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Indian Economy and Demonetisation: Way Forward

Introduction

The delegalisation[1] of the two highest value currency notes announced by Indian government on November 8th has created an impact on the economy at a scale which no other piece of policy has rivalled for a long time.

While plenty has been and continues to be written and spoken about the measure in media and academic literature since then, they have stressed on the efficacy of the measure and its implementation. Here, we shall be more concerned with the way forward for the economy post delegalisation. In this context, we shall touch upon the rationale of the measure and scan it for the lessons learnt. The analysis thereof will also pay particular attention to the role of digital money and corresponding role of paper money.[2]

There are also two more concerns which we shall touch upon in this study.

- Globally the subject of cash as a physical currency versus its arrival as an electronic medium has become very relevant in the 21st century. One of the first large scale application of the principle was through the launch of Bitcoin. More such, are in the offing. Those create a vast and undefined region for economic analysis to venture into.
- At a more basic level as economies of Asia and, particularly Africa find themselves rising up the growth path, they have been assailed by the impact of inequality and corruption that a growing economy without sufficient regulatory control are subjected to. The medium for such deviant practices are often based on manipulation of the cash economy.

Does the Indian demonetisation experiment have any lessons to offer in this context?

The analysis is made possible as the Indian economy has already spent eight weeks since when delegalisation was announced. In the first few weeks, the attention of the Reserve Bank of India and the government was focussed on making available the cash as replacement for those that had been sucked out of the economy. It was also an uncertain space as there were questions on whether the economy had the resilience to absorb a change of such order. By the end of December, the Finance Ministry estimates that ₹ 6.50 lakh crore of cash will have been pumped in to the economy to replace the ₹15.50 lakh crore that has been pulled out by delegalisation. Only after these immediate supply logistics were dealt with was there space for further policy action by both entities. Those actions have begun to move centre stage only now. There are more orderly conditions in business and it is therefore time to examine the issues in depth.

In this Brief, we shall thus examine the main postulates of the delegalisation programme. We shall then put in a synoptic view of the developments in national currency managements, particularly in the Southern countries and then offer a menu of policy options going forward.

Delegalisation and the Way Forward

The press release issued by the Finance Ministry of Indian government on 8 November listed two reasons for withdrawal of the legal tender character of high denomination bank notes of

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This Policy Brief has been prepared by Mr. Subhomoy Bhattacharjee, Consultant, RIS and is largely based on Consultation Meeting with select experts on 'Indian Economy and Demonetisation' that was held on 15 December 2016 at RIS, New Delhi. While many of the issues were flagged by the distinguished experts who attended, due to Chatham House rules, no one is being identified for this brief. The author has benefitted from the guidance received from Prof. Sachin Chaturvedi, Director General, RIS in the development of the theme in this Brief.

₹ 500 and ₹1000. These specified bank notes (SBN) as per the Reserve Bank of India (RBI) terminology ceased to be valid with effect from the midnight of 8 November 2016.

The two reasons offered were: 1) financing of terrorism through the proceeds of Fake Indian Currency Notes (FICN) and use of such funds for subversive activities such as espionage, smuggling of arms, drugs and other contrabands into India, and 2) elimination of Black Money.[3]

In this context, it also becomes significant to examine the third strand of the exercise which was articulated soon thereafter. This is expediting of the transition of the economy to one that is based on digital currency.

As we noted above, various experts have examined if these three were significant enough reasons to remove approximately 87 per cent of the value of the currency in circulation from the economy? Since our policy recommendations are the harvest of the government action, it is necessary to understand the context. Table 1 shows the respective denominations; the segment wiped out by delegalisation were the last two columns, of ₹ 500 and ₹ 1000.

To go back to the first one, the issue of financing of terrorism through the use of counterfeit currency is a felt need. For obvious reasons, the RBI has always underplayed the extent of the problem. But conversations with security experts have always revealed this as a grave concern. The Indian currency (INR) because of the expanding size of the Indian economy now finds use beyond its borders and not just in Pakistan. The relative stability of the currency has added to its lure, as a store of value, vis-a-vis these countries. It has been aided by the fact that the INR is now one of the 15 most actively traded currency in the legal forex markets of the world at just less than 1 per cent of the daily traded volume. In this connection, one must also mention over 25 currency swap arrangements that RBI has entered with countries. The swap arrangements allow for India and the country concerned to settle their trade bills in respective currencies without drawing upon their reserves of say, US dollar or Euro.

