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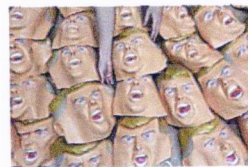
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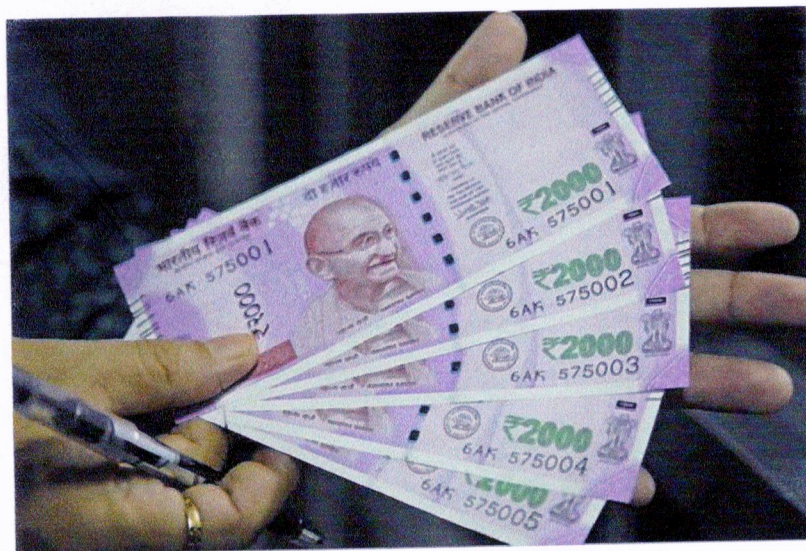
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November 22, 2016 1:00 pm JST

Chaitanya Kalbag -- India struggles to find its feet after demonetization



An Indian shows new 2000 rupee notes he received after exchanging discontinued currency notes in Jammu, India. © AP

Every Indian banknote carries two reassuring messages: "Guaranteed by the central government," and above the signature of the governor of the Reserve Bank of India, the words: "I promise to pay the bearer the sum of ... rupees."

At midnight on Nov. 8, Indian Prime Minister Narendra Modi used an executive fiat to extinguish both those promises, rendering around 16.5 billion bills of 500 Indian rupee-notes and 6.5 billion bills of 1,000 rupee denominations worthless at one stroke.

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Two weeks into his wrenching demonetization of high-value bills, analysts believe Modi has taken the biggest gamble of his career, combining political audacity with economic brinkmanship.

The decision has triggered nationwide chaos. Much of India's cash-based economy has ground to a near standstill. Stock markets are at six-month lows. Millions of people have spent days waiting in line at overburdened banks to exchange useless old currency or deposit it in bank accounts. Nearly every day, the government has announced new steps to manage the crisis, first increasing the limit of money that could be exchanged, then slashing it; one day granting a higher withdrawal limit to farmers who desperately need to buy seeds as the winter sowing season starts, and on the next, allowing more money to hapless families as the country's wedding season kicks off.

The pain has been made worse because India, despite its size, is very underbanked. The World Bank says that as of 2014 India had 13 bank branches per 100,000 population, compared to 32.4 in the U.S. and 33.9 in Japan. The country has only about 200,000 automated teller machines, many of which still need to be recalibrated for newly-printed banknotes of different sizes.

Political gamble

After a four-day silence on the issue, Modi has used unusual situations to talk about his crusade against black money. On Nov. 12 during his recent visit to Japan, he told a crowd of about 500 Indians at the port city of Kobe that he thanked the millions of his countrymen who had coped with the inconvenience. "Many people [with black money] who had parked their aged parents in old people's homes suddenly decided to deposit up to 250,000 rupees (\$3,675) in their accounts," he said mockingly, referring to the limit of old notes an individual was allowed to deposit in an account. A week later he spoke by video link, just before a Coldplay concert at a youth festival in Mumbai, telling the crowd: "To make public policy cool is no mean task!" and vowing to clean up India before quoting Bob Dylan's lyrics from "The Times They Are A Changin'."

A senior official involved in policymaking said that while Modi had emphasized the secrecy of his demonetization plan ahead of the announcement, it had been in the works for months. He said the central bank's former Gov. Raghuram Rajan had been opposed to demonetization, while his successor Urjit Patel, who took office on Sept. 4, had immediately signed off on the printing of a new 2,000 rupee banknote, along with new designs of existing denominations. Although two government printing presses had been working overtime to print the new notes, supplies have been slow to reach the big cities and the vast Indian hinterland.

Modi said demonetization was aimed at India's huge black economy -- some sources estimate it comprises around half of the nation's \$2 trillion gross

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domestic product. But the official said the demonetization would hit transactions in the works; about three quarters of the cancelled currency was in play in current transactions.

