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Demonetisation: Oxymoron or New Economic Movement

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Abstract

Black money is like steroid which boosts up economic growth at a cost of long run damage to our economic and social health. The parallel economy in our country is not only huge in its size (over ₹ 30 lakh crore, 20 % of our GDP) but also well networked. Nexus with political bigwigs and administrative officials (Recall involvement of RBI officers in black cash laundering) widens and strengthens this network. Demonetization is expected to strike a heavy blow to this corrupt parallel economy. Experts remain divided over the economic gains of demonetization in the short as well as the long terms. In this paper we have shown that demonetization move will act as an elixir to remedy most of the economic and social ills of our country both in the short and the long runs. It will be shown in this study that once the economic transactions in the country are made transparent economic growth will shoot up and the Indian society sulking under traditional unhealthy conditions will surge ahead. Major technology driven initiatives taken by the government over past two-and-half years including the financial and tax reforms will usher in a new economic movement breaking status quo of jobless growth.

Keywords: *Benami* Property, Black Economy, Cashless Economy, Demonetisation, GDP, High Denomination Bank Note, Jan Dhan Yojana, *Notebandi*

1. Introduction

Eight-eleven is a startling day to Indian economy which witnesses a dare step taken by a democratic government, known as demonetisation. This is de-legalization of ₹ 500 and ₹ 1,000 banknotes in India after 9 November 2016. Government of India aims to crack on black money, counterfeit currencies, corruption and financing of terrorism and activities threat to national securities. India is shaken. Experts split up over the impact and policy implications - Amartya Sen, Larry Summers, Paul Krugman, Steve Forbes have criticized the move and contrarily, Jagdish Bhagwati, Ken Rogoff, Jean Tirole, Muhammad Yunus view it as a bold and major reform.

In this short article, we investigate how demonetisation drive benefits our economy in the short run as well as long run with a special reference to Indian industrial sectors.

2. Cost-Benefit Analysis and Beyond

Let us examine to what extent demonetisation is a 'monumental mismanagement'.

Firstly, experts in majority opined that short run gain will be wiped out by its cost in the line Chidambarmian explanation. P. Chidambaram, Ex-finance Minister in his article[6] argued that demonetisation will cost 1% of GDP, i.e., ₹1.5 lakh crores due to loss of economic transactions and cost of printing new money. Gain is only High Denomination Bank Note (hereafter HDN) which will not return to the system which he estimated as ₹ 1.4 lakh crores. Therefore, loss will simply wipe out gain. In reality, about Rs 14.5 lakh crore demonetised currency have been deposited with banks[17] keeping only ₹ 75000 crore out.

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Therefore, by the same logic, loss to the economy amounts to₹ 0.75 lakh crore (1.5 lakh crore minus 0.75 lakh crore).

But is the logic so simple? Report says ₹ 3 - 4 lakh crore untaxed cash have been deposited with the banks in disguised form of various accounts[26]. If minimum 50% penalty is imposed on disclosed black cash, a gain will be ₹ 1.5 - 2 lakh crore and an additional tax of ₹ 1 – 1.2 lakh crore will come at a 30% tax rate in perpetuity from these higher income groups. Total gain is at least ₹ 3 lakh crore in the short run confirming huge success to the drive.

Let us examine alternative (long run) arguments of the policy. Economists worldwide warn against volume of HDN. Nobel laureate Paul Krugman, said 'there is really a good case that high-value notes are a bad thing in a modern economy and serves no legitimate purpose'. S. Gurumurthy observed that only 34 percent HDN out of total cash was held by the public in 2004, which rose to 79 percent in 2010 and 87 percent in 2016 with an annual growth rate of 51%. As a result, asset price (land, real-estate, gold and stocks) increased several times more than the growth of money supply. He argued, the unmonitored HDNs roaming outside banks began driving up the gold and land prices by black cash and the stock prices which were largely *hawala* transfers. HDNs outside banks took refuge in stocks, gold and land, produced capital gains-led growth and consumption. The fake wealth effect, powered by HDN cash, scripted high volume growth story of India but miserable employment creation. Indian drive of demonetisation will simply break the status quo of asset inflation-inspired jobless growth.

