

The path from here to Successful Demonetization

Some thoughts on the ongoing Demonetization Exercise – Part 2 of 2

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More than a week into the current demonetization exercise, all citizens must now be vested in its success. The only thing that could be worse than continuing with even the poorly-designed or executed (thus-far) plan would be to now recall/cancel it. Significant costs have already been borne by crores of citizens, and there can now be no going back. The question therefore is, what steps can be taken to reduce the economic friction and disruption to people's lives?

The first and perhaps most important aspect is that the content, frequency, and focus of communications emanating from the government must substantially change. The limited communication till seems designed to create "shock & awe", as opposed to reassurance. The unrivalled bully pulpit of the Prime Minister's Office has been used to deliver messages such as "*illegal tender as of midnight*" and "*relentless pursuit above Rs. 2.5 Lakhs*" that could well create a sense of desperation and panic, which is surely un-intended for the minds of the less-educated or communication-connected sections of society. These messages are further amplified by the mindless drivel that is propagated via WhatsApp, India's new echo chamber of unfounded rumor and unfettered nonsense.

The government is also not doing itself any favors by creating the new – and internally inconsistent - concept of partially-legal tender within one sovereign nation (i.e. Old notes are currently legal tender at Banks, Petrol Bunks, Train Stations etc., BUT NOT at other places!). How does this partial fungibility make sense to a common man?

On the other hand, reassurances such as the "preservation of the full value" of the notes, and concessions on usage points and withdrawal amounts, extension of dates for usage, etc. emanate from platforms/individuals who do not command the same level of press coverage or repetition – and therefore may not be reaching the people who need such information the most. To reduce the likelihood of further economic disruption, as well as the less-informed sections exchanging their old notes at discounted values, the government must undertake a serious and coordinated effort (across all levels of government) to convey messages of calm and reassurance, reducing the inclination for people to either queue for hours at Banks, or exchange their notes at a discount at the street corner - thereby creating new ill-gotten and undeclared gains (black money), for these street exchangers!!

The government also needs to study the relevant concepts from technical fields such as Control Theory and Systems Dynamics – and apply them realistically over the remaining life of the exchange period. It should consider which control mechanisms are critical to becalm a system that has been given a large shock. For example, while printing of new Rs. 500, and all smaller denomination notes in massive quantities is a necessary condition for easing the bottlenecks, it is clearly not a sufficient condition. The critical focus now should be on the distribution points – the roughly 1.25 Lakh Bank Branches, and the roughly 2.5 Lakh ATMs across the country. The focus on secrecy led to the ATMs effectively going out of

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commission for weeks, and bringing them back to full functionality well before the Dec 30th deadline should be a pre-requisite for not having to extend the conversion deadline.

Similarly, the validity of old notes at critical points in the system (hospitals, transportation systems, Petrol Bunks, etc.) should be continued till practically the final deadline, and in fact extended to cover other systemically important points such as fertilizer and seed sales, wholesale farm and fisheries transactions, etc. Even if the notes are not allowed for transactions of all sizes, they should be allowed for transactions up to a reasonable cap – of say Rs. 5,000 or Rs. 10,000 – and such limits should ideally be synchronized with the daily withdrawal limits at the banks (thereby removing the need to queue at the bank to convert the same amount of old notes).

Why is this critically important? From a Systems Dynamics perspective, these transaction points are vital, because a lack of liquidity here will drive 2nd, 3rd and even higher order effects which will cripple their respective sectors of the economy. For example, if old notes are no longer legal tender at Petrol Bunks before there is adequate supply of new notes, fishermen will no longer accept old notes from the Wholesale fish merchants that buy their catch. Why? Without the purchasing power arising from the proceeds of their catch, they will not be able to buy Diesel (which is their highest variable cost input). If they cannot buy Diesel, they will not go out to Sea to fish. On the other side of the supply chain, the retailer will (before the customer notices it) start to see the supply chain dry up. And the natural reaction will be to raise the prices of the remaining fish (or worse, to try and preserve the stock to a point where it creates a health hazard) to compensate for the coming days(s) of no business and no revenue.

Thus, the lack of adequate legal tender at the wholesale fish market (i.e. tender which is acceptable at Petrol Bunks) will effectively create problems up and down the supply chain. This is precisely what did happen for the few days between Nov 11th & 14th, before the government realized the extent of the problem and re-authorized the use of old notes at Petrol Bunks till Nov 24th.

The question now is, will there be adequate supply of new currency in all places by Nov 24th to enable the small-scale fishing industry to not face this problem again? How will the government monitor this situation? And if it finds that problems continue, will it be considerate (and thoughtful) enough to further extend the dates for the use of old notes at Petrol Bunks? And this approach should be applied to every sector of the economy to identify the key points along the supply chains and monitor then to either ensure sufficient liquidity of new notes, or to allow them to keep using old notes till such liquidity in new notes prevails.

In summary of all the points discussed above, the government would be well advised to give up the ghost of intimidation for the remaining period of the exchange, and focus instead of micro-level monitoring of liquidity, sensitive and thoughtful execution, and enhanced communication – especially to the less literate and communications-remote sections of society.

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The definition of Success?

How will we know whether this whole exercise was worth the trouble? The immediate results of how much of the stock of Rs. 500 & Rs. 1000 notes were not tendered (and are presumably liabilities that can be cancelled) must surely be one of the key indicators – particularly since the government implicitly made this its highest priority, as can be inferred from the maniacal focus on **Secrecy**. The extent of counterfeit/spurious notes discovered during the process will also be an immediate indicator of success – or lack thereof.

In the intermediate and longer perspective, the realized costs and benefits must be dispassionately tallied before a judgement can be made. There will likely be significant short-term costs – including reduced GDP growth, a dip in employment, and general reduction in various economic measures due to the sudden withdrawal of liquidity. On the other hand, there will likely also be significant benefits – including a revitalization of Bank's Balance Sheets (presumably leading to greater credit availability for businesses), a reduction in inflation (which may go all the way to significant deflation, at which point it would no longer be a desired outcome), lower short-term interest rates, lower asset valuations – especially for landed assets (again this may turn out to be a bad thing if the drop is very precipitous) and potentially more efficient payments/transactions systems.

The potential for other unintended negative consequences also looms – including a level of new counterfeit notes higher than the previous 0.02% (since people are clearly less familiar with the new notes), as well as the creation of a whole new stock of "Black Money" generated through the discounting / arbitrage of old notes by unscrupulous middlemen during the demonetization exercise. Collectively, these have the potential to exceed the notional gains from the capture of spurious, and otherwise unexchangeable (because they represented black money) old notes.

And we must assume the government has a few further tricks up its sleeve, in terms of schemes or policies to be announced after Dec 30th which will help combat/offset the real and potential negative consequences of this massive demonetization exercise. It would be very irresponsible of the government if that were not true.

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