Cash Shortages and Black Money: A Look at India's 2016 Demonetization Effect, One Year Later

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Abstract of, "**Cash Shortages and Black Money: A Look at India's 2016 Demonetization Effect, One Year Later"**

The decision of demonetization announcement on November 8th 2016, by the Prime Minister of India, Mr. Narendra Modi, was surprising to the general public and controversial to the economic thinkers. While the opponents of such a step have gone through actual calculation of the cost of demonetization in terms of potential GDP loss (2% as predicted by the former Prime Minister and Oxford Economist, Manmohan Singh) some supporters have pointed out the big benefits of this step. In recent days a talk of demonetization has become a "hot potato" that very few want to hold on to. Politically this has become a subject of acute contention and disagreement with some friends turning into foes just for the position they hold on this issue.

In this paper we want to be economically eclectic, and attempt to analyze the real economic costs and benefits of this experiment by keeping away from politics. We intend to ask questions such as, why was this done? What were the consequences faced by the general public when this step was taken? Did we achieve the objectives? and What are the economic opportunity costs of doing this in future? Of course, we do not think that anyone can find all the answers, but the investigation itself is considered to be worthwhile.

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Introduction:

The Oxford English Dictionary defines the verb demonetize as "deprive (a coin or precious metal) of its status as money" – though in the case of India it was to deprive the then current two top denomination notes in circulation of its status as money – namely the 1,000 and the 500 rupee notes.

This demonetization action was a surprise announcement made by the Prime Minister Mr. Narendra Modi in a televised speech on the evening of November 8, 2016. There were three intended consequences of this act. The first was to target the proliferation of "black money" in the Indian economy. Black money is the term employed to indicate illegal (or unreported and untaxed) income in the economy. Estimates of the amount of black money in India have always been guesswork as no reliable metric can be determined to account for this statistic. In an economic survey, the Government of India has used the differences in the "soil rates" of the higher currency notes relative to the smaller denominations to estimate black money – admittedly an unreliable measure.

The second intended consequence was to make it harder to counterfeit the currency as well as hopefully trap the current batch of counterfeit notes from entering the legal economy – as counterfeiters would not be able to document the source of their income to exchange old notes for new. The Indian secret service has been of the opinion that terrorists infiltrating India by crossing the borders have been a source of the majority of the counterfeiting detected in recent years.

The third and not necessarily least important consequence was to hamper and reduce the terrorist activity on Indian soil. To do that the assumption was that the terrorists were using cash payment for terrorist activities channels, details of which are also obscure. This paper is an attempt to document the immediate consequences of the demonetization action as well as to determine the effect about eleven months later.

Section 1: Consequences of Demonetization

The first thing to reflect on is that while the Indian economy has grown tremendously in the last three decades, the structure of the Indian economy is very different from those of Western developed nations. One such major difference is of the need for cash payments in India as compared to western nations. According to reports by Boston Consulting Group and Google India, about 75% of the transactions in India are cash based. It is to be noted, cash payments do not necessarily mean illegal payments. Indian residents make cash payments for a lot of things, legal or illegal, because using cash for these transactions is perceived to be quick and convenient. In rural areas, it is not easy to cash the checks, and cash is seen as the better substitute for convenience. How different is that from say the United States? A recent CBS News report cites a national study to say that in the USA “cash accounts for a relatively small share of total consumer transaction activity at 14 percent.” As one can surmise, the impact of withdrawing currency notes from circulation in an economy is clearly a factor of how much cash is needed to complete transactions. Reportedly, more than 300 million working adults in India had no bank accounts at the time of the demonetization. (This is despite the efforts of current government's "Jan Dhan Yojana" that invited citizens to open bank accounts with zero balance to start with).

In fact, economists often differentiate between the cash based sectors (monetary) and the non-cash based (informal monetary) sectors of the Indian economy. The cash based sector of the Indian economy employs about 50 percent of the total workforce. The laborers are often unskilled or semi-skilled, illiterate, and paid daily wages with which they manage to run their household expenses. Maybe illiterate is the wrong term – for many may be able to read a newspaper or write a letter – but certainly we can assume they are uneducated in the knowledge of using debit or credit cards and operating bank accounts.

What was the impact on system liquidity with the act of demonetization? According to Reserve Bank of India sources (cited by The Wall Street Journal), in March 2016 the 1,000 and the 500 rupee notes totaled 24.4 billion pieces (about 24.4 percent of the total notes in circulation) but in total value they formed 86.4 percent of the cash value in circulation (about14.2 trillion rupees, or approximately $ 210 billion USD).

