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The Political Economy of Demonetising High Value Notes

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A person fills up a challan to deposit cash in his postal savings account at the Vellore Head Post Office in Tamil Nadu on November 11, 2016. Photo: C. Venkatachalapathy The Hindu

The government's high profile war on black money has generated mixed responses. However, both supporters and opponents of the 2016 demonetisation agree that the move has caused immense hardship to people, especially those outside the banking system and without alternative means to access goods and services in a largely cash economy. ***Jayati Ghosh****, Professor of Economics, Jawaharlal Nehru University, discusses the conceptual, practical, and implementation issues arising from the November 8 announcement by Prime Minister Narendra Modi. A more effective way to flush out black money without disrupting normal economic activities, she says, would have been to announce a specific date for demonetisation of old notes followed up by an efficient tracking system.*

The Modi government is extremely adept at optics, at policy measures presented in a blaze of publicity that dazzles the public, rather than with the required attention to detail that might ensure their success. The latest announcement of the demonetisation of high value bank notes is of the "shock and awe" variety of measures. While presented as evidence of the government's supposedly firm resolve to root out black money, in reality it will barely touch the problem of generation of black money, even as it is being implemented in a way that causes immense economic harm to ordinary people and especially to poorer sections of society.

The demonetisation of bank notes *per se* is not the problem. Indeed, it has occurred periodically in India and many other countries, both to reduce concerns about counterfeiting and to spread the use of cash-based illegal transactions. To the extent that it reduces these, it should certainly be welcomed. However, when this has been done in India in the past or in other countries, it has typically been done gradually, allowing adequate time for people to replace the old notes with new ones to prevent too much disruption of economic activity. This overnight shock, by contrast, is hugely destabilising, with likely medium-term material damage to a very large part of the population. It affects very little of the stock of ill-gotten wealth and does nothing about its generation, but it has severe impact upon ordinary people, whose lives have already been hugely disrupted.

Government spokespersons argue that secrecy and speed were of the essence to achieve its goals. Otherwise, they state, those hoarding black money would simply be able to convert their cash into "white" through buying other assets in the intervening period. But this argument is completely specious. Suppose the government had announced that (say) from December 1, 2016, the old notes would no longer be valid. It could then start tracking all large sales of likely assets (such as land, houses, gold) and foreign exchange transactions, to follow up with those who had made them. This would have involved no cost to the ordinary law-abiding citizen but still provided the government with all the information it needs to ensure legal and tax compliance from such individuals.

Instead, the shock announcement seems to have emerged from the current government's penchant for drama and propensity for so-called "big bang" reforms. Other explanations have been put forward about the timing of this move: the need to distract the media – and indeed the entire society – from the government's increasing repression of the media and of all forms of democratic dissent, which had recently become a major issue of concern; and the upcoming elections in the two important States of Punjab and Uttar Pradesh, in which rival parties would definitely be wrong-footed by this announcement while the Bharatiya Janata Party (BJP) might just have got some sort of heads-up before the action. (Indeed there have already been accusations that several accounts held by BJP members in different parts of the country were suddenly filled with large deposits in the month before this dramatic announcement, and that members of the ruling party were informed about this demonetisation well in time to take precautionary measures.)

In any case, both design and implementation of this scheme have been far from ideal. In terms of design, the secrecy and suddenness have already been noted as creating completely unnecessary problems, which have hugely affected ordinary people across the country. In addition, the government clearly failed to recognise that, given the rise in prices over the years, it is absurd to treat Rs. 500 as a "high-denomination" note that poor and middle class people are not likely to use. Given the prices prevailing for many essentials like food items and medicines (with some dals costing nearly Rs. 200 per kg for example), it is absurd to consider that Rs. 500 would be an amount that only rich people or black marketeers would use. These Rs. 500 notes accounted for more than two-thirds of the notes in circulation, and removing those at one stroke inevitably has had huge repercussions on liquidity, markets, production and consumption across the country.

