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Demonetisation of Indian Currency – An Assessment

The Government of India took the bold and unprecedented move to withdraw the legal tender status of Rs 500 and Rs 1,000 notes on 8 November 2016. This move, designed to check the accumulated stock of black money in the economy, has undeniably created a great deal of hardship to the general public. While long queues form at bank branches and ATMs, the public has generally accepted the hardship in the fulfilment of the larger objective stated by the government. However, the nimble footedness of the government and the Reserve Bank are at test to end the limits placed on the withdrawal of cash. The long term effects of the decision are still to be assessed, but it is feared that in the short term the economy will certainly take a hit. An attempt is made in this study to see how the move has unfolded and assess its consequences for the economy.

Mr Vinod Rai[1]

Though three weeks have passed since the de-recognition of Rs 500 and Rs 1,000 notes as legal tender, the country is still witnessing a churn. These notes were scrapped in an attempt to ferret out 'black money', and to tackle the menace of counterfeit currency and funds used by terrorists. There is turmoil in the country because notes in circulation which comprised 86% of currency in an economy which is largely dominated by transactions in cash, has been sucked out of circulation. On the other hand, a rather slow rollout of the new currency has forced millions

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of people to queue up outside banks and ATMs for hours. Grain traders, the informal sector and farmers appear to be the worst hit.

The sudden move to 'demonetise', as it has popularly come to be known, has evoked diverse reactions from academicians and economists across the globe. Sharp criticism has emerged from the political opponents of the present government. Practically all analysts believe that the move will slow down economic growth. Larry Summers, the former US Treasury Secretary, has stated that he thinks demonetisation is a bad idea and that the country's economic growth will shrink by about 1%.

The following have been cited by different agencies, as the challenges before the government:

1. Post demonetisation, logistics and printing of new currency appear to be the key challenges for the RBI and the government to restore business as usual in the economy.

2. Of the Rs 14.5 trillion odd demonetised notes, while about Rs 11.5 trillion has been deposited with banks, only about Rs 2.5 trillion of the new currency has been released for circulation / exchanged till date, and a large share of this has been in the form of Rs 2,000 notes which are not ideal for transacting.

3. As per reports, about 4.5 billion Rs 2,000 notes have been printed. However, a lack of adequate "transactional" currency is still continuing 20 days post the announcement, and it appears unlikely to resolve in the next couple of weeks, with only Rs 2.2 trillion of the residual currency (other than Rs 500/1,000) in circulation.

4. The major difficulty being faced by the public is the inadequacy of adequate currency, and that too of the most commonly transacted tender, viz. Rs 500. The Rs 2,000 currency denomination does not facilitate easy transactions. Now, with the RBI having the capacity of printing only Rs 10, 000 crore per day (Rs100 billion – and that too in Rs 2,000 tenders), the total that can be printed in a month is Rs 3 trillion. Considering the fact that Rs 14.5 trillion has been withdrawn from the system, there appears to be a long haul for adequate currency to be back in to the system. This aspect smacks of inadequate planning for the introduction of the demonetisation scheme.

A major, and possibly even valid criticism of the demonetisation campaign in India has been that it does not get to the major portion of the black wealth that has been hoarded. The cancellation of Rs 500 and Rs 1,000 notes to be replaced by new designs and/or denominations might get at the cash hoarded by the usual defaulters. However, we all know that the real fraudsters, the ones with the ill-gotten gains do not keep them in rupee notes. They stash them away usually in gold, real estate or foreign bank accounts. It is estimated that only a maximum of about 15 % of the untaxed wealth is retained in currency notes.