Apart from breaking the well-nourished status quo of jobless growth, we examine the other implications. Why there is a unanimous welcome from the corporate sectors towards demonetisation drive inspite of short-term downfall? Business houses always look for a transparent, cleanser and competitive market. We should not forget that shadow of black economy and high-end corruption retard entrepreneurial growth. Sudden flood of deposits into financial system will reduce cost of capital. Diversion of more funds into investments driven by lower cost of capital will boost up capital formation and economic growth. Cleaning up of the system will add substantially to the per capita GDP. Ambit's Saurabh Mukherjee, an eminent analyst has predicted that within 3 years this move could lead to an increment of 3 percent in the annual growth rate.

Secondly, 'Cost of Cash in India' commissioned by MasterCard highlighted the Reserve Bank of India and commercial banks annually spend around Rs 21,000 crore in currency operations costs. The burden is unique since India is among the most cash-intensive economies in the world with a cash-to-GDP ratio of 12%, almost four times as much as other markets such as Brazil (3.93%), Mexico (5.3%) and South Africa (3.73%). 'Innovations in the electronic payments space not only deliver greater transparency but more importantly, they simplify transactions, enhance security, increase efficiency and have the potential to dramatically reduce costs," said Vikas Varma, area head, south Asia, MasterCard.

3. Demonetisation and Black Economy

Demonetisation sucks out the blood of parallel economy. Black economy uses very less money or no money in terms of credit. Have you ever heard anybody paid bribe in credit? In the short-run, demonetisation has simply dried out the well-greased parallel economy including counterfeiting, smuggling, terrorism, women-trafficking etc. The crushing of black economy will happen as it needs hard cash to operate. For instance, *hawala* transactions drop by almost 50 per cent post-demonetisation as per recent assessment by the central intelligence agencies. The move has also resulted in choking of fake currency for terror financing (terrorism-related violence in J&K has dipped by 60%). Over Rs 90 lakh has been seized from Maoist cadres/supporters since scrapping of high-denomination currency notes. Demonetisation has also stepped up pressure on CPI (Maoist) cadres to surrender in large numbers.

Demonetisation has crippled the parallel economy that thrived majorly around gold and real estate businesses. Surjit Bhalla, eminent economist of the Financial Express said demonetisation is a Big Bang reform - one of the more endearing, and enlightening. He noticed a truly shocking fact, just revealed by the government, that 6 million units (individuals, small firms and NGOs) have deposited a total of Rs7 lakh crore of the banned notes - an average of Rs. 11 lakh per unit. India 2016 is very likely to go down in history as comparable to China 1978.

Noteworthy, demonetisation not only sweeps out 12% of black money held in the form of cash (4 lakh crore) but opens up the Pandora's Box to reach out the remaining 82% of Non-cash Black money holders. Income-Tax Department does not require shooting out at dark.

Deposits of black cash disguised in white uniform trails a root for unearthing of even largest sources and schemes of corruption. Government has the time and mechanism to chase the culprits. *Benami* Property Act is one of the instruments towards non-cash black money. Prime Minister Modi in his *Mann ki Baat* address said "The law against *benami* property was passed in 1988 but it never got notified. However, this law will be put to use in the coming days to fight corruption. We have reshaped the laws in *Benami* Property Act with strong provisions."

4. Cashless Economy - Daydream or Reality

Demonetisation is a squirm to the economy which propels the speed and attitude of the Indian customers (sweat-earner in majority) towards cashless economy. We should have remembered that the objective of the cashless economy is not a fuss but inevitable future - tracking the accounted transactions, monitoring the capital market and applying the central-bank interventions to exercise money control instruments.

Experts argue that cashless economy is a day-dream in a poor, illiterate country like India where half of the population has no bank account. First of all, cashless economy is not an illusion - countries like Belgium and France are dominated by cashless economies where transactions, according to reports, are as high as 92% cashless in nature. Canada is 90% cashless, even poor country Kenya is 75% cashless.

