higher in numbers and in value (Jineshias academy, 2021). There was need to help formalize India's informal economy which reduces the extent of cash transactions and help in the creation of a less-cash economy.

Effects of Demonetization in India

The demonetization had short-term and long-term impact in India. The Tax Research Team (2016) analyzed demonetization as a large shock to the Indian economy and evaluated the short run and medium-term impacts. It illuminated the impact of such a move on the availability of credit, spending, level of activity and government finances. The Indian demonetization policy of 2016 made 86% of cash in circulation illegal tender overnight, with new notes gradually introduced over the next several months (Chodorow-Reich et al. 2019). Further, Potnure (2017) concluded that the supporter of demonetization quickly articulated this as a big-bang step to convert black money into white money. But the opposition has term it as 'organized loot'. The positive and negative impact from the demonetization is summarized as below.

The Positive Effects

- a) Demonetization and GDP: RBI (2018) proved that the GDP growth of India for the fiscal year 2016/17 was increased by 8.2 percent, which was the highest since 2011/12.
- b) Demonetization and Tax Revenue: The expectation of demonetization was to increase the tax revenue drastically. According to thelondonglobalist.org, since demonetization, the total number of taxpayers has increased by 38%, which represents a 17% increase in tax revenue for the government as well.
- c) Demonetization and Unemployment: Different data proved that the unemployment rate of India becomes least for the FY 2017/18. This fact justified that there was increase in level of employment after demonetization.

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- d) There are large increased in bank deposits during demonetization period. As a result, there was surplus of loanable funds. Different research proved that there was neither change in bank loan nor the interest rate.
- e) The demonetization also affects the political parties, their leaders and the results of an election. The political parties in power were positively affected in these regards. The demonetization negatively affects to the opposition parties, in the following election. Similarly, the political leaders who were supported by black money lost their political image as well.
- f) According to Ghosh (2017), general public across all income groups and locations rated demonetization as a good step and well implemented strategy to involve people in fight against corruption, tax evasion and black money.
- g) Demonetization and Distribution of income: Demonetization creates positive effect on distribution of income as rich people with black money deposited cash money to the poor's accounts. Similarly, there were increased sources of income with the increase in economic activities after demonetization.
- h) Demonetization and counterfeit currency: In 2016, the year when demonetization was launched, 6.32 lakh counterfeit pieces were seized across the country. In the four years (including year 2020 so far), a total of 18.87 lakh pieces of fake notes have been seized across the country in various denominations, according to the RBI data. During 2019-20, out of the total Fake Indian Currency Notes (FICNs) detected in the banking sector, 4.6 percent were detected at the Reserve Bank and 95.4 percent by other banks (RBI, 2020).
- i) The step of demonetization converts the black money of politicians, government officials and traders into white money in the legal version.

The Negative Effects

- a) Indian demonetization 2016 did not result in direct 'cash seizure' i.e. the holders of black money did not deposit in bank the unaccounted wealth in the form of cash (Ghosh, 2017).
- b) Demonetization gave rise to liquidity problem as people found it difficult to get sufficient amount of cash to fulfil their basic needs. Marginal section of the society mainly depends on cash to meet their daily transactions. After the announcement of demonetization, maximum Indian people were unable to fulfill their daily need due to the shortage of cash money.
- c) The government of India wanted to demonetization 86 percent of the outstanding currency in circulation in Nov. 8, 2016. However, at the end of December 31, 2016, about 99 percent of the demonetized currency was successfully returned by the public in exchange and claimed the new currency (Lahira, 2020). As a result, the government of India was failed to impose tax to the black money.
- d) The demonetization strategy is dubbed as a failure based on 'cash seizure' parameter (Ghosh, 2017).
- e) Kushwaha (2018) explored the impacts of demonetization in India and found following negative impacts:

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- i. Cash shortage adversely affected the consumption behavior of the people in India. The sales of consumer durables hampered in short-term, especially sales through unorganized channels are cash purchases. Most of the purchases by retailers were through cash which brought down their volume of trade.
- ii. Withdrawal of highest currency notes reduced the growth rate of the economy. Demonetization reduces consumption pattern, income, investment etc. This may bring a slowdown in India's growth rate as the liquidity crisis itself may last three-four months.
- iii. Deposit of the bank may increase in short-term due to demonetization, but will come down in long-term. Such liquid cash deposited in the bank by people may not be assumed that such amount of money once stored in the banks will be invested for long term.
- iv. One of the main reasons behind demonetization move was to curb black money but only a small portion of the black money is actually stored in the form of cash. Most of the black money is kept in the form of land, gold and buildings etc.

Effects of Demonetisation in Nepal

Nepal, the land-locked country from three sides from India, heavily depends on India for trade and supplies. Indian currency is widely used in Nepal for day-to-day transactions, especially in the border areas and Southern part of Nepal. It is speculated that some Nepalese have with them these notes worth billions of rupees. Different data shows that Rs.33.6 million demonetized Indian rupees have been formally deposited to the central bank of Nepal. The government of India was not ready to exchange the demonetized Indian currency that has been deposited in NRB and Indian demonized currency hold by Nepalese people during that time. This problem is still now faced by Nepal government, Nepalese people and the entire economy of Nepal. Even if, there were various unsuccessful formal and informal meetings and requested held by the government of Nepal with the Indian government. In this context, there is no role of diplomatic relation of Nepal with India.

