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India pays the price of demonetization

Modi's war on black money has hit India's economy. Is the price worth paying?



A man holds placards and shouts slogans during a rally organized by India's main opposition Congress party against the government's decision to withdraw 500 and 1000 Indian rupee banknotes from circulation in Mumbai on Nov. 28. © Reuters

One month after Indian Prime Minister Narendra Modi announced the demonetization of 500- and 1,000-rupee banknotes in his battle against black money, policymakers in New Delhi are finally starting to acknowledge that the shock move has caused immense upheavals, loss of incomes, disruption to businesses and inconvenience to millions of hapless citizens caught in the cross-hairs.

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The economic fall-out from Modi's November decision has been widespread, although the government and the Reserve Bank of India insist the pain will be short-lived. The central bank surprised forecasters by leaving its benchmark interest rate unchanged when its Monetary Policy Committee met on Dec. 6-7. Although consumer price inflation dropped to 4.2% in October, and the RBI saw further disinflation as a result of demonetization in the October-December quarter, the central bank said it would stay vigilant to ensure CPI comes in at a targeted 5% by March 2017 as food and fuel prices trend upward. The RBI said its assessment was "clouded by the still unfolding effects" of demonetization and lowered its growth forecast for fiscal 2016/17 to 7.1% from 7.6%. Although gross domestic product grew by 7.3% in the July-September quarter, gross fixed capital formation has declined for three consecutive quarters. The RBI said demonetization could "transiently interrupt" industrial activity in November and December due to delays in payment of wages and purchases of inputs.

It is still too early for major indicators after the demonetization move, but the Nikkei Markit India Purchasing Managers Index fell back in November after hitting a 22-month high in October. More worryingly, foreign investors appear to be fleeing Indian debt markets. A Nomura Securities report on Dec. 8 noted that foreign portfolio investors and sovereign wealth funds had pulled 141.3 billion rupees out of Indian markets in the first five days of December, after a record withdrawal of 172.7 billion rupees in November, sharply up from 71.5 billion rupees in October. Outflows spiked from Nov. 11 after Modi's surprise demonetization announcement, which coincided with Donald Trump's election as the next U.S. president. More volatility is in store if the U.S. Federal Reserve, as is widely expected, hikes interest rates at its policy meeting next week.

Unforeseen effects

Demonetization has had some unintended consequences, too. State-run electricity companies across the nation, which were allowed to accept payments in the banned notes until Dec. 30, saw a sharp and welcome drop in arrears. But tourist arrivals plunged, and foreign embassies, forced to adhere to limited cash withdrawals, were furious about what they saw as a violation of diplomatic privileges. Some, like the Russian embassy, even threatened retaliation against Indian diplomats in their respective countries.

"The consequences that have emanated from [demonetization] were taken on board, and that is why the planning, the process and the implementation was what it was, keeping in mind that high secrecy had to be maintained," RBI Governor Urjit Patel told a post-policy meeting press conference. The problems of ordinary people, he added, were "at the top of our radar."

There is little doubt that demonetization has affected nearly every aspect of India's economy, and triggered a huge political row that pits Modi against all opposition parties. Parliament's winter session, which began on Nov. 16 and

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will end Dec. 16, has been paralyzed by fiery speeches, daily protests, shouting matches and chaotic adjournments. Pending legislation is in deep freeze. The crucial Goods and Services Tax, targeted for launch by April 1 next year, is mired in political wrangling.

Cracks are starting to appear in Modi's ruling Bharatiya Janata Party (BJP). On Dec. 7, party elder L.K. Advani blasted the lower-house speaker and the parliamentary affairs minister for not controlling the uproar. A day later the normally neutral President Pranab Mukherjee lashed out in a speech, telling lawmakers: "For god's sake, do your job. You are meant to transact business in parliament."

Modi has not spoken in parliament so far about his controversial decision, although he has hit at critics in speeches across the country. On Dec. 8, he took to Twitter to salute Indians for "wholeheartedly" backing his "yagna" (sacrificial fire) against corruption, terrorism and black money.

"I always said that the government's measure will bring a degree of inconvenience but this short term pain will pave way for long term gains," he tweeted, adding that India had a historic opportunity to embrace cashless payments. He said his campaign will "empower the poor, neo-middle class, middle class and benefit future generations."

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Modi's war on black money has hit India's economy. Is the price worth paying?

Modi's Finance Minister Arun Jaitley on Dec. 8 announced a raft of discounts and tax rebates for citizens who used credit or debit cards and mobile wallets for transactions including buying petrol and train tickets, paying tolls or insurance premiums. Government ministers have been commanded to get their armies of bureaucrats to reduce their dependence on cash.

Cashless life?

Jaitley said the government would issue 43 million RuPay debit cards to farmers to encourage digital payments in the countryside, and that two point-of-sale machines would be installed in each village. Banks have been ordered to install an additional one million PoS machines nationwide, in addition to the 1.5 million already in use.

As much as 93% of India's workforce is in the unorganized sector, accounting for about 45% of GDP. Modi's government said in early December that it had organized more than 270,000 "camps" to encourage unorganized workers to move away from cash, and more than 2.45 million new bank accounts have been opened.

Demonetization has also spawned a huge flood of grim social-media humor, but along with the jokes have come rumors about the government's next steps, ranging from a total lockdown of all real-estate transactions in 2017 to imminent seizure of gold jewelry, traditionally hoarded by Indian households over generations.

Will demonetization put an end to India's black money? RBI Deputy Governor R. Gandhi said that until Dec. 5, the value of the banned banknotes deposited totalled 11.55 trillion rupees, which works out to about 78.5% of the total banned value of 14.7 trillion rupees.

Economists say that if nearly all the banned currency returns to the system

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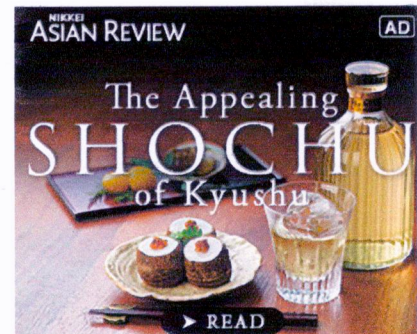
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off, even taking into account a scheme announced by Modi on Nov. 28 that allows Indians to come clean on undeclared wealth, incurring tax and penalties totalling 50%, with a further 25% frozen for four years in state-backed poverty alleviation program.

Experts caution that black money is only a small part of the black economy which, besides criminals, counterfeiters and tax evaders, also consists of millions of people in the informal sector whose incomes fall below tax thresholds. Estimates are complicated by the fact that agricultural income is not taxed, although the government is looking at taxing farm incomes that exceed 10 million rupees annually.

Economist Arun Kumar, who has been studying illegal fund flows for over 30 years, has just published a detailed paper that estimates the size of the black economy was 62% of GDP as of 2012. "The average rate of growth of the black economy in the five-year period up to 2012 was about 20%," Kumar wrote.

Authorities have been racing to stay one step ahead of India's ingenious money launderers and black-marketers. The RBI has issued more than 50 notifications in the month since demonetization was announced. The government says it has so far suspended about 35 officials at state-run banks for facilitating illegal transactions, and income-tax investigators are probing 50 bank branches. But the battle is all uphill, and already, investigators report that illegal stashes of newly-issued banknotes and large stashes of undeclared income have surfaced in seven major cities.

Chaitanya Kalbag is a former Asia Editor at Reuters and editor-in-chief at the Hindustan Times

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