

Demonetisation: Is the Pain Commensurate with Gain?¹

By M. Govinda Rao²

Introduction

The ruling party has hailed the Prime Minister's announcement of ₹500 and ₹1000 notes becoming invalid as an historic and unprecedented attack on black economy. Conversely, the opposition has called the move a 'monumental blunder' and an 'organised loot.'

For people at large, this has sent waves leading to serpentine queues to deposit money and collect cash for their daily needs. The discussion on the difficulties and questions on selective demonetisation will not go down anytime soon. In an economy with over 96 per cent of transactions in cash, rendering 86 per cent of currency with the sleight of hand cannot but plunge the economy into a chaotic spin.

For the most part, people have been patient and enduring. However the question on everyone's mind is for how long? The Prime Minister in his broadcast asked for a forbearance of 50 days but whether or not normalcy can return by then remains to be seen.

The measure was ostensibly taken to curb black economy, though objectives like ending terror financing and nullifying counterfeit notes were also mentioned. In light of this there are some important questions that need to be addressed:

- i. Whether this policy choice is appropriate to achieve the stated objectives?
- ii. Has the government taken into account the capacity of the system to cope with such a large scale invalidation of cash?
- iii. How long will it take to remonetise the economy?
- iv. What are the short and medium term implications of the measure?

As far as the appropriateness of demonetisation is concerned, the selective demonetisation undertaken is neither necessary nor sufficient to deal with the black economy. The measure by itself, will not have any impact on the incentives to generate black money and will not deter illegal income earners and tax evaders. The principal sources of black economy generation in political funding, election expenses, real estate transactions, construction, tax evasion, government contracts including defence contracts and bureaucratic corruption will continue.

Kautilya, more than 2000 years ago wrote, "Just as it is impossible not to taste honey or poison that one may find at the tip of one's tongue, so it is impossible for one dealing with government funds not to taste, at least a little bit, of King's wealth." As long as the bureaucracy has discretionary power to endow or reduce punishment there will be bureaucratic corruption.

The government has stated that there will be additional policy initiatives to deal with the generation of black economy. These measures however should have been initiated first for they are independent of demonetisation and would have impacted the process of generating black money without inflicting pain and misery on the poor and vulnerable.

To understand the significance of the policy it is important to understand the size of black economy and the extent of black economy held in cash. The estimates made by the National Institute of Public Finance and Policy (NIPFP), National Institute of Financial Markets (NIFM) and National Council of Applied Economic Research (NCAER) for the government are not in public domain yet. The World Bank has estimated the size of the parallel economy at 20.7 per cent (same as that of Israel!) and McKinsey & Company has estimated it at 26 per cent. Credit Suisse has estimated that the wealth to gross domestic product (GDP) ratio in India is about 2.

Assuming that parallel economy has the same ratio and taking the McKinsey estimate of black money flow, the black wealth works out to 50 per cent of the GDP. This implies that the demonetised money, ₹14.18 trillion (₹14 lakh crore) which is equivalent to 10 per cent of the GDP is equivalent to 40 per cent of the black economy or 20 per cent of black wealth. Assuming that 15 per cent of the currency was not deposited in the banking system, the measure would have impacted about 6 per cent of the black economy or 3 per cent of black wealth!

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This is consistent with the estimate contained in the White Paper brought out by the Ministry of Finance in 2012. The extent of cash revealed in various search and seizure operations between 2006 and 2012 was 3.8 to 7.3 per cent. Thus, the generous estimate is that only about 5-6 per cent of the black economy is held in cash and only a small proportion of this may find its way into the banks.

An important point to note is that not all currency accumulations are illegal and only a small proportion of illegal wealth is held in cash. An overwhelming proportion of black economy is stashed abroad, held in gold, real estate, foreign currency and the volume of black wealth held in cash is less than 6 per cent even by the most generous estimates. This begs the question as to whether the government should have adopted such a sledgehammer method to deal with just 3 per cent of black wealth.

Further, within this 3 per cent, the black wealth can only be extinguished to the extent that it does not actually find its way back into the banks. It is reported that already over ₹11 trillion of the ₹14 trillion has been deposited in the banks and the volume of invalid currency not coming back into the system is yet to be seen.

There are stories about round-tripping through measures like surrogate accounts to impregnate Jan Dhan accounts, laundering through the North-eastern route, converting by using paid labour and advance payments for services to be rendered in the future. The capacity of income tax administration to unravel these remains to be seen and surely, quite a few of the cases will end up in already overburdened courts.

Is India's banking system geared to meet this contingency? The fact that the Reserve Bank of India has been coming out with more than one regulation each day speaks volumes for its capacity to cope with the problem. Admittedly, demonetisation had to be done with utmost secrecy. Nevertheless, it is important to analyse the capacity of the system to cope with such measures and work out costs and benefits of it before embarking on the adventure.

A significant percentage of employed people (over 45 per cent) in India are in the informal sector. Additionally, over 30 per cent are casual and contract labourers who receive their wages and pay for daily needs through cash. These people have been forced to lose their daily wages while standing in queues. How long will this problem continue?

It is estimated that remonetising about 12 trillion against the prevailing 14.18 trillion at present capacity printing presses would take not less than 170 days. Hopefully the extent of suffering will abate in time but in the next two months banks will continue to be crowded.

What are the short term implications of this policy on the economy?

Demonetisation has led to unprecedented hardships reminding us of the era when the economy was scarcity-hit and rationing was the order. This is especially true for the informal sector employees, small and medium enterprises and farmers. The informal sector in India provides 80 per cent of employment and contributes 45 per cent of GDP and the impact of cash crunch has been severe.

