

Demonetization

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I. Introduction

The Indian government banned the high denomination notes (500 & 1000) from the midnight of 8th November, 2016. This move wiped out around 86% of the currency in transaction. The intentions of the apex authority behind this move was given as elimination of unaccounted tenders and curtail the circulation of counterfeit currency. This paper attempts to give a comprehensive assessment of the Demonetization move and tries to understand the rational behind the move from different perspectives. The first part of the paper deals with the ideological fit of demonetization.

Ideological evaluation: I Year PGP in Management, IIM, Indore, MP

Historical overview

Before getting into the discussion of demonetization, it is important to go back in time and look into the evolution of the different political and the economical ideologies. It can be seen that a change in any one of these has a significant impact on the other. Contemporary scholars have pointed out that any study on economic terms is incomplete until the political aspect is given a thought and vice versa. Hence, the political aspects of demonetization assume a prominent importance in this evaluation

Stakeholders Vs. Shareholders conflict:

This age old conflict is the one of the primary reasons behind the advent of the political and economical systems that we have in place today. In a much simpler context, the stakeholders involve the law making body and the shareholders involves the common people. The power tussle between these two parties time and time again have been agents of massive change. The section that gets the maximum power determines the type of economic system in place. For example, in China, the stakeholders have more power and hence it has a communist economy in place. It is quite the opposite in the USA.

India adopts a mixed economy where the balance of power between the two sections is quiet delicate and is one of mutual trust. Hence, it becomes imperative that either of the two parties has to maintain this trust. The government, by announcing demonetization has breached this trust and the balance of power has tilted towards the government. It would be wise to note here that “Emergencies have always been the pretext on which the safeguards of individual liberty have been eroded”. From this we can see that the demonetization move does not go well with the political and historical context

The tyranny of experts:

There are generally two school of thoughts when it comes to developmental economics. The first one puts the onus on the law making body to step up and steer the economy in the direction in which they can foresee the growth. The second one gives more freedom to the people to decide and the government merely acts as a facilitator in the approach chosen by the people. Generally, the development experts have always preferred the first approach but have made only a diluted effort to their cause as they often resort to the second approach towards the end. In this context, the Indian government has clearly adopted the first approach by announcing Demonetization. This makes us clear that our government predicts the future is going to be in the cashless economy. Hence, the country has been steered towards this path with an eye for the future. It can also be seen that various campaigns introduced by the government like ‘Digital India’, ‘Startup India’ are well aligned with the central strategy of the government. Thus, it is clear that the government is clear in what it’s targets are for the future. Such well thought out plans are generally the sign of a government that has growth has its primary motive.

Pareto’s principle:

This famous principle given by Vilfred Pareto states that 20% of the factors cause 80% of the problems. This can be seen from the fact that only 12% of the people own around 87% of the financial assets in India. Pareto also goes on to explain that a system would continue to follow this pattern unless the entire system is changed. Unless and until the system is changed completely, the status quo would continue. Small incremental changes will not have any effect on the system. Demonetization can be seen as the move that is

aimed at altering this status quo. It is important to note here that demonetization is only a tool used by the government to overhaul the current economic setup. It is by far not the change in the system that can affect the Pareto status. But, it has definitely set the wheels in motion for the change that the poor people have been demanding for a long time. A claim for equality of material position can be only met by a government with a totalitarian approach.

Theory of rational expectation:

One of the major allegation leveled against demonetization was the timing of the announcement. It was alleged that the announcement came out of the blue and the people were not given enough time to adapt to this new system. It is essential to understand the rationale behind this move. The theory of rational expectation suggests that there is direct link between the success of an economic reform and the element of surprise associated with it. It goes on to say that when a major economic reform is widely anticipated and expected by the public, then this reform when introduced will not have the desired impact. This Keynesian school of thought has passed the test of time and has become a sacrosanct factor to be considered before the announcement of any major economic reform. In these lines, the demonetization was well executed and the surprise element was a necessary evil.