The Indian currency is therefore an attractive paper to settle trade in the region, including even the unofficial ones. For illegal transit across the region, it is far more attractive to carry INR from Pakistan all the way to Bhutan than any currency of the neighbourhood. In such an environment, it makes sense for clandestine currency press to specialise in printing INR than any other. It is for this reason that security experts have advocated flooding the Indian borders with ₹ 1000 denomination notes than the lower ones, since it is more costly and more difficult to counterfeit. As the volume of illegal drug trade across the borders has exploded—National Drug Enforcement Statistics show a huge 105 per cent rise in number of seizure of drugs in just four years from 2012 to 2015[4], the spectre of this trade being financed through INR is very real. Yet this data does not capture the extent of the trade. A Brookings India report notes— India has witnessed a whopping 455 per cent increase in drug hauls over three years from 2011 to 2013.

> *"India faces a range of challenges associated with illegal drugs: narcoterrorism, illegal cultivation of opium poppy and marijuana, the diversion of legal opium into the illegal trade, and rising drug use".*[5]

The risk of drugs then, alive as it is, is allied with a larger problem. Drug runners across the border provide cover for terrorism funding. Delegalisation, consequently seeks to address this big concern.

We now turn to the next aspect. The uprooting of black money. This is the larger theme and is central to the exercise, so far. The presence or absence of black money matters as it has an impact on governance. The impact makes itself felt through corruption of governance. This, in turn, implies that black money distorts public policy.

How does it happen? While black money is clearly any income on which tax has not been paid, the rationale for building up of it as a hoard is not just to avoid tax. It is a means to create an asymmetry in favour of the holder. The holder earns an advantage in obtaining of government resources. The pervasiveness of black money can assail any level of governance from municipal to the centre. In India where resources (including non-material ones like a trade license) are not often available—at times due to state action, the ability of the applicant and the willingness of the arbiter to be bribed can be decisive. The next question is: Does this black money remain as cash or migrates to other holdings or as favours where the current exercise cannot target?

1 Demonetisation has been the term most used for this exercise. However the right term would be delegalisation as the Indian government's powers to extinguish a currency without Parliamentary approval is not clear. But it certainly has the right to delegalise a currency through an executive notification. In the rest of this Brief we use the term delegalisation. For more on this please see Subbarao, Duvvuri (2016).

2 Press Information Bureau, GOI. Available at: http://pib.nic.in/newsite/PrintRelease.aspx?relid=15340

3 *ibid*

4 National Drug Enforcement Statistics as on 31 March, 2016, Narcotics Control Bureau

5 Illegal Drugs in India and the 2016 Global Drug Policy Review- Brookings India

6 Sukhthankar and Vaishnav (2015).

"Transparency International and CMS (2005) estimate the costs of bribes paid annually for accessing various government services across India to be ₹ 21,000 crore. Hence, attention-grabbing one-off scandals may deflect attention from corruption that is just as costly, but is harder to find and measure" (Sukthankar & Vaishnav 2015).[6] What they point out is that this "day-to-day corruption" is often as big as the mega scams. The gains from this corruption is largely cash based. So there is eminent possibility that those could be unlocked in such an exercise since it targets the existing hoards of cash.

No wonder within hours of the announcement of 8 November, Transparency International welcomed the decision. "It is our earnest hope that citizens will go through this short term difficulty in the larger interest of the nation. Transparency International India support decision of the Government of India". There are therefore strong reasons to target black money.

Having established the rationale of the step, the question that emerges is as follows: Given that delegalisation has already happened, what are the range of policy options that flow from here onwards since black money is a public policy issue?