In fact, when the Morarji Desai government had demonetised high value bank notes in 1978, it cancelled only those notes with values of Rs. 1000 and above – and Rs. 1000 at that time would be the equivalent of Rs. 25,000 today! As it happens, precisely because the notes involved were of such high value at the time and accounted for only 0.6 per cent of the money in circulation, the demonetisation of 1978 was not so badly felt by ordinary people. However, even then the Reserve Bank of India (RBI) Governor of that time, IG Patel, pointed out that "such an exercise seldom produces striking results" since people who have black money on a substantial scale rarely keep it in cash. "The idea that black money or wealth is held in the form of notes tucked away in suit cases or pillow cases is naïve." And in any case, big players holding large amounts of undisclosed cash can usually find agents to convert the notes through a number of small transactions "for which explanations cannot be reasonably sought." Yet the government was insistent, and so "the gesture had to be made, and produced much work and little gain [1]." The economists Brahmananda and Vakil noted that a measure like this "has primarily a political and not economic objective. In such a case it becomes a business in and among politicians [2]."

If this is what has driven the current exercise as well, then perhaps the government's willingness to tolerate and justify the massive administrative glitches and associated harm to common people are easier to understand. In terms of implementation, what has been even more surprising than the design is the apparent lack of preparation on the part of the administration for such a major move. Once again, the need for secrecy is being advanced for this, but that argument is untenable. The chaos evident in the week after the announcement is partly because not enough notes have been made available to banks and ATMs, and arrangements to deal with what should surely have been an expected rush to exchange notes were completely insufficient. Removing most (86 per cent) of the currency in circulation at one stroke is a huge move that necessarily constrains the payments system and can even bring it to a halt in parts of the country where the new cash notes do not become readily available. It is surely foolhardy to imagine that economic activity in such a heavily cash-based economy as that of India would be unaffected if these volumes of currency are not very rapidly replaced.

Then again, the choice to introduce first the Rs. 2000 note rather than the Rs. 500 note is mystifying: obviously, this would hardly create an effective liquidity substitute for the Rs. 500 note, yet government representatives appear to be surprised when people complain that they cannot find anyone to give them change for the higher value note. The shortage of other lower value notes, that is inevitable when only newer notes of even higher value are being introduced, should also have been anticipated, yet that too was not factored in. In any case, surely if the idea is to eliminate black money, then it is hardly desirable to introduce even higher value notes that would presumably be even easier to store for those holding large quantities of undeclared cash.

If the Prime Minister is correct in claiming that this was not a sudden move but something that has been planned for nine months, then it is incredible that so little effective preparation was made. It appears that there was little official recognition of likely implementation problems: the government began by claiming that things would be sorted out in a matter of days, then weeks, and most recently 50 days, during which time the Prime Minister has asked the people of the country to bear with him. But it beggars belief that simple matters like ensuring that the Reserve Bank of India (RBI) has sufficient notes to replace the ones that have been demonetised, or that ATMs are appropriately configured, were not taken care of before going through with this, especially as there is no pressing need for choosing this particular moment to do so.

Still, all this this would have been worth it, if indeed such a move would eliminate all black money in the country. But in fact, it will do little more than scrape the surface of the problem, even if it does so in a blaze of hyperbole.

The nature of “black money”

What exactly is “black money”? The first mistake is to see it as a stock of cash or pile of accumulated assets, because it is not about stocks at all so much as flows or transactions that are concealed from authorities or under-reported, so as to avoid taxes and various other regulations. Bribery and other instances of corruption are one form of such transactions, but there are many other forms, such as under-invoicing and over-invoicing by companies of all sizes, under-reporting of the values of sales of goods and services by individual providers, overstating of costs, reporting false or non-existent transactions and of course criminal activities of various kinds. Many of these do not necessarily require cash transfers at all but can be just as easily (and more speedily) done through electronic means, and relate to different sorts of account-keeping. Also, money does not acquire a particular colour and keep it; as it flows through different transactions, it can move through white, black and grey hues.