Table 1. Calculation for Unbanked Indians

Unbanked Indian Adults (Word Bank's Global Findex Database, 2014)	42 Cr.
MicroSave research estimates new accounts opened for the first time bank goers in 2015	14 Cr.
Total unbanked adults in 2015	28 Cr.

Calculation: Authors' own

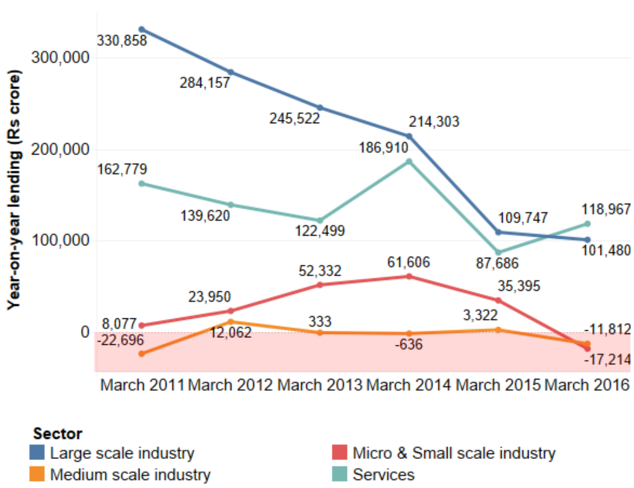
Let us estimate coverage of Indian population in terms of savings bank accounts. RBI statistics released in March, 2016 shows that total number of savings bank accounts in India is 117 crore in 2015 out of which 144 crore was under Pradhan Mantri Jan Dhan Yojna (PMJDY). In 2015, only 28 crore or 22% of total Indian adults till remain unbanked (See Table 1). Noteworthy, if we add up 33.97 crore Post Office Saving Bank Accounts (Feb, 2016), picture of financial inclusion looks brighter – 2 per capita accounts (75 Crore adult Indians). This is quite contradictory to the common perception that half of the Indian population does not have access of bank accounts.

India is ready to embark towards cashless economy with 40 crore smart phones, over 94 crore debit cards and near 9 crore credit cards with transactions amount ranging between Rs 2.6 and Rs 2.9 lakh crore. Google-BCG (Boston Council Group) research expects that by 2020, digital transaction will be around 35 lakh crore rupees and cashless economy will move to 40-45 per cent of consumers payment by 2025. Online marketing of products will lead to sharp increase in the sale of the goods, as internet users will instantly know about the new goods, their uses, features, prices etc. and will place orders with the online marketing organizations and make payment online. The prices of the good supplied on-line are in most of the cases cheaper than the goods purchased from nearby accessible market places.

5. Role of Banks

Technology has become a key driver for financial inclusion. Driven by technology, payment systems, which have long been viewed as a 'background activities', have now become central to the day-to-day activities of the entire economy. The disparities caused by advancements of technology means that banking method has had to be reshaped to suit the new environment. Current generations are no longer satisfied with cookie-cutter banking. In the age of fast internet connections and powerful smart-phones, banks have restructured their models to ensure that they provide service is quick, excessive, flexible, personalised and relevance.

Loans to different sectors have declined during the last six years. The NPAs of public- and private-sector banks were around Rs 6 lakh crore as of March 2016. Declining demand due to economic recession and stagnation of existing industrial capacity has been contributed to the rising NPAs. If NPAs rise, capital gets eroded, forcing banks to lend less. Credit to the corporate sector (manufacturing and services) declined 60%, from Rs 4.7 lakh crore to Rs 1.9 lakh crore over six years (See Figure 1).



Source: RBI Data [*See, cit.19*]

Figure 1. Lending to Industry and Services 2011-16.

