

Effects of the Issuance of the New Generation Banknotes

Introduction

The Central Bank of Kenya in a gazette notice dated 31st May 2019 announced that it has launched new generation notes of Kshs 1000, Kshs 500, Kshs 200, Kshs 100 and Kshs 50 denominations aimed at tackling illegal financial flows. The regulator further highlighted that all the old Kshs 1,000 bank notes in circulation, valued at Kshs 217.6 bn, shall cease to be legal tender and be withdrawn from the market by 1st October 2019. Below is the summary of the old currency notes currently in circulation;

Denomination	Value (%)
1,000	54%
500	38%
200	3%
100	3%
50	1%
20	0%
Total	100.0%

Source: CBK

Demonetization refers to the process by which the current form of currency is withdrawn from circulation losing its status as legal tender, and replaced with new currency. Some of the reasons for demonetization include;

- Facilitation of regional trade, where countries adopt a single currency, as was the case with the Euro in 2002.
- Control of Inflation, where a country's currency with a diminishing value is demonetized and replaced with a more stable currency, as was the case with the Zimbabwean dollar in 2015.
- Combating illicit financial flows such as counterfeit currency, money laundering and tax evasion by demonetizing the currency making it valueless and forcing perpetrators to return proceeds of the black market into the formal financial system.

Case Study of Currency Demonetization

The successful demonetization of Australian Dollar in 1988;

In 1988, the Reserve Bank of Australia introduced polymer bank notes to replace the existing paper currency, aimed at curbing counterfeit currency, due to the former's high security features that made it difficult to counterfeit.

Key factors that led to the successful demonetization of the Australian dollar currency include;

- High security features of the polymer currency that made it difficult for counterfeiters to adopt
- The authorities took adequate time to research, develop and conduct trials on the new generation bank notes (1968 – 1988)
- The Federal Reserve of Australia involved banks at the commercialization stage prior to the adoption of the policy by the public

The demonetization of the Indian currency in 2016;

In 2016, the Federal Bank of India unprecedentedly announced the demonetization of the 500 Rupee and 1,000 Rupee bank notes, giving currency holders 2 months to deposit the notes with banking institutions.

Reasons for this demonetization include the Rs. 500 and Rs. 1,000 bank notes include:

1. Curbing illicit activities such as money laundering and financing of terrorism, that are heavily cash reliant, so as to avoid detection,
2. Bringing the large population of unbanked Indians, estimated at 32.5% of the bankable population as per the Global Findex report, 2015, into the financial system,
3. Enhancing government revenue by increasing the tax base as the informal sector is brought into the financial system, and,
4. Lowering interest rates owing to increased savings by the public in financial institutions and the expected liquidity of the money markets.

The Indian currency demonetization policy encountered many challenges, failing to curb illicit financial flows. Some of the results of the demonetization policy included;

- a) Slowdown of India's GDP due to systemic issues that led to cash shortages and disruption of small businesses,
- b) Sharp increase in digital transactions, with citizens adopting e-payment solutions for convenience,
- c) Disruption of SMEs due to heavy reliance of the firms on cash transactions, resulting in slowdown of the sector,
- d) Increased number of tax payers and government revenue, as more Indians were integrated into the financial system, and,
- e) Counterfeit currency and money obtained through illicit activities was able to find its way back to the financial system.

Lessons Learnt on Demonetization Policies

1. Demonetization may have little or no effect on the black market; as in the case of India, where up to 93.0% of the old currency, was returned to the financial system,
2. Demonetization is likely to increase government revenue, as the informal sector is brought into the financial system,
3. Sudden or short-tenured implementation of demonetization may result in severe cash shortages, decline production and negative investor sentiments, thus slowing economic growth in the short term,
4. With the shift to more digital economies, inclusion of the informal sector in the financial system, reduced interest rates and increased tax revenue in the long term, demonetization policies, if implemented efficiently are likely to boost economic growth, and,
5. Demonetization of the currency implemented over an insufficient transition period may negatively affect small and medium enterprises whose transactions are majorly on cash basis, as in the case of India's policy in 2016, leading to declined performance of the sector, and overall slowdown of the economy.

Expected Effects of Withdrawal of Current Bank Notes in Circulation by the CBK

Immediate Effects

a) Effect on capital and money markets

Given the ample time provided by the CBK to exchange old notes with the new generation notes, we expect the demonetization to have little or no effect on market liquidity based on the following reasons;

- The long transition period (approximately 4 months) will grant market players enough time to restock their capital balances,

- The phased issuance of new generation notes to first demonetize 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 a largely cashless economy. This implies that demonetization would hardly affect money circulation. The transition is expected to be efficient aided by the well-developed banking and mobile money infrastructure.

b) Effect on illegal financial activities

Demonetization policies, if carried out within short timelines, are likely to have a detrimental effect on the black market. 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 may use 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
- 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.

c) Effect on Small and 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 e.g. 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 to 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

a) 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 area e.g. in India, where up to 1.9 mn 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 of the bankable population.

b) Assertion of monetary control and financial stability

Demonetization of the currency is expected to lead to more consumer spending as holders of black money look to dispose it. Coupled with reducing interest rates due to higher market liquidity, increased consumer spending would likely result in higher inflation levels in the country. However, with the return of unbanked money into the financial system, the regulator's effectiveness in maintaining financial stability of the market is likely to be enhanced and we therefore expect the CBK to better manage impending inflation and stability of the Shilling moving forward.

Expected Challenges in Implementation

1. 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.

2. 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. We expect that perpetrators of illicit transactions will have enough time to formalize black money into the financial system.

3. Cost to the tax payer and banks

The currency demonetization move will also force banking institutions to incur costs associated with collection of old bank notes and recalibration of Automatic Teller Machines (ATMs). The taxpayer is also expected to incur the cost of printing the new notes.

4. Risk of counterfeiting of new notes

Many Kenyans remain largely uneducated on the new notes and failure of the CBK to conduct intensive public awareness of the demonetization move is likely to open an avenue for the introduction of counterfeit new currency.

Conclusion

Demonetization of currency is often associated with curbing of illicit activities especially operations of the black market as well as enhancement of financial inclusion especially in the informal sector, although recent studies on countries such as India and Myanmar have failed to prove the effectiveness of the policies. Sudden implementation of demonetization policies especially in developing countries that lack adequate banking infrastructure, has been shown to result to market illiquidity, traders freezing sale of commodities due to uncertainty and general investor panic in the short term, factors that result in slow down of economic growth. However, in the long term, with enhanced financial inclusion of the informal sector, transition to a more cash-less economies, enhanced revenue collection by governments, increased savings by the population in formal institutions and consequently reduced lending rates, demonetization policies may lead to the economic growth if effectively implemented.

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. It is likely that perpetrators of illicit activities and beneficiaries of corruption will have enough time to formalize black money through such activities as use of multiple depositors through mobile and banking agents, conversion of the Kshs 1,000 bank notes into lesser denominations, collusion with businesses to make backdated sale entries and investment in less regulated sectors that encourage cash transactions.