The whole operation was justifiably kept secret. The argument provided for the surprise element of why the move was announced and administered overnight is that it denies hoarders of black money the chance to dispose it. While that may appear to be sound logic, it has also apparently impacted the banking system's ability to ensure a smooth transition. But the last mile turned out to be rather difficult, as serpentine queues outside every branch and every ATM of the country were proof of the fact that bank branches were not battle-ready. The fact that the common man has had to face immense inconvenience in managing his daily chores and has had to stand in long queues to draw his own money, and that too receive it in rationed amounts, appears to have raised the maximum uproar. Thus, the preparedness of the government and the banks regarding the implementation of a move of this scale has come to be questioned. The removal of large sums of legal tender unquestionably affects all individuals who need to engage in cash transactions in some form. Those with access to plastic money are less directly impacted in the short term, but in both the long and short term, specific sections have been disproportionately hit. The rural poor still do not possess access to bank accounts and since they currently hold all their money in cash, have been directly hit. Even those who do have access to accounts have had to struggle, with the banks being ill prepared and dispersed in number. They have had to take off several crucial hours from work – sometimes in vain. It is also difficult to estimate the number of women across the board who will potentially and irrecoverably be impacted by this policy – women who do not inform their families of hidden stashes of cash, and are otherwise fully dependent on male members of the family, and who stand to lose years of savings because they cannot confess about these hidden stashes of cash.

The government also does not appear to have made things any easier by making almost daily changes in the policy regarding how old notes can be exchanged, the limit on amounts that are being disbursed from the ATMs, the amount that one can draw at a time or in a week from the bank, etc. It is also a fact that most of the transactions in rural areas and in the agricultural sector are undertaken by cash. These people were indeed taken by surprise and now find that purchase of seeds, fertiliser, pesticide and fodder, as well as payment to labour has become a problem. People have had to stand in long queues either at ATMs or bank branches, quite often to be frustrated by the time their turn comes, as the ATM/ branch runs out of cash. Some people have died while standing in the queue, though how much of the cause of their deaths can be attributed to being in the queue is anybody's guess. Media has sensationalised the phenomenon of people in queues, even to the extent of showing a person who probably was under medical treatment standing in the queue carrying his inter-venous drip paraphernalia with him. The remarkable thing, however, has been that there has not been very many instances of rioting or disgruntled elements taking to disorderly action. There was also a photo op of a prominent party leader standing in the queue to ostensibly share in the pain of the common man. However, none of these attempts to instigate large scale disruption has evoked any response from those engaged in the wait. The often repeated refrain of the multitudes before ATMs and bank branches has been that since the government's action is for the greater good they are willing to share in the short term pain for the long term gain of the country. In a very oblique manner, those having huge amounts of currency stashed away and are desperate to have it converted, have had to employ 'others' to stand in the queue and exchange the money for them ‒an element of poetic justice as the 'cost of the transaction' has been the well-deserved gain of the poor. This indicates the extent of dissatisfaction of the people towards the existence of a parallel economy and how it had come to harass them in their daily life. Despite the pain which people are facing in the exercise, generally the scheme has been hailed by Indians across the spectrum. The sentiments are positive and encouraging.

Indeed, a genuine concern is that, those in the informal sector who have legitimate business, which over the years has been legitimately transacted in cash, will be undeservedly hurt. Some may be hurt rather harshly and this may result in their permanent closure, leading to job losses and the slowdown of GDP growth. Some unexplained estimates see GDP growth plummeting to zero in the next two quarters and not recovering in the foreseeable future. Such estimates, or rather speculations, have been unnecessarily alarming. All medium, small and even micro production enterprises (production MSMEs as opposed to wholesale or retail traders) certainly have access to formal credit sources, though they prefer not to conduct business through those channels. This must be true of MSME export units that are reported to account for 45 per cent of India's total merchandise exports. The majority of MSMEs deal only partially in cash. These units, anticipating the onset of GST, had started to move away from cash transactions as they would not receive any tax credit. Therefore, to argue that demonetisation spells doom and disaster for MSMEs is being unduly alarmist. In fact, this action of the government may well be a blessing, as it will serve as the nudge that they needed, to switch to and get familiar with formal channels, so that they would be better prepared to handle a GST regime as and when it is introduced.