To help banks meet a minimum cushion of liquidity, the finance ministry in August 2015 said that PSBs would need Rs 1.8 lakh crore capitals over the next four years. "State banks are dependent on the government for capital but capital injection by the government is not sufficient to address capital needs," said Vishwas Utagi, secretary of the All India Bank Employees Association (AIBEA), "With markets on the decline, the prospect of raising capital from the market looks weak."

Out of the blue, demonetisation appears as a boon to the banks reviving from capital erosion. Rising deposits triggered by Figure 1. demonetisation could lead to Rs 38,000 crore treasury gains for PSBs, according to this report from India Rating & Research Credit Agency, which would allow PSBs to meet their minimum capital needs.

6. Demonetisation, Economy and Corporate

Demonetisation, called a 'Surgical Pokhran' towards Indian business – delegalising 86% of HDNs leads to drop in current consumption drastically which ultimately reduces market demand and growth. India faces a strong financial hardship during the transition period for first three months till the re-printed new dominations meet up the currency transaction demands, and partly, digital currency takes its own course.

Let us examine the outlook of Indian economy in post-demonetisation period, particularly with reference to the corporate sectors. Economy is steadily getting back on its feet and poised for good growth in the quarters ahead after a tumultuous period. CSO data released on 28 February, 2017 confirms that India recoded a growth of 7.0% 2016-17Q3 (Oct- Dec 2016) at constant (2011-12) price against an advance estimate of 7.1% for the same.

In November 2016, contrary to expected slowdown, Index of Industrial Production (IIP) Industrial production grew by 5.7% compared to a fall of 3.4% in the same month previous year. Factory output grew in November 2016 due to better performance of manufacturing, mining, electricity and capital good (See Table 2).

Table 2. Percentage growth in core sectors

Sector	Nov, 2015	Nov, 2016
Electricity Generation	0.7%	8.9%
Mining	1.7%	3.9%
Capital Goods	(-)24.4%	15%
Consumer Goods	1.3%	5.6%

Source: CSO (See *cit.* 12)

Balance of trade has shown substantial improvement - export grows by 5.72% in December 2016 at $23.9 bn compared to $22.6 bn in the same month of last year. Trade deficit reaches at lowest $76.54 bn as against $100 bn during the nine-month period.

Moody's Corporate Finance Group Managing Director Laura Acres said, "Strong GDP growth, capacity additions and stabilizing commodity prices will support EBITDA growth of 6-12 per cent over the next 12-18 months". Exploration and production companies reflect higher production volumes, low subsidy burden and recovery in oil prices, which will offset lower natural gas prices and higher royalty payments, whereas, power, hotel and sugar industries is stable while that for the real estate (41% downfall noted) and cement sectors is negative.

The World Bank said that the 'adverse effects' of demonetisation in India will disappear in the medium term. "Any reform has short-term costs but ultimately reforms will bring long-term gains. In the case of India, we expect whatever the adverse effects of these changing of notes to basically disappear in the medium term," Ayhan Kose, Director of Development Prospects Group at the World Bank told reporters during a conference call. World Bank is expecting growth picking up over the period FY18 and FY19, supported by private consumption, infrastructure spending, and a rebound in investment growth.

Credit rating agency CRISIL, a critique of demonetization, also reported that steel product companies are expected grow at a high 25% and robust export growth. Power, steel products and pharmaceuticals are expected to record better operating margin compared with last year. The aggregate revenue of large formulation firms is also expected to up by 11%.

Assocham said Modi's steps extremely positive for economy. Raising credit guarantee limit to Rs 2 crore will support SME and MSME sector. Tax-waiving scheme for farmers, interest subsidy and low-cost housing together will enhance fast recovery of Indian economy from initial set back. Considering that post-demonetization there has been a substantial surge in deposits, resultantly banks have started reducing interest rates and further rate cuts will only revive consumption demand and reinvigorate the investment cycle.

According to the quarterly EY Global IPO Trends, India has recorded a 38% increase in deal volume with 83 IPOs raising $3.8 bn in Oct-Dec, 2016 while world witnesses a fall of 16% in IPO numbers and capital is down by 33%. The EY report says 'the activity looks set to remain strong driven by a combination of high investor confidence and regulatory reforms'.