The major effects of demonetization policy of India in 2016 are as follows:

- a) Currency Circulation: According to the financialexpress.com NRB (NRB) is saddled with Rs 7 crore of demonetized Indian currency but India is not making "adjustments" to take back the notes. It is estimated that Nepali people one side had huge amount of Indian currency of Rs 500 and Rs 1000 notes during demonetization and another side the central bank of Nepal had Rs.33.6 million demonetized Indian currency at that time (The Kathmandu Post, 22 April, 2018). This type of large amount of Indian currency has created greater negative effect to Nepalese economy mainly because of heavy dependence on Indian economy.
- b) Tourism Industry: The Indian tourists, whose share in total tourist arrivals is 21.23%; the highest in Nepal, bring with them huge amount of Indian currency (MOCTCA, 2020). Demonetization badly affected the flow of tourists from India to Nepal. But their number fell drastically following this event. Further, nearly two- third of the customers of the casinos are Indians in Nepal. Because of the liquidity crunch for not being able to

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withdraw required amount of money from ATMs or their accounts, tourist arrival to play casinos declined.

- c) Small Farmers and Workers: More than 10 million Nepalese citizens work in India. The Indian currency is widely accepted and used up to the remotest corner of Nepal. The millions of poor and small farmers and workers with their life savings, and living in remote areas, are still left with small amounts of demonetized Indian currency, which has now become a worthless piece of paper.
- d) Trade and investment: More than 60 percent of the total trade of Nepal is with India (Ministry of Finance (MOF), 2020), and at least one-fourth of the total currency used in Nepal was the Indian rupees. Similarly, the big business houses are also belonging to India. Therefore, big traders and businessmen were forced to exchange the demonetized Indian currency in black market in India at high price. Further, the demonetization of Indian banknotes had halted trade of cardamom in the eastern region. Though Nepal's trade with India through the formal channel may not be affected much, trade via informal channels, which is mostly conducted in cash, is probably going to take a hit (Himalayan News Service, Dec 17, 2016).
- e) Diplomatic Relations: Nepal and India have been enjoying good diplomatic and cultural relationship from long period. However, after the ignoring for exchanging of demonetized Indian currency hold by Nepal, there is the development of anti-India sentiment in Nepal and Nepal is forced to be closed with China. At the same time, there is also a discussion for killing the one-way currency pegged with India. As a result, there is the expansion of trade with China in current days.

Lesson Learned

The basic reasons of demonetization policy of 2016 in India were: i) it allowed the state to seize the wealth in the economy that was accumulated through undeclared income i.e., control of corruption ii) it estimated the scourge of fake currency that was circulating in the economy iii) it was intended to be a way of pushing India toward a modern digitized economy and iv) forced the people to convert their old cash into the formal tax network (Lahiri, 2020).

Samuel and Saxena (2017) found that the impact of currency swap on country's tax structure would be felt in years to come. The increase in government revenue and bank deposits may lead to lower interest rates on loans. Moreover, the decrease in unaccounted cash flow may reduce the funding to illegal or unlawful activities which helps to track unreported income resulting in reducing of corrupt practices and money laundering.

The business sector and general people are hard hit by the demonetization because India is not making "adjustments" to take back demonetized Rs 500 and Rs 1000 notes with an estimation of more than 100 million demonetized Indian currency at that time period. Further, the Nepalese tourism sector is hard hit by the demonetization policy in India. The informal labor market is heavily affected due to this policy departure where more than two

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million Nepalese are working in the Indian informal sectors. The major findings that relate to Nepal are as follows:

- a) This measure controls the usage and flow of black money in Nepal but unable to its control the causes. Since its root causes are corruption, bribery, smuggling and drug trafficking.
- b) The demand for the new Indian currencies were all time high.
- c) The hoarding of new Indian currencies increased sharply which have further reduced the liquidity in the market.
- d) The small trade/shopkeepers have faced difficulties in trade and investment because they are mostly involving in informal activities and cash-based transactions.
- e) Apart from this, the experts are also expecting an impact on `Nepal's small and medium enterprise (SME) sector, agricultural production and agriculture trade.

Lesson I: The 2016 demonetization of India dragged down economic growth in neighboring Nepal with adverse effect on trade, remittances and tourist arrival. NRB and Government of Nepal must have appropriate policy measures timely to address the adverse effect of demonetization.

Lesson II: India's demonetization produced some substantial thinking about cash, corruption, black money and the digital economy. It paved the way for digital payments, aid the process of financial inclusion and the overall transformation in the economy translates into long-term benefit for the industry. Nepal has also learned from Indian experience of digital economy due to demonetization to improve the policy measures from NRB and Government of Nepal to promote the digital economy in Nepal.

Lesson III: The demonetization is one of the major policy instruments that many governments are adopting to formalize the informal economy and reduce the size of the black/underground economy. The shadow/underground economy in Nepal is not yet decrease significantly due to open border and excessive use of funds by politician for election finance. Nepal's economy is heavily reliant on India for trade, employment and investment. The policy departure in India has direct effect in Nepalese economy. NRB needs to formulate a clear policy with regard to the demonetization of the Indian currency and act swiftly to address this issue.

Lesson IV: The other important lesson from this study is that there should be good and balance relationship with all the neighboring countries. If there is unbalanced and only one way relationship as Nepal's relation with India then there may be some problems and dangerous for national economy. The domain and large country may be uncooperative in many cases.

Conclusion

The 2016 demonetisation policy of India clearly upended the daily life of Indians and Nepalese in a significant way. The informal firms faced the liquidity crunch to pay their suppliers and workers without the standard access to cash. The demonetisation policy has

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created negative effect in Nepal to the greater extent from migrant labors to big business houses. It is not yet clear that how Nepal can be profited from the demonetization in India that ultimately continues the strong relationship between these neighboring countries. Nevertheless, certain groups of people are still hopeful in Nepal that some mechanism would be developed to exchange the scrapped Indian Notes.

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