The immediate effect of such a sudden withdrawal of 86% of cash value in circulation was to create extreme shortages of cash. There was insufficient cash to stock ATMs, foreigners visiting India were limited to cashing only about $65 USD per day per person, while residents were allowed a limited amount of money in demonetized notes per day that could be exchanged at their local bank branches for the new 500 and 2,000 rupee notes. Invariably, this led to mile long queues at banks, often with more than one family member lining up simultaneously, so as to increase the amount per household that could be exchanged. While in the main, people were grumbling, yet most tended to accept their lot and waited for hours somewhat patiently. There were a few instances where tempers flared and minor fisticuffs broke out when banks ran out of the new notes and so could not exchange the old ones for those who had already spent quite a while waiting in line.

It is clear that in the immediate short term, there was a lot of turmoil and disruption of day-to-day transactions and a significant impact on cash-based business transactions such as small scale manufacturing like cotton looms. These businesses were unable to pay their daily workers so had to lay them off, and some of the workers on losing their jobs returned to their villages. Besides hampering new production, the lack of cash led to a lot of unsold inventory piling up in the cash sector. Thus, loss of revenues for cash-based businesses was immediate, future prospects of recovery at that time was unknown.

About two months after the demonetization announcement, The Times of India, dated January 4, 2017 had a headline: “97% of scrapped notes deposited with banks as on Dec 30: Report.” So, given this tally is accurate, as far as capturing the black money in the system – the demonetization cannot be said to have achieved its objective. While we mention earlier that no accurate figures of the black money in the Indian economy can be definitely stated – it is safe to assume that it must be significantly more than the 3% of the scrapped notes not deposited back into the banking system.

What about the second intent – of making it harder to counterfeit the higher denomination rupee notes? A headline in Hindustan Times dated February 23, 2017 said, “Fake Rs 2000 notes of ‘Children Bank of India’ dispensed from SBI ATM in Delhi. Within three and half months, counterfeits of the new notes had infiltrated the government bank ATMs in the capital city. The earliest reports of counterfeits of these new note though was in an Ahmedabad Mirror article dated November 22, 2016 which said, “Even as Rs 2,000 notes printed by the Reserve Bank of India (RBI) are yet to reach banks everywhere, the first fake note of this denomination has surfaced in Gujarat.” The problem lies in that the new 500 and 2,000 rupee notes have no special security features that would make them hard to duplicate. Whether the amount of counterfeiting post-demonetization will be less than earlier remains to be seen – however these incidents do highlight that counterfeiting of the new currency has already been implemented by criminals.

Regarding the third intended impact – that of reducing terrorist activity on Indian soil-, it is too early to judge as the terrorism is an ongoing long term problem. One shot remedy for it is not only ineffective, but also somewhat academic. One can hope that in the long run shortage of cash will definitely have hampered the terrorists’ planning activities and thus help reduce their evil actions in future.

The notion behind the demonetization was conceptually a good idea but it would be fair to say that there were flaws in its execution. In the October 2017 podcast, Professor Satish Deodhar has cleverly defined the black money transactions and other objectives of demonetization, and he has given some important justifications for the demonetization attempt. (see Deodhar (2017) in the reference list).

In a recent TV interview however, ex-Finance minister of the Congress party, Mr. Arun Shourie has responded with a scathing attack on the demonetization attempt. Opponents of demonetization including Mr. Shourie, have pointed out that the growth rate of nominal GDP has slowed down to 5.7% in the second quarter of 2017, which was as expected by Ex-Prime-minister Manmohan Singh in November 2016. It is either remarkable or coincidental that his forecast has come close to being exactly right about this slowdown of the economic growth rate. Some others (basically the political proponents of demonetization, and economists aligned to ruling Bharatiya Janata Party (BJP) of Mr. Modi), however argue that this decline in growth rate could be a combined result of newly launched Goods and Services Tax (GST) which is taking a long time to be adopted correctly, and jury is still out if this new tax system has saved any headache for tax payers. One thing is true is that in third week of October 2017, as we are closing down the first year after the demonetization declaration, the tax authorities have realized an increase in the tax revenue by 16%. Ironically government sources, as quoted in Times of India (October 15, 2017) have declared that the temporary blip in the economic activity was due to adaptation for GST, that this slowdown is now over and the economy will sail the smooth path of high growth quickly. International Monetary Fund (IMF) Chief Christine Lagarde in the annual meeting of IMF has given a strong support not only to the demonetization but also for GST implementation in India. She believes the Indian economy will trend upward in next few years.

Section 2: Costs of Demonetization

As one can expect – costs of economic actions is hard to determine accurately, and yet one must make an attempt at it.