Impact of Post-demonetisation growth trend has been presented in the Figure 2. Responses from different industrial growth show that economy is recovering very fast from initial setback. Question is whether new equilibrium will take up Indian economy towards a higher steady-state path of development or not. Otherwise, entire effort will turn in vain.

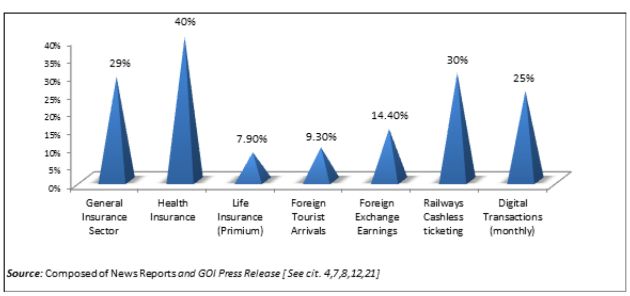


Figure 2. Post Demontisation Growth Trend in Selected Sector.

7. Towards a New Economic Movement

Let us examine the five pivotal initiatives undertaken by present government. Make in India (to boost up investment and entrepreneur growth), Skill India (to meet up need for new-generation human capital), Digital India (movement towards cashless or less cash economy) along with two major reforms – financial and tax system.

As depicted in the Figure 3, the interdependence and inter-relations among the five initiatives reflects that financial reforms and tax reforms promotes investment and growth (Make in India and Start-up India) supported by technological drive (Digital India) and employability drive (skill India). The network of these five drives, complementary to each other, takes off towards a new economic movement and India will soon be bestowed with two-digit inclusive growth.

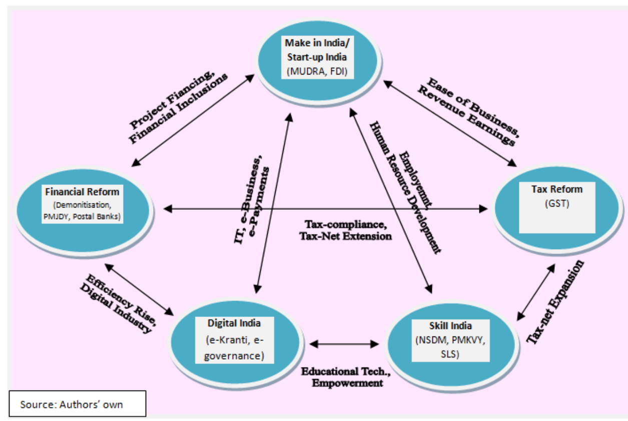


Figure 3. Comprehensive network of new economic movement.

8. Conclusion

Demonetization is a gradual process towards cashless economy. The move to be effective is twofold – firstly, Note-ban is the first strike prior to succeeding sequential actions to be taken constantly to combat well-structured black economy (e.g., strike on non-cash black assets, punitive actions towards tax-evaders, realign fiscal policy, build financial infrastructure, create trust on digital mode of payments, etc.) unless it get defunct, second, channelizing the captive resource towards growth and development (substantial investment on social and physical infrastructure, promote entrepreneurial activities, tap global market share etc.).

Corporate finds it easy to operate in a formalized, transparent and technology driven economy. This is the time to plunge over black money hidden in different forms of assets or hedged in foreign bank accounts. Demonetization has opened up the root towards the black money. It is utmost important to take the control of financial market of India to devise policy by the government. A pro-growth, pro-job development strategy, not freebies, accompanied by transparent, strong and well-organized governance can bring long run prosperity.

There is a clear indication that Indian economy is recovering from its temporary setback of demonetization towards a new and higher level of growth-path. Government initiative towards digital economy preceded by schemes Make in India, Skill India, Financial Inclusion and Tax reform has created a well structure network for new economic movement. Financial reforms and tax reforms promotes investment and growth supported by technological and employability drives.

This is the time for common man to smile.

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