It is being claimed by politicians, who appear to have been caught unaware and have had their 'wealth' being rendered useless, that farmers are in deep distress and dying. Of course most of the narratives are always in the name of the ' farmer' and the 'common man'. This appears to be an over exaggeration. Farmers can sell their kharif harvest of sugarcane to mills with receivables being directly credited to their bank accounts as always. Any amount of paddy can be sold to the FCI at the government-declared minimum support price (MSP). Agro-inputs are normally available at 30-60 day credit to virtually all farmers. On the other hand, it is reported that most of rabi sowing had already taken place, hence, the shedding of tears on behalf of the farmer appears to be misplaced. It is, therefore, not surprising that the opposition parties find themselves devoid of public support. They have been patently unsuccessful in taking their protests out of Parliament to the streets, where they will be exposed to the strong public support for the government's move. It thus appears that despite public inconvenience, people at large seem to support the government’s move against black money. It is true that the queues have become shorter and there appears to be less distress as people in the rural areas are managing with barter and IOUs over the short term.

Meanwhile, the government has introduced the Taxation Laws (2nd Amendment) Bill, 2016, after it was noticed that some people were trying to illegally exchange the demonetised Rs 1,000 and Rs 500 currency notes. As per the proposed amendment, passed sans debate in the Lok Sabha on 29 November, 2016, the bill entails a tax of 30 per cent of the income declared, an additional surcharge of 33 per cent of the tax amount, and a penalty of 10 per cent of the declared income. This adds up to a total liability of about 50 per cent. In addition, the amendment states that 25 per cent of the declared income is to be deposited in an interest-free deposit scheme to be called the Pradhan Mantri Garib Kalyan Deposit Scheme, 2016, with a lock-in of four years. This money will be utilized for developmental activities such as irrigation, housing, construction of toilets and infrastructure, primary education and primary health. If undeclared, then the unexplained amount will face a flat tax of 60 per cent, a surcharge of 25 per cent of the tax amount, and a possible 10 per cent penalty at the discretion of the assessing officer. This takes the total levy on undeclared income or assets to as much as 85 per cent. It is far too early to comment on the efficacy of this amendment.

In terms of the conceptual downsides of the scheme being observed during implementation, it is being feared that a lot many people would have surreptitiously managed to deposit their undisclosed cash into multiple accounts under the 'less than Rs 250,000' category thereby averting an investigation. The Jan Dhan accounts appear to have been the conduit.

Additionally, had the aforementioned disclosure scheme as contemplated in the amended Taxation bill 2016, been announced alongside the demonetisation on 8 November itself, it is felt that the "commission" paid to convert currency would have in fact accrued to the government in the form of additional tax/penalty.

Long Term Positives Implications

All this breast beating over the short term has diverted attention from what appears to be the long term path laid out by the government for getting access to hitherto secret bank accounts maintained under the cloak of confidentiality in Swiss banks. The Finance Ministry has announced that India and Switzerland have signed a pact for automatic exchange of information that will enable tax authorities to receive financial information of accounts held by Indian residents in Swiss banks from 2018. In the statement issued by the government, it appears that it will now be possible for India to receive from September, 2019 onwards, the financial information of accounts held by Indian residents in Switzerland for 2018 and subsequent years, on an automatic basis. India has joined a list of select countries with which Switzerland will commit to an annual exchange of all financial information automatically, on a reciprocal basis for tax purposes. India has been lobbying hard to be a part of this initiative in a bid to prevent its citizens from stashing undeclared funds in Swiss banks. It finally managed to convince the Swiss authorities that it will respect Switzerland's tradition of banking secrecy by respecting confidentiality of account holders and using the data for tax purposes only.

The government has separately been working on the long-term desired reform of the welfare system. The attempt is to move away from government purchases of food stuffs, a notoriously corrupt, and wasteful practice, to the distribution of cash to the poor with which they can buy necessaries in the extant free market. This requires that rural India become banked and motivate people to conduct transactions in cards, as much as urban and professional India already does. Demonetisation will expedite the transition in this direction.

In the final analysis the economic implications of demonetisation are likely to yield varied results. It will inspire confidence in the international community that India is serious about its commitment to fight corruption. This will enhance India's ranking in ease of doing business as well as in various global indices of corruption. The move to seek details of otherwise secret accounts abroad has contributed to this feeling.