The real impact on incomes will be known only when the third quarter GDP estimates come out. The measure has also adversely impacted trade, tourism, small-scale manufacturing and construction activities. The measure has been taken at a time when *rabi* sowing season is in progress and cash deprived farmers are finding it difficult to purchase seeds and fertilisers. For states facing drought, this comes as a double whammy. With declining money supply and volume of transactions (velocity of circulation), the quantity theory of money posits that at the prevailing rate of inflation, income will decline sharply. If about 15 per cent of the demonetised currency is not deposited by December 31, the nominal GDP is estimated to decline by 1.7 percentage points. The deceleration impact on real GDP varies widely depending on the assumptions made but could be close to 2 per cent.

The release of the second quarter GDP shows that the economy has virtually been stagnant and all sectors excepting agriculture have decelerated. In fact, the growth of Gross Value Added (GVA) - which is a more appropriate measure than GDP - despite better performance of agricultural sector in the second quarter has slowed down from 7.3 per cent in the first quarter to 7.1 in the second.

With the GDP growth during the first two quarters averaging at 7.2 per cent, the RBI's growth forecast of 7.6 per cent average for the year can be realised only if the growth rate in the next two quarters average at 8.2 per cent. With trade, tourism, small-scale manufacturing and construction activity coming to a standstill and agricultural sectors deprived of cash for purchasing seeds and fertilisers for *rabi* sowing, the GDP in the economy will decelerate significantly.

At a time when gross fixed capital formation relative to GDP has been showing steady decline from 32 per cent to 29 per cent and growth is primarily fuelled by private consumption, the selective demonetisation has hurt the growth prospects significantly in this quarter and the next. The core sector growth has grown at a six-month high of 6.6 per cent in October, particularly due to strong performance of steel (16.9%) and cement (6.2%).

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Demonetisation is likely to adversely impact these sectors as real estate transactions and constructions have come to a grinding halt.

One positive implication is the gains to the government from the measure. To the extent that demonetised currency does not get deposited, the Reserve Bank's liability gets extinguished. The mismatch in asset-liability position can be corrected either by extinguishing the government securities (assets) or by issuing new notes (seignorage). In the first instance, interest payments on government debt in the future gets reduced and in the second, RBI's profits will increase and it will pay larger dividends for the government which could then be used to reduce fiscal deficit or recapitalise banks or for additional spending.

Unfortunately, there is no precedent to go by and a part of the gain may have to be kept in reserves. The other major gain may be that excess liquidity could prompt reduction in the interest rate which could translate into lower deposit rates. The additional market stabilisation bonds will arrest this to some extent.

However, the lower lending rate could trigger economic activity. The important issue therefore is how much of the cash will not return to the banking system, how much impact it will have on lending rates, how much of that will be transmitted? Finally, will this result in more lending at a time when the banking system is overburdened with the overhang of non-performing assets and the industry yet to get ready to make new investments and excess capacity continues to exist?

The long term benefits from the measure will be formalisation of the economy by switching over to digital transactions. At present 98 per cent of the volume of transactions and 68 per cent of values are transacted in cash and even if the number of cash transactions are reduced by 10 per cent in the next few months, the country will continue to be predominantly cash dependent. Even that is a questionable assumption because, in a country with 1.5 crore shops the point of sale devices are just 14.6 lakhs. There are issues with the availability of power, internet connectivity and bandwidth. Nevertheless, to the extent it promotes formalisation, it is a benefit but the question is, whether such a sledgehammer method was called for. There is also an issue of potential loss of credibility, for the measure penalises not just those who hold their ill-gotten wealth in cash but the entire population. Can this be a deterrent for keeping the black incomes and wealth in cash? Now that we have ₹2000 notes, keeping the ill-gotten money in hard currency has become easier! We will have to live with

the decision for which we are not a party, We will also have to brace up to the situation where there will be a number of sophisticated digital frauds.

It has been mentioned that demonetisation is one in a series of measures that will be taken to deal with the menace of black economy. Since these measures are independent, it would have been more appropriate to begin with the measures that adversely impact the generation of black money rather than starting with the sledgehammer measure. If the government is serious about tacking black money menace, it should begin with cleaning political funding.

The high moral ground taken by the Prime Minister will be amply justified if the ruling party throws open its books of accounts to independent audit and subjects itself to the Right to Information Act. In 2013, the Central Information Commission ruled that political parties are public authorities and yet, all the six national parties (except the left) closed their ranks to violate the ruling by rejecting the right to information.

The donations to political parties have continued to be opaque and the limits on election expenses are violated with impunity. The Election Commission has laid down the ceiling on election expenses at ₹70 lakhs for a Parliament seat and ₹28 lakhs for a seat in Legislature for the candidates, but there is no restriction on the spending by political parties. The Hindu media studies report estimated that as against a declaration of ₹7000 crore by candidates in the 2014 General Elections, the estimated expenditure was ₹30,000 crore. Indeed, as Roosevelt famously said, "Carry a big stick and you can speak softly!"

Apart from the reform of political funding, abolition of capital gains tax and reduction of stamp duties by the states to 3 per cent will substantially reduce the black money generated in real estate transactions. Similarly, simplification of laws and procedures to reduce discretion by bureaucracy will help a great deal in reducing bureaucratic corruption. The clearances required for construction abound.

We keep reading about the huge corruption in defence purchases. We are well aware of the goings on in the Medical Council of India and despite the Rajya Sabha report severely criticising its functioning and an important report by the NITI revealing much that is wrong and making important recommendations, not much has been done. Hope, the government will act on it sooner than later. The situation is not very different in the case of higher and technical education.

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¹ This essay is a lecture delivered by Dr. M Govinda Rao on demonetisation at the Centre for Multi-Disciplinary Research, Dharwad, Karnataka on 8 December 2016.

² Dr. M Govinda Rao is the Councillor of The Takshashila Institution.