Fortune towards the bottom of the pyramid:

The idea of solving poverty with profits is gaining steam in the recent times. This approach advocates the opening of gates for the corporates to operate in the most backward and rural areas thereby generating employment in these areas. It will also give a chance for the poor people to get a taste of the goods and services that were beyond their reach. The advent of cellphones is a classic example. By allowing more corporate to operate in the Indian telecom space, cell phones which were once restricted only to an elite few, has made its way across the entire spectrum. Thus, any action can have a full benefit to the poor only if the field is flat without any barriers. Demonetization fails miserably in this regard in the short term. The barriers that are preventing the poor to be on the right side of demonetization are lack of banking infrastructure, access to technology, asymmetric information etc. Unless and until these issues are addressed and rectified, the bottom segment will never be able to the intended benefits of demonetization.

This part of the paper gives a detailed analysis of the impacts of demonetization.

II. Anatomy Of Demonetization

Shadow economy:

Shadow economy is nothing but what we commonly know as black economy. The currency that circulates in this economy is called as the black money. They are usually illegal money earned through illegal sources. Black money is one which enjoys the benefits of legitimate money but does not pay the cost associated with it. The quantum of black money in India is debatable with the figures ranging from 15% -45% depending upon the source. There are numerous ways to convert this black money into legitimate tenders. One commonly used way is to decentralize the risk to various parties. This is done by spending this money on salary payments, investments in real estate and infrastructure etc. The recipients of these unaccounted money are generally the poor people who gets them in the form of daily wages and micro financing. They in turn spend these on goods and services thereby legalizing this money. Thus the poor have been unknowingly acting as money laundering agent for the people who are holding black money. Hence it is important to address this channel of money laundering. This can only be done by establishing some sort of accountability in the transactions taking place in the unorganized sector. The government has been very active in addressing this issue. Bank accounts are being opened for the bottom segment at a very rapid rate. Also by the announcement of demonetization, the government has taken a strong step towards a cashless economy which will bring the transactions taking place in the unorganized sector under the government's purview. Thus, demonetization will address the issue of black money laundering in an indirect way mentioned above.

Credit creation:

There have been claims made by the government that as a result of demonetization the credit giving capacity of the banking institutions will increase. To check the validity of this argument let us try to understand the mechanism of operation of RBI. They generally hold some reserves in the form of foreign exchanges and gold and these are highly liquid in nature. These reserves are generally called as the high powered money. These high powered money is the base in which the entire economy is supported. As we aware that the monetary notes issued by the central government are promissory notes stating that it assures to pay the bearer the sum promised. RBI is dependent on the stock of high powered money held in its vault to fulfill this promise if the need arises. Demonitisation will lead to increased deposits made by the public in the bank. This will increase the high powered money stock which in turn will enable the RBI to give out more credit to various sectors. Assuming

that the RBI continues with the same strategy of having a 4% reserve ratio (percentage of high powered money compared with the total cash and credit extended to the public) and a statutory liquidity ratio of 22%, the percentage increase in credit creation ratio has been worked out for different scenarios of deposits made by the public in the table given below. The percentage remaining column gives the total money left in the bank account after the initial deposit.

Percentage remaining in account	Value in account	Potential credit creation	Potential credit as multiple of stock of debt today	Percentage of incremental credit
70	992600	24815000	3.082345	138.9
60	850800	21270000	2.64201	119.1
50	709000	17725000	2.201675	99.2
40	567200	14180000	1.76134	79.4
30	425400	10635000	1.321005	59.5

Clearly it can be seen that the additional deposits due to demonitisation is capable of stimulating a significant increase in the potential credit that can be created in the economy. Provided that this increased credit capacity is invested properly, the GDP of the country is tend to increase in the long run.

Macroeconomic implications:

As a result of the increased credit creation, investments will increase in various sectors. This increased investment spending will decrease the interest rates. This will result in an increased per capita spending. However, an inflation is unlikely to happen as no new currency is being introduced into the system. Also, the decreased interest rate would cause a currency depreciation. But this pressure on the currency is expected to be put down by the growth in the size of the GDP. To sum up, demonitisation will dampen the economy in the short run but the long run impact is expected to be expansionary.

