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Demonetization: politics trumps economics

The possible macroeconomic consequences of demonetization are cause for concern as cash is the lifeblood of the economy

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It is exactly one month since Prime Minister Narendra Modi announced the decision that Rs500 and Rs1,000 notes would cease to be legal tender acceptable for payments in settlement of transactions. There was some provision for exchange or deposit of old notes at banks, but with specified limits on sums and time.

The past century has witnessed several demonetizations, when governments have decided that existing national currencies, guaranteed by the sovereign, are no longer legal tender. It has happened in: (a) countries that have experienced hyperinflation—where inflation rates are measured per week or per month rather than per annum—such as Germany in 1923 or Argentina thrice in the 20th century; (b) countries on the verge of economic collapse, such as Zimbabwe in 2015; and (c) countries in deep economic or political crises, such as Ghana in 1982, Nigeria in 1984, Myanmar in 1987, Zaire in 1993 and the USSR in 1991. In most, outcomes were failures, if not disasters.

The situation in India is completely different from what it was in these countries at the time of demonetization. The economy is characterized by rapid growth and price stability. The polity is a vibrant democracy with an elected government. Hence, past experience elsewhere has little relevance. Yet, history matters.

What, then, is the rationale for demonetization in India? The stated objective is economic. The government hopes to eradicate black money, as also combat corruption, smuggling, and counterfeit notes. The unstated objective is political. The government, exactly halfway through its five-year term, concerned about perceptions that little had changed, wanted to do something bold. For the Prime Minister, there is also a pro-poor populism, in acting against the rich who evaded laws, and in reaching out to people directly, without any intermediation through his political party. The state elections to come in early 2017 are part of the same political calculus, not only because Modi wishes to be seen as a man of the people, but also because demonetization will wipe out any hordes of black money held in cash by opposition political parties. Of course, it must be recognized that economics and politics, closely intertwined, are inseparable. Indeed, their interaction is likely to shape future outcomes.

The implementation of the demonetization decision requires evaluation, even at the end of one month, because it has affected the lives of most people. The logistics of this exercise would have been tough in a perfect world. But it is exceedingly difficult in a situation where 86% of currency notes in circulation have been withdrawn at one stroke in what is essentially a cash economy. Poor implementation has made the situation far worse. The replacement notes, either unseen (Rs500) or of little use (Rs2,000), are scarce. Millions have queued at banks and ATMs, which do not have enough cash. Getting one's own money is an elusive quest.

Frequent changes in rules about what a citizen can or cannot do suggest day-to-day reactions rather than prior planning. The stipulated limit on exchange of old notes for new at banks has been changed thrice and the facility has been simply discontinued five weeks before the announced date. The acceptance of old notes for specified transactions, at petrol pumps, pharmacies or public utilities, has been introduced and withdrawn in a haphazard stop-go manner. The regulations about the deposit of old notes at banks, or the limits on what people can withdraw from their own accounts, have kept changing. The ground was simply not prepared.

What does demonetization mean for ordinary people? Some essential facts provide part of the answer. In India, just 53% of adults have bank accounts, but two-fifths of these accounts are dormant. And only 15% of existing bank accounts are used to make or receive payments. Bank penetration would have been far less but for the 250 million accounts that were opened under the Pradhan Mantri Jan Dhan Yojana (PMJDY) during 2014-16, of which 60 million accounts have zero balances even now. It is clear that almost half our population has no access to the banking system, and an even larger proportion does not use it.

Thus, an overwhelming proportion of economic transactions—more than 95%—are in cash. This is particularly true of rural India, home to more than two-thirds of our people, where the density of bank branches and ATMs is less than one-fourth that in urban areas. It is just as true of the informal economy in urban India—construction, wholesale retail trade, hotels and restaurants, domestic services, transport, and small-scale manufacturing—where sales and purchases are mostly in cash; so are wages. Given this reality, the quest for a cashless economy could be futile, even if we assume that everyone can buy and use smartphones. It is a noble idea, but its time has not yet come.