It is too early to predict the exact fallout of demonetisation on the economy or growth of GDP. Ambit capital, a Mumbai based equity research firm, has officially estimated that the demonetisation driven cash crunch will result in GDP growth crashing to 0.5% in the second half of the fiscal year 2016-17.This means that GDP growth for six months, from October 2016 to March 2017, could decelerate to 0.5%, down from 6.4% in the previous six months. It further estimates that during the October to December quarter that we are currently in, the GDP growth may contract, thus showing negative growth. However, Ambit is hopeful that a strong formalisation of the informal economy will ensue through 2017 until 2019.

However, if the government hikes up public spending as it also relaxes the norms for the construction and real estate sector, the temporary setback can be remedied. The banks are flush with deposits and if regulated properly this can be made a big game changer.

A very positive and long term result of the demonetisation will be the boost to financial inclusion and digitisation. The general public has been induced to open new accounts, and to resort to Apps like Paytm which will reduce the need for cash.

While planning for demonetisation, the government would have factored in repercussions like sluggishness in the stock and housing market, and in general, government's tax revenue in quarters ending December and March. Demonetisation will lead to lower conspicuous consumption and real estate activity. Thus, residential investment could suffer and impact 300 industries which provide inputs in the housing sector. Therefore, India's growth rate in the short run could be a matter of concern unless the government uses the fiscal multiplier to boost growth. Additional support to low-cost housing schemes and specific schemes aimed at farmers, viz irrigation, etc. could be targeted. The near-term slowdown in growth, accompanied by a pull-back in discretionary spending, is likely to push inflation lower in the near term. Likewise, the fiscal headroom would allow the government to maintain fiscal discipline. This, in turn, would help the medium-term inflation target

Further, the expected introduction of Goods and Sales Tax (GST) in April 2017 would have led to better observation of accounting standards. Demonetisation would hasten the process of such accounting standards because of shift from currency to digital payments and banking. Longer-term gains are likely to be in the form of wider tax collections and hopefully, the tax to GDP ratio can start to inch up. It will increase compliance from small businesses in the informal sector. It could make implementation of GST more meaningful. However, with the constant disruptions in parliament, a question mark has arisen over the passage of the GST Bill.

Residential property demand would see a much longer-term impact, which could extend beyond FY18. The same would impact housing finance and cement as well. A large fiscal stimulus from the government from the one-time savings could partially offset the negative impact from the property slowdown.

Conclusion

Demonetisation has only hit the stock of unaccounted wealth kept exclusively in the form of currency. To curb regular accumulation of more unaccounted money, the government should institute a mechanism of incentivising tax compliance, as well as punitive and demonstrative deterrents for those caught while generating black money.

Extensive financial literacy on the harmful impact of unaccounted money – ranging from personal health to national loss – will help. This should become part of school and college curriculum. Finally, and as has been the public demand for long – the government should consider introducing transparency in political funding/election funding, as in the USA and some other advanced countries.

It is undeniable that the move to demonetise the large denomination currency has been an audacious move, which by its suddenness caught all by surprise. However, it appears to be showing signs of instilling fear and uncertainty in the minds of those who had got accustomed to evading tax, hoarding black wealth and brazenly ignoring the government machinery in their pursuit of ill-gotten gains. Nevertheless, what the government will have to guard against is the fact that with all these new rules and regulations which are being introduced just about every other day, there is no return to the dreaded *'License Raj'*, which has the government machinery getting the discretion to knock on the doors of all and thereby become a source of harassment. We cannot have a situation where, after declarations of minimum government, the general public gets questioned for every payment made and amount deposited, with validation and certification being at the discretion of the inspector. The tax inspector is not the friendliest of officials and one whose probity is unquestioned. So his getting authority to seek verification on all deposits over Rs 250,000 or amounts drawn for marriages does not portend a good sign for the public. This power of discretion may most unwittingly usher in a potential for unmitigated corruption.

The general public has most readily accepted the short term pain for the move initiated by the Prime Minister. It has appreciated the objective behind the action and endorsed it whole-heartedly, but in the process it should not be subjected to procedural difficulties. It has endorsed long term and sustainable major-ticket reforms and should not in return be subject to being questioned by anyone claiming to represent the government. That will indeed be a very sad augury.

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