International linkages:

Since no new money is created in the economy, it should be a zero sum game in the long run. The foreign exchange rate should remain unaltered. But this will drive a huge short term impact on the GDP. This fall in GDP in the short run may have its impact on the stock market performance. Also, as a result of the decreased interest rate, the phenomenon of 'flight of capital' might take place which may build up the pressure on the Indian rupee against the other currency specifically the dollar. As for as the promissory notes issued by the Foreign Institutional Investors are concerned, a lot of controversy has been surrounding around the anonymity clause. With the advent of KYC clause, the government is trying to address this issue. A point to note here is that it is like walking on egg shells. Too much restrictions and regulations will make this option unattractive for the foreign investors and can even drain out the foreign capital inflow. Hence, the rope has to be held tight to make sure that this does not happen. At the same time some sort of control has to be exerted by the government on these foreign investors to regulate the P-note investments.

Impact on SMEs and the unorganized sector:

SMEs have been a large creator of black money in the past. Though it was driven by coercion and not by choice, they have been victimized. A stern move from the government's side was long overdue in this regard. Demonetization is seen as the agent of reformation in this sector. Their credit rating also has not been one of repute. With increased credit available, there are high chances that these SMEs will clear their bad debts of the past. Only then they will be eligible for the new credit that will become available. It will also enable the tax authorities to maintain a better track of this sector which has not contributed much in terms of tax revenue in the past. SMEs are an integral part in the fight for black money and a proper reformation in this sector will strengthen the government's cause. The impacts of demonetization were discussed from various aspects in the above section. For the government to achieve its desired outcome from demonetization, there exists some barriers that have to be overcome. These barriers act as slippery slopes which will keep pushing us back until and unless they are curtailed and addressed as early as possible.

III. Slippery Slopes Of Demonetization

Transformation of State owned giants:

The banking sector is predominantly dominated and operated by state owned entities. There have been widespread accusations about the efficiency and the bureaucratic nature of the employees working in these banks. Going forward, this image has to change without which the public will hesitate to involve these banks more and more in their transactions. For most of the people it is going to be the first time they will be availing the banking services. These people have to be guided properly and be welcomed into the banks. Hence the onus is on the bank employees to step out of their comfort zones and make sure that the government's indented goals

are met. However, it has been proved time and time again this expected change in the banking sector will not be an easy one. This sector has always resisted the change and have always been reluctant reactors to change. Credit should be given to the banking sector for their work after the announcement of demonetization. But it is important they realize that their job is only half done and the major chunk of the work is yet to be done. No sort of complacency can creep into the system.

Issue of the laggards:

The theory of innovation given by Everett Rogers states the people can be classified into five major categories based on their adaption to a new change in any system. They are innovators, early adapters, early majority, late majority and laggards. The first three sector represents the people who adopt to any changes in a short span of time. But the true success of any change is making the people in the other two sectors to adopt to the change as early as possible. With respect to demonetization, the people who are generally technology averse and unaware falls under the category of late majority and laggards. It can be roughly estimated that around 50% people fall under this category. Hence it is essential to convert these late adopters and laggards to adopters for the demonstration to become a success.

La Lingua Pura:

La Lingua Pura refers to a common bridge language that exists in a land of multiple languages. To a certain extent, English was doing that job in India. Hence it became the official banking language of India. With the exception of Hindi in certain regions, the other languages do not find place in the banking sector. It is imperative that a myriad of Indian languages is incorporated into the banking sector to accommodate people from all walks of life to enter into the banking system. Usage of regional languages in the banking system will make the people understand the banking system better and make them self-reliant.

Infrastructure:

There is need for a significant upgradation of the banking system as well as in the telecom infrastructure that would act as the backbone for digital transactions. For people to be able to transact at any time and place as well as for them to consider it a reliable medium of exchange, it is important that not only the banking system is upgraded to ensure that transactions can be completed without a hitch, but the supporting infrastructure too is up to the mark. For instance, in many parts of the economy, there is limited and intermittent supply of electricity as well as mobile connectivity. In these areas, it would be difficult to expect people to shift to electronic medium of exchange.

IV. Conclusions

The people can't expect the government to wave a magic wand and eradicate black money all of a sudden. The government can also not relax and bank on demonetization to do the job. Eradication of black money can be realised only through a set of well thought out and interlinked web of activities. In this regard, the government has taken the first step by announcing demonetization. It surely is the hub from which different spokes are supposed to branch out. It is important for all the spokes to be strong for the wheel to be perfect. Similarly, from now on, each and every individual of this country has to make sure that he/she has to take up the responsibility of eradicating the money in any small manner they can and make the country great again.