How demonetisation is hurting India's growth

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September 3, 2017

The patient was the Indian economy.

Among the 176 countries that have been ranked by Transparency International on a scale from 100 (very clean) to zero (highly corrupt), India ranks in the second half of the list at 79, with the illegal money of sizeable proportions.

The central government, which was elected on the promise of a cleaner government, is worried about coming to power again. With the impending election two years away, it had to do something drastic: a much-dreaded surgery with uncertain consequences. That was the November 2016 decision of demonetising Rs500 and Rs1000 currency notes in order to curb black money.

The demonetisation was clearly aimed at eliminating black money. Idea was that around Rs5 trillion or so would be declared illegal; RBI's liabilities would be extinguished, giving rise to larger than usual annual profits and they would be turned over to the government as dividend for funding planned social welfare schemes and infrastructure projects. The windfall did not materialise.

Early this week, it was announced that of the estimated Rs 15.44 trillion of currency that was rendered invalid due to demonetisation Rs 15.28 trillion has come back into the Indian banking system. Does it mean that the so called "illegitimate money" that has now been legitimised was, in fact, a close 99 per cent? The unreturned money of about Rs 0.16 trillion is just 1 per cent.

The question is: was the team of surgeons, minimum in number for secrecy purposes, competent enough? Or if a member expressed a contrary view, was it given due consideration? That will remain a secret for some time.

For every fait accompli decision, there are always two views, one supportive and another opposed, whether one likes it or not.

So, is the achievement worth the effort? The price of "achievement" following demonetisation has now been measured. Economic growth rates have been falling. Though not big falls and of course the growth rates are positive.

In the April-June 2017 quarter, the gross domestic product grew at 5.7 per cent - a three-year low, much below the 7.9 per cent GDP growth in the corresponding quarter of 2016 and lower than 6.1 per cent recorded in the January-March quarter of 2017. It is a clear downward trend.

GDP growth can always be attributed to not one but a combination of factors in a developing economy. The most important component of aggregate demand is domestic consumption. Falling demand is also influenced by decreased external demand for domestic output and competitiveness of India's exports and, of course, investment demand. The government's chief statistician was in a hurry to point out that it would be incorrect to attribute it to 'demonetisation effect'. He laid the blame on the impact of GST roll out on the industry.

All along, ever since the November decision was announced, the growth momentum has been halted. The fears of economic doom have gripped the nation. The middle class has been rudely shaken.

The International Monetary Fund in January 2017 updating the earlier October 2016 World Economic Outlook lowered its estimate of India's growth. It said India would grow only at 6.6 per cent as against its earlier estimate of 7.6 per cent on account of the "temporary negative consumption shock, induced by cash shortages and payment disruptions associated with the currency note withdrawal and exchange initiative." The IMF hoped demonetisation would strengthen India's institutional framework by reducing tax avoidance and corruption and would support efficiency gains.

The finance minister Arun Jaitley is now keen to highlight tax avoidance, broadening the tax base and reducing the size of the informal sector and other likely gains, and continues to downplay the main purpose behind the demonetisation decision. "People with inadequate understanding of how to tackle black money linked note ban with money returned to system," said Jaitley. "Money has now been identified with its owner."

It is touted that not only has liquidity been restored but that now there is an excess of it. A working paper on 'Demonetisation and Bank Deposit Growth' notes an unusual increase in cash deposits of about Rs 1.7 trillion.

Last month, RBI deputy governor Viral Acharya referred to an unintended outcome of demonetisation decision: a benefit indeed. It is the shift away from bank deposits to financial assets. Bloomberg reported that funds have moved from low-cost current account and savings accounts to other financial instruments. Mutual funds are among the beneficiaries with their assets at Rs18.96 trillion as of June 2017, compared to Rs 16.28 trillion in October 2016.

The finance minister is keen to get on with his work, apparently, he does not want to spend any more time discussing why the windfall did not materialise and why only one per cent of the Rs 15.44 trillion liabilities were extinguished. He has no time to waste on the elusive black money.

The only solution is urgent cleaning up of the public sector banks: the twin balance sheet problems; mounting corporate debt; commercial banks' rising non-performing assets; the poor flow of bank credit and speeding up proposed bank mergers. With the return of the 99 per cent of the so-called black money, liquidity is no more a hurdle. RBI knows money stock has risen with unexpected deposits, and it has to be on guard against inflationary conditions.

Instead of plodding the RBI for another cut in policy rate in the next October meeting of Monetary Policy Committee, the government should resume good governance. It has to raise investor confidence. It must bestow full autonomy on RBI in the pursuit of its mandated goal: price stability.

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