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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 reneging 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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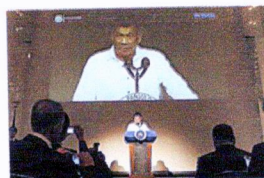
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