The first and obvious cost is the cost of printing the new currency notes. In an October 29, 2017 article in The Hindu it was reported that the RBI has announced that post demonetization it spent Rs. 7,965 crores on printing the two new currency notes plus other denominations. In the previous year, the RBI had spent just Rs.3,421 crores on printing all notes – so this difference of Rs. 4,544 crores may be attributed to the cost of demonetization.

The next obvious cost is the loss of productivity and lower sales of goods and services as denoted by the lower GDP. This though is an object of contention as well as unsure of measurement. For instance, should we look at the difference between actual GDP of this current year post-demonetization versus a year ago? Or would it be more appropriate to compare it with the projected GDP for this last year? I think all economists would agree that pre-demonetization, Indian economy was on a growth trend – which would have reasonably been expected to continue into the calendar year 2017. Then it may be reasonable to look at what the projected GDP growth was and measure the difference between projected and the actual growth rate.

According to an August 31, 2017 article in The Times of India here are the following comparisons on a year-on-year basis:

In Q1 2017 (April-June), quarterly GDP growth was at 5.7 percent, while 2017 January-March GDP growth was only 6.1 percent. The Q1 GDP growth a year ago was 7.9 percent. While different sectors contributed differently to this slowdown of 2.2 percent, the largest hit was taken by the manufacturing sector which in the 2016 quarter had expanded by 10.7 percent as compared to only 1.2 percent in the 2017 quarter. The financial, insurance, real estate and professional services sector slowed down by about 3 percent from 9.4 percent growth in Q1 2017 to only 6.4 percent growth in Q1 2017.

If we were to compare actual versus projected growth pre-demonetization the losses (or costs of lower GDP growth) would be greater.

According to statisticstimes.com – citing the Planning Commission, Government of India, the Ministry of Statistics and Programme Implementation, and the IMF as its sources – the Economy of India was about 152.51 lakh crore rupees. Suppose we were to approximate that there was about 2 percent lower GDP growth after demonetization. Then this two percent loss would equate to Rupees 305,020 crores loss in GDP – due to demonetization.

Section 3: Other Issues and Conclusion

The above costs of losses to the economy post demonetization must be tempered by the confounding effects of the introduction of the Goods and Services Tax (GST) in to the Indian economy. While any attempt to measure the impact of a change in the economic landscape is bound to be difficult – in the case of trying to measure the impact of demonetization the task is made almost impossible as the GST was introduced on July 1, 2017 almost 8 months after demonetization. Thus any look at the state of the Indian economy in the first year post demonetization will include a little over 4 months of GST impact running concurrently with the impacts of demonetization.

So where does that leave us? It essentially leads to the uncertainty filled future that is marred by consequences of not only demonetization but also by the good or bad implementation of GST. Government policy makers are still (circa November 10, 2017) not firm on the list of commodities that will be assessed GST. They have changed the list more than 5 times already and the way political winds are flowing more changes are yet to come. Another future headache will be to address potential complications of individual items. For example, take the Banarasi saree weaving industry, a 5,000 crore rupees per year industry that has traditionally been centered in Varanasi (former Banaras). This industry has always worked on credit for raw materials to weavers and historically has been a 100% cash based industry. According to an article in Quartz India, the general secretary of a Banarasi saree trade association says that demonetization saw a drop in business by about 50% and now, post-GST business was down by about 60-70 percent. Weavers are also confused by different GST on raw materials namely, 5% on silk and cotton, 12% on zari (gold thread), and 18% on polyester. But as an interviewee said – some sarees are a combination of cotton and polyester, so how would the GST be determined?

Similarly, the real estate and construction industry in India has received a severe jolt for two reasons: On the one hand the demand for new and used houses has declined considerably with the slowdown of growth rate and on the other hand the lack of cash payments which in this industry was severely needed even for the daily payments of temporary and daily construction workers. Some big corporations such as DSK Constructions have to declare bankruptcy as the firm could not honor the fixed deposits (FD) schemes and was overloaded by the loan repayment burden. Fortunately the manufacturing is affected by a smaller margin, and the service industry is untouched by the demonetization attempt, otherwise the decline in real GDP could have been even more serious. We are therefore left with an array of mixed but voluminous arguments from both sides of the controversy.

So, to answer the question, “Was the demonetization successful in getting all its goals achieved”? We elect to have the answer to this question by four words “We Do Not Know”. Time will tell us if there was a complete (or if incomplete with what percentage) success. Right now it seems that this puzzle of demonetization can be answered only discretely, using some data with anecdotal evidence, and the picture may depend upon the political party to which one belongs. One thing is true that both sides have enough fuel to light up the fire in many different angles. While being Overseas Indian Citizens (OIC) the authors of this paper would not take any political position, and as astute observers of Indian economy will express their honest opinion that the demonetization exercise, along with GST introduction needs more time to be successful or to fail.

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