For all these reasons, estimates of the exact amount of “black money” in the system at any given time are necessarily problematic, since they rely on assumptions about both the number and the value of unrecorded and tax-evading transactions. A recent estimate by a private agency has claimed that black money amounts to 20 per cent of total Gross Domestic Product (GDP) or 25 per cent of recorded GDP, which would make this one of the lowest in the world already [3] . However, a report by the National Institute for Public Finance and Policy (NIPFP) on the incidence of black money in India (which was submitted in December 2013 but has still not been made public or even submitted in Parliament) is reported to have suggested that the black economy amounts to as much as 75 per cent of the recorded GDP [4] .

Most of this is not – and indeed cannot be – held in the form of local currency. It is more than obvious that those who are significant recipients of such funds would speedily seek to transfer them into other assets. In India today, these are mostly land and other real estate property, gold and jewellery, *benami* accounts in banks, holdings of dollars and other global reserve currencies, holdings of stocks and shares through the anonymous vehicle of Participatory Notes and, most of all, sending the money abroad through various means.

Let us try to estimate what proportion of the money in circulation is black money that could be flushed out by this new measure. As noted above, estimates of the incidence of black money vary between 25 and 75 per cent of GDP. Meanwhile, we know that currency in circulation currently amounts to 12 per cent of GDP, and 86 per cent of this currency is in the form of Rs. 500 and Rs. 1000 notes.

But we also know that a significant proportion of our GDP – around half, according to current CSO estimates – is produced in the informal sector, and around 85 per cent of the population relies on it. This is unrecorded income, even though it is estimated in the GDP, but it is dominantly not “black” because incomes here are generally too small to fall into the direct tax net and are anyway subject to indirect taxes of various kinds. Indeed, the incomes of farmers (which are not taxed), the returns of small traders and micro entrepreneurs, the incomes of daily wage workers, the incomes of small service providers: all these and many more such incomes are clearly the result of what would be considered as “white” transactions even though they are not registered and reported to any fiscal authorities.

This informal economy in India is hugely, if not completely, dependent upon cash. The preponderance of the informal sector is indeed why more than 90 per cent of all transactions in India are still estimated to be in cash. It is not unreasonable to assume that anywhere between half to all of the estimated GDP of the informal sector would be in the form of cash transactions. Since estimated cash balances amount to 12 per cent of GDP, the cash equivalent of anything between 3 to 6 per cent of GDP is involved in such informal activity, which is completely legal.

This in turn suggests that a move to demonetise larger denomination notes of Rs. 500 and Rs. 1000 would be successful only to the extent that it flushes out the *part of black money that is held in cash*, which would then be equivalent to 2.3-5.2 per cent of GDP. In terms of the available estimates of black money, this comes to only 3.4-6.8 per cent of the NIPFP estimate of black money or 10-20 per cent of the smaller recent estimate provided by a private agency. In all these cases, the numbers suggest that only a tiny or at most a small proportion of black money (or rather, of the assets acquired through illegal or unrecorded transactions) would be captured through this move.

The impact of sudden demonetisation

Whatever little effect this measure may have to bring such black money out into the open would still be an unmitigated benefit, if the move did not simultaneously cause so much grief to innocent citizens. The fact is that the both the insensitive design and the shoddy implementation have already cause a huge amount of distress to different people in various ways, and the pain is likely to linger for some time. The rapid and sudden strike without warning meant that ordinary people had no opportunity to prepare for it. The immediate impact – in the form of drastic cash shortages leading to immense hardship especially among less privileged groups; long and tedious waiting times in queues that often prove to be fruitless because banks and ATM machines are unable to provide the required cash – all these have been widely portrayed in the media.

