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Consequences of the demonetisation shock

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With the overall tightening of the regulatory environment, tax evaders and wilful defaulters may consider changing their game. Photo: Pradeep Gaur/Mint

The images on television are troubling. Harassed people queuing for hours. An elderly man, obviously quite sick, crying helplessly. The hospital wouldn't admit him for the required surgery nor would the chemist sell him the drugs he needed because his money had ceased to be legal tender. A lady crying, her husband had just died because no hospital would admit him. The treatment money she had had suddenly become worthless. Frustration is widespread, patience is running thin, and there are worrying reports about incidents of violence, fortunately still isolated. It is a challenging moment for the country. It is a pity that instead of empathizing with the people in the queues, some TV panellists are dismissing their plight or even provocatively asserting that all complainants must be black-money *wallas* or terrorist sympathizers. Let's step back from emotion and dispassionately consider the consequences of the demonetization shock.

In tune with Joseph Schumpeter's theory of "creative destruction", disruptive technologies and events are now considered to be good things, the forces that drive competitive capitalism. The demonetization shock is certainly disruptive. Eighty-six per cent of the money in circulation has been extinguished at a moment's notice. It had to be done suddenly, without warning. Otherwise, its whole purpose would have been defeated. But is it good for Indian capitalism? What are likely to be its immediate and longer term consequences?

In addressing these questions, we must first recognize that the big fish who have amassed huge wealth from black money, i.e., tax-evaded income, hold most of it as real estate, gold and other real assets. Some of it is also held as assets abroad. None of these will be affected by demonetization. A relatively small portion is held as non-bank money to finance "black" transactions. This component is the target of demonetization.

However, black money cannot be easily separated from white money. It depends on whether or not a particular transaction generated any tax-evaded income. Some portion of such black money flows from criminal activities such as drug peddling, human trafficking or worse. But most of it is generated from normal economic transactions.

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Thus, you may purchase something from your tax-reported income, i.e. from white money. But if the shopkeeper doesn't report the transaction, the money now becomes black money. If he then spends it on something with tax-compliant billing, the money is transformed back into white money. Alternatively, he could under-report your transaction by, say, 50%. In which case half of the transaction is white money and the other half is black. Thus, the same Rs 1,000 note is white at some stage of its circulation and black at another, or a part of it is white and the other part black! It is therefore extremely difficult to estimate how much of the money in circulation is white or black or, for that matter, how much of India's national income is white and how much is black.

Without getting into technicalities, let it suffice to say that black money is so intermingled with white money and so widespread that any attempt to curb it sends shock waves through the system. The shock can have both negative and positive effects.

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The largest adversely affected group, numerically, is the working class. Casual workers are at the bottom of the working-class hierarchy. Their incomes are the lowest and least secure. They spend the money as they earn it. Those paid in old Rs500 or Rs1,000 notes would have had to lose a day's wage to queue up at banks to convert their money. If the cash ran out, they would have had to lose another day's wage. Meanwhile, they would have had no money to buy food, medicines or other essentials, and God help them if they had a medical emergency. In the towns and cities, these workers are queueing up at banks. What about unbanked villages? The banks have reportedly despatched armies of mobile-banking correspondents to service such villages. How that is working out on the ground I have no idea.

Next, there are the medium-skilled blue- and white-collar workers in the unorganized sector and contract workers in the organized sector. Finally, there are the regular organized-sector workers, the most skilled and the best paid. All of these wage/salary recipients would have received their wages shortly before the demonetization. They too would have had to miss work and queue up at banks or ATMs to convert their money. Without conversion, they would have had no usable money for food, medical expenses and other essentials.

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The entire working class adds up to about 400 million persons. Most of them are unlikely to have any tax-evaded income because their annual incomes would be below the income-tax-exemption threshold. They and their families are bearing pain for the sins of others. Hopefully, the pain will be short-lived and the working class will be back to business as usual once the demonetized notes are replaced by new notes and normal money supply is restored.

The next major group adversely affected are the small-medium enterprises in services and industry, especially wholesale and retail traders. Cash transactions are an integral part of their daily operations, especially for traders. Their range of goods includes everything from raw materials to intermediate inputs to food items and other consumer goods. Numerically, this class is not as large as the working class, but their impact on economic activity is very large. Demonetization is a bit like a car running out of fuel in their case. Their businesses have been severely disrupted. Those with substantial stocks of black money are also probably taking large haircuts. We are likely to see a significant dip in economic activity till January or even till the end of the financial year because of this disruption.

The third group adversely affected are the self-employed professionals, for example, doctors, lawyers, accountants. It has been suggested that the incidence of tax-evaded income is high among this group, many of whom are high net-worth individuals. Their wealth portfolios would be similar in structure to those of the “big fish” even if not quite as large. For both groups, the large non-monetary component of their wealth would be unaffected, but the monetary component will be extinguished to the extent that demonetization forces the unloading of hoarded black money.

For all the three groups above, the impact would probably be quite short-lived. But for a fourth category, the real-estate industry, the disruption is likely to be quite severe and long lasting. This sector is the destination where large proportions of black-money flows are converted into real assets, and black-money transactions are all-pervasive. The sector has already been in the doldrums for the past couple of years and transactions are likely to remain frozen for quite a while, with corresponding downstream effects in cement, steel and other construction materials.

Turning to broader macroeconomic implications, let’s first look at the fiscal impact. Of the large deposits flowing into banks every day, if a significant component turns out to be tax-evaded income, it will generate an incremental flow of direct-tax revenue and penalties. On the other hand, as mentioned above, we are likely to see significantly reduced economic activity during the next few months, and that will reduce the flow of indirect-tax revenue. Clearly, no hard estimates of the net effect is possible at present. But my judgement is that total tax revenue will be well below budget projections, leading to an increase in the fiscal deficit.

On the monetary side, a very interesting phenomenon is playing out. On the one hand, 86% of currency in circulation by value has been extinguished in one shot, delivering a huge negative monetary shock. On the other hand, there is a massive increase in bank deposits. Essentially, a part of the money supply that was taken out of the banking circuit has been brought back into it, i.e., from the black economy to the white economy. The large growth of bank deposits will enable the enhanced flow of bank credit. Whether that actually happens or not will depend on the banking sector’s other problems, particularly the dire stressed assets situation in public sector banks. The Reserve Bank of India (RBI) has provided some accommodation on that front by recently easing its asset classification norms.

Thus, there will be two forces acting to increase aggregate demand. The increased fiscal deficit and, possibly, the increased flow of bank credit. Whether this will be enough to offset the immediate negative impact of the monetary shock on economic activity is a judgement call. My own guess is that on balance, we will see a reduction in economic activity over the next few months.

Will demonetization curb the growth of the black economy, its main goal? This question has to be addressed in the larger context of an evolving policy environment. The legislation on benami transactions is now in place. So is the bankruptcy code. Demonetization is forcing the declaration of hoarded black money. The goods and services tax will also tilt the scale against tax evasion. With the overall tightening of the regulatory environment, tax evaders and wilful defaulters may consider changing their game.

Describing this as a possible paradigm shift in the policy environment, former RBI governor Y.V. Reddy mentioned in a recent conversation that action may gradually shift to the courts as tax evaders and wilful defaulters look for legal protection. Whether or not measures like demonetization can clean up Indian capitalism will depend ultimately on how effectively the judiciary, the legislature, the executive and RBI cooperate in the joint campaign against black money.

Sudipto Mundle is emeritus professor at the National Institute of Public Finance and Policy, and was a member of the Fourteenth Finance Commission.