In this context, various authors have pointed out that it is important to go after the causes of corruption to minimise the generation of black money. This is important, they have argued since the current action is meant to take care of the stock. "We know that black money (currency) is only a small part of the black economy. However, this does not necessarily imply that it is not worthwhile to liquidate stocks of black money without simultaneously attacking other "illegally" acquired assets". (Kumar 2016)[7]

The stock and flow debate on black money is important but it is important to point out that in both forms they are trouble since they distort public policy. The presence of black money changes the rules of the game, as for instance can happen when a license is handed out to some one who can jump the queue. There is an opposite argument here. It is that black money plays a useful role to quicken decisions in an economy where decision making is slow and so keeps the economy working at brisk pace even in a downturn (Basu 2015)[8]. This is an ingenious argument but it does not take account of the possibility that the same results could be achieved by a fairer distribution of resources. Indeed the reason why black money emerges is because of the perceived notion about the economy that

Table 1: Banknotes in Circulation

Denomination (₹)	Volume (million pieces)			Value (billion)		
	Mar-14	Mar-15	Mar-16	Mar-14	Mar-15	Mar-16
2 and 5	11,698	11,672	11,626	46	46	45
	(15.1)	(13.9)	(12.9)	(0.4)	(0.3)	(0.3)
10	26,648	30,304	32,015	266	303	320
	(34.5)	(36.3)	(35.5)	(2.1)	(2.1)	(1.9)
20	4,285	4,350	4,924	86	87	98
	(5.5)	(5.2)	(5.4)	(0.7)	(0.6)	(0.6)
50	3,448	3,487	3,890	172	174	194
	(4.5)	(4.2)	(4.3)	(1.3)	(1.2)	(1.2)
100	14,765	15,026	15,778	1,476	1,503	1,578
	(19.1)	(18.0)	(17.5)	(11.5)	(10.5)	(9.6)
500	11,405	13,128	15,707	5,702	6,564	7,854
	(14.7)	(15.7)	(17.4)	(44.4)	(46.0)	(47.8)
1,000	5,081	5,612	6,326	5,081	5,612	6,326
	(6.6)	(6.7)	(7.0)	(39.6)	(39.3)	(38.6)
Total	77,330	83,579	90,266	12,829	14,289	16,415

Source: RBI Annual Report
Note: Bracket figures are %

7 Kumar (2016).

8 Basu (2015).

9 Ravallion, Martin; van de Walle, Dominique; Dutta, Puja; Murgai, Rinku. (2013).

10 Is inequality in Africa rising? Christoph Lakner; The World Bank, 02/08/2016 http://blogs.worldbank.org/africacan/is-inequality-in-africa-rising

11 Report of the Committee on Digital Payments, Ministry of Finance, GOI

it is not able to undertake any reform of the current arrangement of policy framework. There is a stasis.

The result of what such a statist position could do is reflected in the performance of government's anti-poverty programmes. Buoyed by such perceived unchanged position, the delivery of say, government's anti-poverty programmes would suffer. Tracking the results of an information campaign in Bihar about MGNREGA, shows this is true. The state did not make efforts to make "supply side changes" which meant goading those in charge of the programme to reach out to those who need it. As a result there is no rise in employment, which is the key result the scheme aims to generate. (Ravallion, Van de Walle, Dutta & Murgai, 2013)[9]

Example for other developing countries

As successive economies in Africa and central Asia have begun to grow faster since the 1990s they have come across the standard paradox that assails development. An IMF forecast shows Africa will be the second-fastest growing region in the world between 2016 and 2020 with an annual growth rate of 4.3 per cent. But as the Arab Spring experience in North Africa and other unrest in sub-Saharan Africa shows this hides the potential for political disruption. The disruption is fuelled by the expanding inter- country and intra- country income inequality, though there are plenty of national variations within those. The Africa-wide Gini has increased from 52 per cent to 56 per cent (Lakner)[10]

The Indian exercise can be very useful as policy pointers for these countries in this context. The usefulness stems from the prospective level of digital currency. It is also interesting as the pioneer in use of digital money is Kenya through its mPesa experience.

