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Making the most of demonetisation

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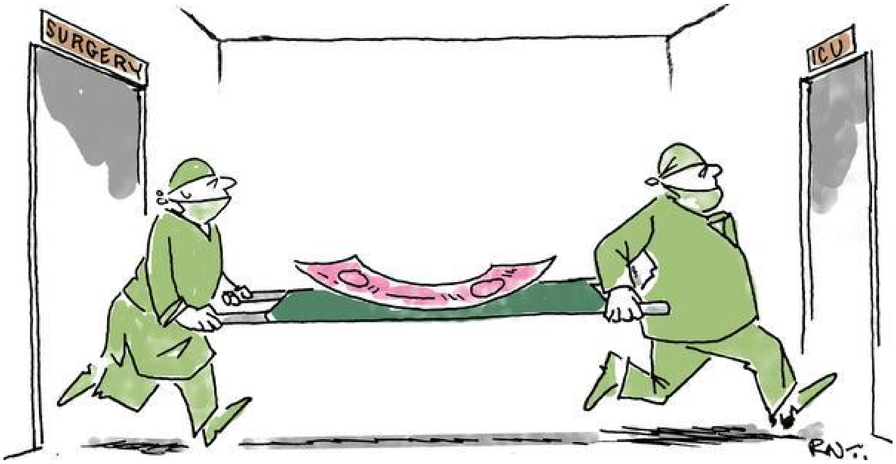

The current steps are welcome, but for black money to shrink in the long term supportive reform steps are called for

The demonetisation announcement came truly as a bolt from the blue. The shock treatment is part of the measure. This is a standard prescription to deal with black money and this is not the first time it has been done in India.

To understand the full implications of the step, we need to know the motives behind the measure which has already caused a lot of inconvenience and upheaval.

The objectives

The new measure has three targets. First, those who hold unaccounted income or black money in the form of currency; second, those who finance terrorism through cash dispensation; and third, those who make fake currency. The last two categories stand apart from the first. The economic impact is largely analysed in terms of the impact on the first category.

To what extent will demonetisation reduce the existing stock of black money? This depends on the extent of currency extinguished. Those who are not able to provide adequate explanation for the cash they are holding will not be able to go to banks to convert their cash into new currency. While some attempt will be made to distribute cash, those with huge sums will find it difficult to provide an explanation. One has to wait and see how much of currency will not return to banks.

Two aspects of the measure need to be taken note of. First, it attacks only that part of unaccounted income held in the form of currency. Those who have kept it in the form of gold or real estate, escape. It is also argued that the bulk of unaccounted income is not held in cash and as such demonetisation can make only a limited dent on black money. Second this measure by itself does not prevent the accumulation of fresh 'black money'. The measures may at best have only an 'announce effect' that the Government is seized of the situation. Other measures are badly needed to curb further accumulation.

The long and short

Nearly 85 per cent of the value of currency in circulation is being withdrawn. As a demonetisation measure, the extent of coverage is far deeper than the previous attempts. The disruption caused to the economy can be both temporary and permanent. Without adequate cash in the hands of households, retail transactions such as those relating to the buying of commodities of common usage such as vegetables can be, and are being affected. The RBI and the Government must overwork the printing press and bring the current situation to an end as quickly as possible by providing adequate currency to meet the normal need for cash. With the limitation on the capacity of note printing presses, advance action over a long period without provoking attention was a necessary prerequisite.

The permanent impact will be on sectors such as real estate where the transactions are largely done through cash. Initially they may shrink. Over the longer run, if cash transactions come down, there will be a salutary change.

The currency to GDP ratio is high in India. If this round of demonetisation pushes society towards more digital transactions, it will be a distinct gain. Through the Jan Dhan Yojana, crores of new accounts have been opened. These accounts, which have remained dormant, can be made active. Even otherwise, at least in urban areas, a strong push should be made to use electronic transfers. This is an opportune moment to make the shift. Aggressive action on the part of banks, including the new payments banks is needed to increase transactions in the digital mode. With the new experience of shortage of cash, many are moving towards the electronic mode.

Some questions have raised about the introduction of new notes in the denomination of ₹2,000. On the other hand, there are those who criticise the Government for including 500-rupee notes in the demonetisation net on the ground that the denomination is too low and is used by everyone. The introduction of ₹2,000 notes as such does not make any big change, if one takes into account the rise in prices since 2009-10. The impact on the financing of terror can be significant. It will have an immediate effect. The impact on the printing of fake currency will also be immediate, even though old counterfeit currencies may still be in circulation. The new notes, we are told, have several new security features and may be difficult to counterfeit.

Preventing accumulation

As far as measures to check the generation of fresh black money goes, they must be directed towards those forms in which black money gets converted, such as gold and real estate. However, the source of black money is the tendency to avoid payment of tax.

Two steps are necessary in this context. One is to keep the rates of taxation at moderate levels and widen the base, and the second is to tone up and streamline the tax administration. Electoral reforms are equally relevant to curb the excessive use of cash that has been recently noted.

Impact on growth and inflation

One question that crops up is the impact on growth rate. Certainly, the temporary disruptions can have an adverse effect on growth if they continue to linger. Over the longer run, the beneficial effects are the spread of the organised financial system with more and more transactions being channelled through the digital mode. Also, if followed up by other measures, the generation of black money can come down. The immediate impact on prices will also be beneficial. To the extent that some part of the currency will get extinguished, it may have the same effect on inflation as reduction in money in circulation. This will happen only at the end of the period given for surrender of old currency.

Even as people welcome the measure to demonetise, the major concern is the inconvenience because of the lack of adequate new currency. It also affects the livelihood of the poor. Small businesses, particularly, can face shortage of liquidity which can hurt them seriously. The Government, the RBI and banks must handle this problem on a war-footing, otherwise the generally welcome measure may turn sour.

The writer was chairman of the economic advisory council to the Prime Minister and governor of RBI

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