

MODIMONETISATION ANY EFFECT ON THE BLACK ECONOMY?

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Abstract: “There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency.” John Maynard Keynes 1919.

On the 8th of November the Narendra Modi government announced in the late hours of the day that over 14 trillion rupees worth of 500 and 1,000-rupee notes which makes up about 86% of all the currency in circulation would no longer be legally acceptable as a medium of exchange throughout the nation. The government goal was to make good on his campaign pledge to fight “black money” the illicit proceeds often held as cash of tax evasion, crime, and corruption. It also hoped to render worthless the counterfeit notes reportedly printed by Pakistan to fuel terrorism against India. India economy holds an unparalleled record as an economy where unreported income is the norm. According to a 2010 World Bank estimate, the shadow economy in India makes up one-fifth of the country’s G.D.P. A 2013 study by McKinsey, the consulting firm, puts the figure at more than one quarter of the GDP. Reports by Central Bureau of Investigation said that Indians have US\$500 billion of illegal funds in foreign more than any other country. The World Bank estimated India’s shadow economy to be 23.2% of India’s total economy in 2007, and eight years later one would expect it to have increased further both in percentage and in absolute amount. Note that that last decade has seen a fast pace of GDP growth in India. Therefore if the shadow economy is 25% of the total economy, this will be equal to over \$2 trillion in PPP terms (India’s GDP in 2016 is \$8.7 trillion in PPP terms or \$2.3 trillion in nominal terms).

Usually as it is with most government policies, the demonetisation policy after its initiation has sparked off a huge dichotomy among the citizens of India. While some faction believed it was a “master stroke” as well as a “surgical strike” to rid the nation of black money and to counter terrorism, a huge number of the population has criticized the action as being ill conceived and poorly executed. This has led to various forms of protest the most notable being led by the west Bengal chief minister Mamata Banerjee. Opponents insist that the current demonetisation has adversely affected the poor, wage labourers, small businesses, farmers and other minorities. Often these small income earners save cash for a rainy day. The incidence of bank accounts and bank transactions will be extremely low among these groups. These are the communities who do not engage in the formal banking sector too much. Rather they save their daily or weekly wages in cash, often in large denominations. It is these groups who have been hit the most by the severe economic disruption caused by the demonetisation drive.

Introduction: This is not the first time an Indian government is introducing a demonetization policy. The current demonetisation is the second one since independence. In 1978, the government led by Morarji Desai introduced the high demonitisation bank note Act which made the Rs.1000, Rs.5000 and Rs.10, 000 notes illegal. The expectation at the time was that the black or shadow economy, estimated to be around 15-18% of GDP then, would reduce if not get totally eliminated. But black money went up to 18-21% during 1983-84.

In the case of the current demonetisation policy, there has been a huge effect on every sphere of the Indian economy. The poor and lower middle classes, who greatly rely on cash for their daily activities are the main victims of this supposedly “pro-poor” policy. Small producers, lacking capital to stay afloat, are already shutting down. India’s huge number of daily wage workers can’t find employers with the cash to pay them. Local industries have suspended work for lack of money. The informal financial sector which conducts 40% of India’s total lending, largely in rural areas has been brought on its knees. Farmers have been unloading produce below cost, because no one

has the money to purchase, and the winter crop could not be sown in time, due to lack of cash for seeds. The effect of the policy extends far beyond queues that we see in front of banks. Hospitals are turning away patients who have only old banknotes; families cannot buy food; and middle-class workers are unable to buy needed medicine. As many as 82 people have reportedly died in cash queues or related events. Furthermore, it seems likely that many of the short term effects of the demonetization could persist and intensify in the longer term, with closed businesses unable to reopen. It could also cause lasting damage to India’s financial institutions, especially the Reserve Bank of India.

Ambit Capital, a respected Mumbai-based equity research firm, has officially estimated that the demonetisation-driven cash crunch will result in GDP growth crashing to 0.5% in the second half of financial year 2016-17. This means the GDP growth for six months, from October 2016 to March 2017, could decelerate to 0.5%, down from 6.4% in the previous six months. It further stated that during the October to December quarter that we are currently in, the GDP growth may contract, thus showing negative

growth. However, Ambit is hopeful that a strong formalisation of the informal economy will ensue through 2017 until 2019 and this disruption could also crimp GDP growth in 2017-18 to 5.8 % from their earlier estimate of 7.3%.