It is true that these are essentially temporary disruptions, which should be eased over the coming weeks. Even if that does not provide much comfort to those whose livelihoods have been adversely affected, there is the argument that this temporary pain is worth it to ensure the greater common gain of eliminating black money. As noted earlier, the latter goal is unlikely to be reached with this measure. However, some sectors like real estate are known for the fact that cash typically accounts for a substantial share of the transactions. Those engaged in this business (whether as buyers, sellers or intermediaries) who have been caught at the point when they happen to be holding large cash balances will be affected, and face substantial losses. To the extent that it curbs the tendency to demand a certain proportion of the price for a property transaction in "black", and makes property more affordable, this is definitely a good thing.

However, there have been and will be other effects that are very damaging for the economy and especially for the groups that are already in a weaker position. It will definitely put a brake on economic activity. Indeed, the immediate dislocation, uncomfortable as it is, may even be less damaging than the medium term impact.

The biggest negative effect is the loss of liquidity for the informal economy, which has already been of massive proportions. This has led to breakdowns in payments systems and has drastically affected trading. As the chaos continues, the knock-on effects on economic activity have grown. People hoard their slender cash holdings and do not shop; this affects large and small retailers who rely on cash sales; this affects their own demand for purchase of goods in the wholesale markets; and so on. Even in megacities like Delhi, there are reports of shopkeepers simply shutting their shops because of the lack of buyers as a result of the cash squeeze, while traders in *mandis* have been caught with huge amounts of unsellable stock of perishable items like fruits and vegetables because of lack of cash purchasers. This has permeated down the distribution chain to the small vendors and street hawkers. This has also affected production systems, as moneylenders providing working capital to small producers are unable to provide the new notes.

The decline in trade – even if temporary – has a knock-on effect on production, and thereby generates further negative multiplier effects in the local economy. There are already reports of daily wage labourers unable to find work because employers cannot pay them with the new money and are only able to offer old notes, which are now without value.

All this is worsened by the impact that the cash shortage has on consumption, as people cut down on purchases of non-essentials and even of food and other essentials, because of the lack of liquidity with which to purchase these items. Consumption squeezes have been especially dreadful for those facing medical emergencies. Many private hospitals and clinics are not accepting old notes. Even when public hospitals do accept them, they expect the patient's family to purchase the required medicines and materials required for operations, which in turn can only be with the new notes. Stories of individual tragedies resulting from this mess are abounding.

Of course, as always happens in capitalism, the market quickly responds to these needs, in the form of intermediaries who offer to collect the old notes and exchange them for a discount. The prevailing rates in Delhi in the days after the banks purportedly opened were at 20 per cent discount: Rs. 400 for a Rs. 500 note and Rs. 800 for a Rs. 1000 note. Similar rates were also being offered by market vendors for their goods. Those who are desperate to get hold of some cash quickly for whatever reason, or who cannot afford to lose a day's wages for standing in the queue at the bank, are then forced to take these rates. Since the people forced to take these rates also include the poor, this amounts to an attack on their already low incomes.

In rural areas, matters may be even worse. The cash distribution systems for the new currency notes that have failed so miserably in the major metros and other towns are unlikely to be much more efficient in villages. In any case, the number of rural bank branches has declined in past years, and these branches are now few and far between. Banking activities are supposed to be conducted through ATMs and though the Banking Correspondents (BCs), most of whom have been largely dormant for a while now, and thus far these systems have proved completely inadequate to the task of ensuring the supply of new notes.

This has led to some truly difficult circumstances, which will be hard to imagine for those in the administration or ruling party who fondly believe that demonetisation will simply lead all Indians to shift to cashless transactions. Migrant workers in Delhi report that in their home village in Uttar Pradesh, which is still not electrified, kerosene remains the essential fuel for lighting and cooking. But the current cash crunch has affected villagers' ability to buy kerosene as the local private dealer (the only one in the village) refuses to accept the old notes – so households must sit in darkness until they are somehow able to exchange their old notes for the new ones. Since the nearest bank is also some distance away and the villagers have received word that it has also not received the new currency, things are not going to improve anytime soon for them.