The lessons from the third leg of the Indian currency reform, which was nascent at the initial stage, is thus a pointer. The Indian experience, at this point shows some interesting trend. It demonstrates that instead of depending on the re-injection of currency notes back into the economy, it is possible to transport the economy to a digital currency platform. The Indian government has discovered that while there is a need to bring the use of currency back into the economy, it is not necessary to reprint the entire value of the old stock. In fact as the exercise has unfolded, the government has begun to push both micro enterprises and the citizens dependent on salary to use digital money in a more robust form. It has taken a carrot and stick approach to nudge the populace towards the goal.

> *"Digital payments is to finance what invention of wheel was to transport. It offers an unprecedented opportunity to our people, most of whom live in rural India or are migrants in big cities…access to formal financial services and benefits from e-commerce, specially for those who continue to be excluded".*[11]

In the pursuit of this rationale, the Indian government has relaxed taxes on small ticket e-currency transactions and leaned on companies to do the same. The underlying reason is electronic payments chain opens up for government inspection the pipeline of trades and profits therefrom for long distance. The data that the inspection generates creates opportunities to craft tax models that are progressive and are able to deliver. For long the governments of developing countries were hamstrung by lack of data to do so. The key to the payment infrastructure is Aadhaar. The Petroleum Ministry has linked transfer of cash transfer to LPG customers through the use of Aadhaar platform. Electronic payments create a linkage that sidesteps the limitations of weak bureaucracy.

So the power of digital payments to vastly improve the state's ability to curb tax leakages, funding of criminal activities and reduce cash related costs creates an opportunity for these and other countries which is pretty much, 21st century.

Way Forward

Delegalisation in the current form as India has attempted is the largest ever macro economic programme ever attempted consciously. It has been a huge leap of faith for the policy mandarins in India led by the Prime Minister.

- There have been and rightly so, discussions on the collateral damage to the lower income group, as we have outlined in the case of agriculture. Those are costs and possible action areas for changes.
- Within the reach of digital economy, for instance, the debate is particularly keen with

respect to agriculture and how it has fared from India's largest ever monetary sector intervention. Partially, it is also because of the disproportionately high employment load it carries. The Ministry of Agriculture data shows Rabi crop sowing is about 5 per cent more than last year—but last year was the second successive year of drought. The acreage is 9 per cent lower than 2014[12]. So there is an adverse impact of cash crunch. Where cash makes itself felt is availability of credit. Interestingly since 76 per cent of total outstanding agro-credit came from banks (excluding cooperative banks) and all of which issue Kisan Credit Cards, it is an easy fruit to migrate to digital banking. But this would need Points of Presence in villages to be ramped up massively—and make it effective by seeding the accounts with Aadhaar. It is here that the centre and the state governments' response to the crisis will be measured the most (Gulati, 2016)[13]

- The Advance Estimate of GDP for 2016-17 is 7.1 per cent.[14] Within it, 'agriculture, forestry and fishing' sector is expected to show a growth of 4.1 per cent in its GVA (gross value added) during 2016-17, as against the previous year's growth rate of 1.2 per cent. There is criticism against these numbers like the following from rating agency, Crisil: "There are only a handful of indicators for the fiscal's third quarter that the CSO could have looked at, to arrive at the full year forecast now, such as agriculture production and sowing data, government expenditure, sales tax etc. For most of the non-agricultural parameters, data is available only till November, which wouldn't have fully captured the impact of demonetisation".

  This is true. By the same logic there is equally little evidence to deduce the reverse, viz a slowdown, more than what that CSO has estimated. The GVA estimates of this sector have been compiled using the First Advance Estimates of production of major Kharif crops for 2016-17 and targets based on rabi sowings. Till more data arrives, this is the best estimate, as of now.

- What has not been flagged is the damage to segments of the upper income groups as they have been forced to redo their financial arrangements in full glare of the state. The most tell tale pointer to the efficacy of the government move is the reported drop in the sales of luxury cars, and costly tickets of real estate. If as the apologists have claimed that black money is hardly if ever stored in cash, then there would not have been a precipitous decline in the sales of these items. There was a high percentage of such sales conducted in cash, and obviously despite the income tax department's instruction to quote PAN (permanent account number) for them the instructions were disregarded. It is the first among other pointers of distress for segments holding black money. The pressure points built up here should persist.