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November 22, 2016 1:00 pm JST

Chaitanya Kalbag -- India struggles to find its feet after demonetization

Will demonetization vacuum up all the black money? Economists believe most illicit, untaxed funds would be diverted into buying gold or real estate; indeed, gold imports spiked in the days immediately following the announcement. But will India ever be cashless?

A Nomura Securities report said that India's cash-to-gross domestic product ratio was high at 12%, compared with an emerging-market average of about 4%. The demonetization erased about 86% of total currency in circulation. RBI data shows that between 2011 and 2016, the number of 500 rupee notes rose by 76% and of 1,000 rupee notes by 109% -- which begs the question, why did the central bank continue to print so much currency when the country's GDP only grew by a total of 30% over the five-year period?

Modi has aggressively pushed financial inclusion, and the government has opened 255 million Jan Dhan ("people's wealth") zero-balance bank accounts for the unbanked poor, to use for any social welfare transfers and ideally, for deposits. But nearly a quarter of those accounts were still empty as of Nov. 9, and the remainder each had average deposits of only 1,788 rupees. In 2014, the year Modi took power, the World Bank estimated only 53% of the population above the age of 15 had bank accounts.

One senior economist said that with all major banks this year signing up for the government's United Payments Interface scheme, which enables fund transfers between bank accounts and to merchants using a smartphone app, the government ought to have concentrated on moving more transactions online.

Some critics question whether demonetization will also hit counterfeiting and terrorist funding, two other reasons Modi cited for the demonetization. RBI data shows a total of 632,926 counterfeit bills were detected by banks in the year to March 2016, from an estimated total of 90.27 billion banknotes in circulation. Government ministers have said Pakistan-based terrorist groups

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-raiding India-ruled Kashmir use counterfeit currency; experts say it is only a matter of time before new currency notes are copied, which is why the government continually issues new series with enhanced security features and phases out old ones as soiled notes are returned.

Although the government has given Indians until Dec. 30 to exchange or deposit their old banknotes, progress has been slow. The RBI says that from Nov. 10 to Nov. 18 a total of 5.45 trillion rupees, about a third of the demonetized banknotes, had been exchanged or deposited in banks.

Parliament's winter session, which began on Nov. 16, the exact midpoint of Modi's five-year term, has been paralyzed by opposition parties accusing Modi of financial skulduggery and demanding a rollback of the demonetization, which is now effectively impossible. But political parties, including Modi's, are not prepared to be transparent about their election fundraising, which runs into billions of dollars.

Black economy

Modi's big reform will doubtless force more people to pay their taxes. In the 2015-16 fiscal year, 28.7 million Indians filed tax returns but only 12.5 million actually paid taxes -- less than 1% of the population. In this tax-evasion culture, demonetization is seen as breaking the social contract. If the government does not improve infrastructure or provide better services, people will continue to avoid paying taxes.

Demonetization is unpleasant, confiscatory, and underlines a failure in tax administration, a second senior economist said, characterizing it as one step removed from the arbitrary expropriation of property. Most black money is spawned by completely legal activity, except that no tax is paid to a government that is seen as renegeing on its part of the social contract.

The broader question here is what impact demonetization will have on India's economy in the short to medium term. Nomura estimates the loss of about 1.9% of GDP. It sees GDP growth as slowing to an annual 6.5% in the September-December quarter from an earlier forecast of 7.3%, but expects GDP to grow by a healthy 7.7% in 2017. Furthermore, it expects the banking system to be flooded with 4.5 trillion rupees in new deposits, leading to lower deposit and lending rates.

Mumbai-based Ambit Capital is more pessimistic, and forecasts the informal sector -- which accounts for about 40% of GDP and around 80% of the labor force -- to contract and prompt the closure of around half of all non-tax paying businesses, with tax-paying businesses in the formal sector the ultimate beneficiaries. Economic activity will be paralyzed in the short term, Ambit says, and GDP might even contract in the September-December quarter. Ambit sees GDP growing only 3.5% in 2016-17 from an earlier forecast of 6.8%, and at 5.8% in 2017-18 against an earlier 7.3% estimate.

Whatever the immediate impact, most economists expect a temporary



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disinflationary effect, and likely further cuts in the benchmark repo rate -- the discounted rate at which a central bank repurchases government securities from the commercial banks -- by the RBI at its Dec. 6-7 policy meeting. Modi has spoken of more policy measures to be introduced after Dec. 30. His government was forced to deny a spate of rumors, one of which suggested that all bank lockers would be sealed and all jewelry and household gold holdings would be seized. Hopefully, by the new year, Modi will know if he rolled the demonetization dice correctly.

Chaitanya Kalbag is a former Reuters Asia editor and editor-in-chief of the Hindustan Times.

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