Farmers are in a particularly difficult condition. Across north and central India, and in many parts of the west and east as well, farmers have recently harvested the *kharif crop* and are now about to begin sowing the rabi crop. Many of them had saved up the cash proceeds of their *kharif* sales to buy inputs for the next sowing season. They need money to buy seeds and fertilisers, and to hire tractors and other equipment – and they need it *now*, because the agricultural season does not wait upon humans. Even a day's delay can be critical in some cases depending upon weather conditions, but these farmers have already been waiting nearly a week. In most rural areas, the compensating delivery of coupons promised to farmers has simply not materialised, and not all of them can access public supply systems for inputs, as these too have run out of supplies. If delays caused by this policy-created cash shortage affect sowing, it would surely be farce turned to tragedy for these farmers and for agricultural output.

This particular policy move has also been shockingly gender-blind, and therefore has already had highly gendered consequences. Policy makers persist in seeing India in terms of households, not recognising that men and women can have very different requirements and relationship to banking. Around 80 per cent of women do not have access to the banking system, and even when they do, it is often in the form of joint accounts with their husbands. So saving up some money in cash hoards to guard it from husbands who would use it for drink or other such purposes, or to ensure some savings for children's future needs, or to provide for medicines in case of illness, or even to protect themselves from abusive husbands, is a very common practice.

There are numerous stories of women who now do not know what to do with these hard-won and carefully stored notes, and who have neither the time nor the capacity and autonomy to go and stand in those endless queues to exchange the money. When the amounts add up to what may seem like a tidy sum in the context, say Rs. 50,000, the problem for the woman becomes more acute. She not only stands to lose control over the money, but even the knowledge of such a private hoard can infuriate the adult men in the house, with potentially violent consequences. Surely this is not the kind of black money that is being sought to be forced out into the open? It is extraordinary that those who introduce such a policy could have such little awareness of Indian society that they do not stop to think of such consequences.

The cashless society?

It is not as if at least some of these aspects are not known to those in the ruling party who are currently signing paeans to what they describe as this "historic move", supposedly a game changer" in the reform process. Not so long ago, in fact in January 2014 when the United Progressive Alliance (UPA) government had tried to phase out old Rs. 500 notes issued before 2005 (and that too in a phased manner rather than this abrupt move), the then BJP spokesperson Meenakshi Lekhi had described the move as "an attempt to obfuscate the issue of black money stashed outside the country… This measure is strongly anti-poor. The 'aam aurats' and the 'aadmis' – those who are illiterate and have no access to banking facilities will be the ones to be hit by such diversionary measures [5] ." So what could have changed over the past three years to make BJP leaders change their tune to such an extent? They would probably suggest that this time is different because of the much greater coverage of banking services through the Jan Dhan Yojana. Indeed, the official website of the scheme notes that on July 1, 2016, 25.45 crore accounts had been opened, with only around a quarter of them with zero balance and an average of Rs. 1,780 per account. This has led to the claim that almost all households in the country are now covered by banking. But despite these claims, it is estimated that around one- third of the adult population does not have any bank account, even of the no-frills variety [6] . Others may have an account, which has been dormant ever since they were made to take it on, but the distance from and sheer difficulty of getting to the nearest bank has meant that institutional banking plays no role in their lives. They rely on intermediaries – the BCs created by the banks themselves, or local middlemen who spring up to meet these gaps. So the logistical issues involved in exchanging the old money for the new would be huge in any circumstances, not to mention the strained and overstretched conditions of today.

The RBI – which surely should know better than any of us the true state of the penetration of e-banking and digital transactions in the economy – had its own Marie Antionette moment in a press release of November 12, 2016:

> “public are encouraged to switch over to alternative modes of payment, such as pre-paid cards, RuPay/Credit/Debit cards, mobile banking, internet banking. All those for whom banking accounts under Jan Dhan Yojana are opened and cards are issued are urged to put them to use. Such usage will alleviate the pressure on the physical currency and also enhance the experience of living in the digital world [7]."