- Going ahead from here, there will be certain imperatives that will demand attention. Data as those of high end cars and real estate sales will now come up regularly with the tax department. The Indian government has rightly set in motion the income tax machinery aided by the disclosures made to the banks to unearth black income. It is essential that this focus does not flag. As a recent media report showed the percentage of successful prosecution by the revenue department has been abysmal. In 2014-15 show the department put up 669 cases for prosecution of which the charges stuck in only 34 or just 5 per cent. (Bhattacharjee 2016)[15]

- In fact prosecution for not just tax offences, but for those in say, state owned firms who have been chargesheeted in vigilance cases, should also wound up fast. The interminable delays in India's judicial system has been cited as one of the chief reasons for the country not managing to improve its position in the Ease of Doing Business. Advancing on the index is helpful not as much for big business which in any case find out ways to get their ways, but for the millions of micro and small business. This is where the ability of the courts to hand down fast and efficient justice will be a critical component to make people feel that the benefits from demonetisation has been harnessed well.

- What would be the impact of delegalisation on government finances? The benefit for the government comes through opening up of more space for borrowing; it helps banks since they are in any case flush with

[12] Rabi Crops Sowing Crosess 327 Lakh Hectare; Press Information Bureau; http://pib.nic.in/newsite/PrintRelease.aspx?relid=154378 25 November 2016

[13] Gulati, Ashok & Hussain, Siraj (2016).

[14] http://mospi.nic.in/sites/default/files/press_release/nad_prn_6jan17.pdf

[15] Subhomoy Bhattacharjee (2016).

[16] ibid

The standard argument about the Indian government is that it performs at its best only when there is a crisis. The delegalisation experience has been a demonstration that this need not necessarily be so. There was no crisis before 8 November 2016. The government actions since then has been a demonstration that it can take myriad actions and involve vast swathes of the bureaucracy, to pursue a thought through goal for the economy. To the extent that other nations of the South would want to administer this tough medicine, it is imperative for the Indian state to be seen to have got it right.

funds. This is a huge escape route from the fiscal dragnet that the Finance Ministry is wrestling with. Also as the cost of printing money comes down and digital money expands the government's revenue would expand (think of the service tax and other fees each transaction can potentially create)—it is something which has not even begun to be mapped. In subsequent years this will be a sizeable gain for the government.

- For the middle class, it matters when the limits on cash withdrawals are relaxed. The earlier it is the better it will be, all round. The limit on restrictions is like higher price for cash, as it encourages those with resources to try to buy more cash (hoard it)—makes cash like Giffen goods. Very little of the money given out by the banks has returned to them as people sacrifice transaction role of money substituting it as store of value. An interesting way to counter this build up would be to relax the limitation on withdrawals as a counter intuitive move.
- For over 25 crore first generation Jan Dhan account holders the adverse publicity surrounding the accounts has been a collateral damage. The Pradhan Mantri Jan-Dhan Yojana (PMJDY) till recently has been the biggest success story in financial inclusion. The government will need to double down to popularise the idea that only few accounts were compromised and the overwhelming majority of the accounts, by and large, will not face more scrutiny at this stage and are rather to be encouraged.
- This in turn should also open up the space for clearing up the regulatory maze that India has often been characterised as. Corruption is seen to be most acute in those sectors where the regulatory footprint of the state is the greatest (Sukthankar)[16]. It has often been seen as the result of poor enforcement ability of the Indian state. The current exercise is a demonstration of turning this aphorism upside down.
- And finally, it is essential that the push for introduction of GST as per the stated time table should not flag. Reforms in sales tax transactions are possibly the biggest piece of reforms in the Indian state with the capacity to throw up gargantuan data on evaded income. Currently stamp duties including those on real estate are to be kept out of GST. But given the possibilities that has been opened up by the current delegalisation exercise, it will be sagacious for the states to demonstrate their commitment to cut down on black money by bringing stamp duty also within GST.

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