This leaves us with the big questions does the current demonetisation policy of the Modi's government have any effect on the black economy. If yes what are some of these effects and how do they affect the economy. Also another question that comes to mind is if the supposed effect achieved is worth the trouble that the whole economy has to go through?

To say the demonetisation policy has not had any reasonable effect on the economy would amount to being economical with the truth. The government's demonetization dragnet has no doubt caught some illicit cash. Some tax evaders will surely bring out their cash stashed away in mattresses and false ceilings. Report in some section of the media stated that some people have turned in their black money and paid a penalty; others have destroyed part of their illegal stashes in order not to draw attention to their businesses.

The effect of demonetization comes through the netting of black money deposited in the banking sector in form of banned notes since November. Up to Rs.12 lakh crore of the Rs.15.44 crore demonetized currency is with banks now. It is estimated that up to 1.5 to 2 lakh crore may be identified as black money. Out of this, around 1.2 lakh crore may be collected as taxes at 50% to 85% tax rate. This could amount to 1.75% of India's GDP.

But the overall benefit has been small. Shrewd and criminally minded ones have resorted to the use of multiple bank accounts in other names. Some have further redistribute their money in small parts, bought gold and converted local currency into foreign. We can say that the effect is probably only limited strides in shrinking the black economy. But this is only a minuscule percentage of the total while affecting all of India's 1.3bn citizens, the poorest most of all. The demonetisation so is on its way towards triggering a recession, while not entirely addressing the black economy. It has affected only those individuals who hold cash. Many have already converted their money into assets, and invested in gold and other luxury items are only marginally affected. This demonetisation is not likely to impact the structure, level and incidence of corruption in India. Often the proceeds of corrupt bureaucrats and politicians never arrive in India; they are handled off shores.

It was the Government's case that high value denomination currency is used to hoard black money, but it came up with the decision to reissue new Rs.500, Rs.1000 and Rs.2000 notes. The act of Issuing

these note is completely incomprehensible and surprising. Such action will make the job of moving black money very easy and fun.

One important factor which I believe the Modi government did not take note of is that the bulk of black money in India isn't money at all it's held in gold and silver, real estate and overseas bank accounts. . Not all black money is in cash, and not all cash is black money. Those who held large quantities of black money seem to have found creative ways to launder it, rather than destroying it to avoid attracting the taxman's attention, as the government expected. As a result, most of the black money believed to have been in circulation has now flooded into banks, depriving the government of its expected dividend. Another is that even if demonetization can flush out the black money that is held in cash, with no improvement in catching and punishing tax evaders, people with ill-gotten gains will simply start saving in the new bills currently being issued.

One a closer note one can say that the Modi's government demonetisation aims mainly at treating symptoms instead of dealing with the cause and source of black money. The government's plan does nothing to control the source of black money. It will not be long before old habits of black money generation such as under-invoicing, fake purchase orders and bills, reporting of nonexistent transactions, and blatant bribery generates a new store of black money.

Conclusion: While i laud Narendra Modi zest to rid India of any form of black money and terrorism. I must be quick to add that tackling corruption also goes beyond demonetization of currency, cash or even banking. It requires reformation of institutions and mind-sets, and carefully creating policies that understands and acknowledges the complexity of economic and social life. The government ought to understand that not all of India's shadow economy which provides real employment and income; if not real tax revenues can migrate quickly and easily above board.

The government also needs to take a bold step forward by ensuring that tax evasion is not encouraged in anyway or treated with kid gloves. It could start by ensuring that offenders are severely punished and reforming India's outdated anti-graft laws would be a step in the right direction.

The government also has to take cognizance of the fact that in a country like India, where the illegal economy is so intimately intertwined with the mainstream economy and an indiscriminate government intervention against shadow activities can do a lot of harm to the vast majority of the people.

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