It is no surprise that this massive *notebandi* has disrupted lives. The demonetization of Rs500 notes, which constituted about 46% of cash in the economy, has been particularly damaging, since these are the medium of exchange in the market and store of value at home for most ordinary people. It would serve little purpose to recount stories of difficulties faced, or tragedies experienced, by people without money in hospitals, pharmacies, and bank queues. There is widespread distress in rural areas and much hardship in towns and cities, particularly for the poor. Even if the object is to penalize the dishonest rich—the idea has popular support—should 99% of people pay this price for punishing the guilty? The irony is that their own money is now being rationed to people by government. The inconvenience is turning into irritation. If cash remains scarce for long, it could turn into resentment and anger.

The economics underlying demonetization has three flaws. First, all black money is not held in cash, and all cash is not black money. Political



real economic activity. Consumption expenditure in the economy will drop sharply, for ordinary people starved of cash, and for the rich who cannot spend their black money on eating-out, luxury goods or tourism. Investment simply cannot pick up with this massive liquidity crunch, which means no cash for the informal economy, and erosion of investor confidence. Output will contract. So will employment, as workers are laid off, hurting livelihoods and dampening consumption demand to reduce output further through multiplier effects. Economic growth, already stuttering, is bound to slow down. Gross domestic product (GDP) growth projected for 2016-17 will not materialize. Even when things return to normal, macro-economic effects might linger and dampen growth for longer.

What does this mean for the government? The total value of demonetized notes is about Rs14 trillion, and Rs11.5 trillion has been deposited, while Rs350 billion has been exchanged, in banks. People can continue to deposit old notes in banks until 30 December and with the RBI until 30 March. If the total amount that is exchanged and deposited is less than Rs14 trillion, the difference would accrue to the RBI as a windfall gain since its liabilities would be reduced by that amount. In principle, reduced liabilities on balance sheets are not transferable to the profit-and-loss accounts. But that might be possible as the RBI is not a corporate entity. If this sum is treated as a surplus of income over expenditure, under the RBI Act, its board decides how much of the surplus can be paid to government as dividend, keeping in mind its responsibility for macroeconomic stability.

It is not possible to predict what the reduction in RBI liabilities will be following demonetization. Much will depend on the ability, or ingenuity, of people to move their cash holdings into bank deposits. The obvious avenues are deposits of less than Rs2.5 lakh, cash-in-hand held by small businesses, and the agricultural sector which is income-tax-exempt. In three weeks, Rs365 billion has been deposited in PMJDY accounts, almost doubling total balances. Laundering old notes at a discount is a new business. The government, worried about such leakages, introduced yet another amnesty scheme on 28 November, which allows cash deposits in banks without limits until 30 December, but 50% is payable as tax-cum-penalty and another 25% is placed as a zero-interest four-year deposit.

Obviously, politics trumped economics in the demonetization decision. But Modi has taken a big gamble. And the stakes are high. If the negative consequences for people and for the economy persist, or become worse, economics might trump politics. Will it? The actual outcome is uncertain, unpredictable and unknown. Perhaps only the results of the forthcoming state elections, especially in Uttar Pradesh, will reveal what people really think.

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parties, corrupt government officials, lawyers, doctors, traders or builders, might keep some black money in cash, but more than 90% is in the form of gold, real estate, foreign accounts and used in consumption or business expenditures. Similarly, less than 10% of cash in the economy would be black money. Second, it is very difficult to separate black money from white money because the distinction is not once-and-for-all. White money used to purchase something becomes black if the shopkeeper does not pay sales tax but could become white again if he then buys something with it for which he is billed with tax. Third, demonetization would indeed wipe out stocks of black money held in cash if it cannot be laundered. But it could be business-as-usual with new notes as flows of black money resume, unless there are changes in government regulations or behavioral patterns of individuals and institutions that induce such transactions.

The possible macroeconomic consequences of demonetization are cause for concern. Cash is the lifeblood of the economy, 86% of which is gone, while complete replacement could take months. This shock-therapy is bound to disrupt

drawbridge