Statements like this make one wonder whether the RBI is living only in the digital world. Surely the worthies in that institution have some idea of the conditions under which banking and money exchange occur for most Indians? As well as some knowledge of the importance of electronic transactions in the wider world? It is worth noting that even in the U.S. currency is said to account for around 63 per cent of transactions

In fact, e-banking has been increasing in India, but the shares are still very small: cash is still estimated to account for more than 90 per cent of all transactions, and the remainder is approximately equally split between cheques and e-payments. The facile assumption that moving to e-banking is just a matter of personal choice, which appears to underlie some of these arguments, is completely mistaken.

Of course, it is desirable to move to less reliance on currency, but that cannot be done in this abrupt and coercive manner, especially when most bank accounts are still not e-enabled, when basic infrastructure for this (such as secure internet connections or even electricity) is not accessible everywhere, and where levels of education for a very large section of the population do not allow for easy e-banking. This must occur as a smooth and gradual process because of the greater ease and facility of such transactions. Disrupting currency transactions is a painful and ultimately much less effective way to push the population towards greater e-banking. It also disregards the point that this is not something people can just do at one stroke, and certainly not at this moment, when the pressures on banks are anyway so intense that they are in no condition to handle these new requests.

So what can be done to control black money?

It has been argued, with some justification, that this is a diversionary tactic, designed to draw attention away from the fact that – despite its fervent campaign promises – this government has so far done very little to deal with the problem of black money. As it happens, there is a lot it can do, relatively easily, if only it truly does have the necessary political will – and none of these measures would cause any hardship to the common people.

In terms of preventing the generation of black money, what is required is a more effective, clean and accountable tax administration that uses all the information at its disposal to go after those who are evading the law in various ways. For companies, it is possible to identify practices such as over- or under-invoicing, false transactions and attempts to use loopholes in the laws. For individuals, it is now easily possible to uncover undisclosed incomes by tracking payments and following suspiciously large purchases, and put them under scrutiny. Obviously, movement of funds abroad is a major avenue, which needs to be monitored much more closely. Indeed, this is what most countries that are known to have relatively “clean” economic systems do as regular practice, without making a great song and dance about it.

In terms of dealing with the assets held from such undisclosed incomes, this too can be easily done if the government has a mind to do so. It is not just land deals and gold and jewellery purchases that can be monitored, precisely as the government is trying to do now in the middle of this cash crunch. The completely uncalled for possibility of making buying securities through “Participatory Notes” in the stock market, which do not require the buyer to reveal his/her identity, is an obvious means of parking illicit funds. These should obviously be done away with – yet both the previous UPA government and this supposedly anti-corruption BJP government have proved to be curiously reluctant to do so.

The most obvious thing to do – and the issue that Modi continuously railed about in his electoral campaign speeches – is to go after those who have stashed away their undisclosed funds in bank accounts and other assets abroad. He had promised to "bring back" all this money, to the point that many holders of Jan Dhan accounts today still fondly believe that they will each receive around Rs. 15 lakh as their share of the returned money! Yet the Modi government has steadfastly refused even to divulge the names of such individuals, much less take any action against them. Other wilful defaulters are similarly being dealt with kid gloves. The facility with which the king of defaulters, Vijay Mallya, was allowed to leave the country makes a mockery of the subsequent official noises made against him, which are made with the full knowledge that he will not be deported back to India by the U.K.

Overall, this ill-conceived and even more poorly executed move appears to be an attempt by the government to display a lot of sound and fury, but signifying very little. It is unfortunate that in the process it has inflicted such damage on ordinary people and on the economy.

(*This article was updated on November 18, 2016.)*

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Source: Government of India.

Resources: Withdrawal of Legal Tender Character of ₹ 500 and ₹ 1,000: RBI Statement: November 12, 2016. [PDF 97 KB]

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