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Modi’s Demonetisation Gamble

By Pradumna B Rana

Synopsis

Since the costs of the shock currency move of last November continue to mount while the benefits are less obvious, the forthcoming state elections will be a key test for Prime Minister Modi and his economic reform programme.

Commentary

ON 8 NOVEMBER last year, in a surprise move, Prime Minister Narendra Modi announced that the two largest currency bills, accounting for 86 per cent of currency in circulation by value, would be invalid immediately. This shock move led to a nationwide commotion and outrage.

Two months on, it appears that the costs of the cash crunch are outweighing the benefits. Some economic and political fallout of the bold move are inevitable in the short term. It should not be a surprise if Modi suffered some setbacks in state elections that are approaching.

Economic Reforms in India

India embarked on economic reforms in the early 1990s in response to a severe balance of payments crisis. Monetary and fiscal policies were tightened, tariffs were reduced, and the pervasive industrial licensing system was liberalised. These reforms unleashed market forces and placed the economy on a higher growth path. India’s share of global GDP had also started to rise somewhat and there was talk of the emergence of a “Shining India”.

But these hopes were dashed when the private-sector-led economic growth due to
“first generation” reforms ran out of steam and the world economic environment turned unfavourable after the global economic crisis of 2008-2009.

PM Narendra Modi was elected in 2014 on a platform of economic reforms. The centre-piece of his programme has been the “Make in India” campaign which seeks to encourage foreign and domestic investors to invest in the manufacturing sector. The campaign is being supported by three programmes: Skills India (the human resource component); Digital India (the communications component); and Smart Cities (development of 100 smart cities). A key constraint is infrastructure, hence the government plans to construct 30 km of road a day compared to two km day under the previous administration.

The “Make in India” campaign and its supporting policies were implemented in a gradual and politically sustainable manner. An experimental approach was adopted in the case of sensitive reforms such as labour market reforms which was first adopted in the state of Rajasthan and subsequently replicated in several other states.

Gradualism had worked and the country’s economic growth had increased to 7.2% in FY 2014/15 and 7.6% in 2015/16 making India the fastest growing country in the world.

“Shock Therapy” of Demonetisation

In 2016, PM Modi accelerated the pace of reform and went for the “shock therapy” of demonetisation. Over two months on, while the costs of demonetisation have been mounting, the benefits have become less obvious.

Initially, the cash crunch ground India to a halt. But now some semblance of normalcy has returned although there are still limits on the amounts that can be withdrawn from ATMs and bank deposits. Part of the reason for the high costs were the delays in printing and distributing the newly minted currency notes and the need to recalibrate ATMs because the size of the new notes were different from the old ones.

A survey by the All India Manufacturers’ Organisation has suggested that there was a dramatic drop in business activity and lay-off in the month following the demonetisation. Recently, Maruti Suzuki reported that its car sales had fallen by 4.4% in November 2016 as compared to the same period in 2015. Sales in consumer durables sector had also fallen by 37 to 38 per cent that month.

The government has predicted a relatively robust growth of 7.1% for FY 2016/17 ending in March but this forecast does not fully account for the impact of demonetisation. Most private sector economists have placed the growth forecast for this fiscal year at a lower rate of 6.3 to 6.4%.

Benefits of Demonetisation

The key benefits of demonetisation were to be the elimination of black money and the detection of fake currencies of high denomination favoured by terrorist groups
and corrupt officials. It appears that these benefits have not been realised as most of the “old cash” in circulation has been deposited in bank accounts. This happened because almost everyone with unexplained cash in hand found a way of bringing it into the banking system by depositing it in the accounts of friends, domestic help, and agents who were willing to do so for a fee.

Although deposits above a certain threshold limit are still being scrutinised by bankers and tax officials, it is likely that ultimately most of the liquidity would re-enter the system and it would be “business as usual” once again for both black marketers and others. If this happens, somebody would have to take the blame for causing so much pain.

Another benefit of demonetisation was to be the increase in transactions through digitisation and move to a “less cash” economy. Here some success has been achieved, but from a very low base. In recent months, Paytm, a popular e-wallet has seen a three-fold increase, while Oxigen Wallet’s daily users has spiked by over 160%. The recently launched mobile payment app by the government called BHIM is also very popular.

Now even small vendors and rickshaw drivers in urban areas are offering ways to pay via electronic means. The situation in the rural areas is, however, quite different.

Digitisation has also led to an increase in tax revenue. Recently, India’s finance minister announced that direct tax collection had risen by 14.4% and the federal government’s indirect tax collection by 26.6% since demonetisation began.

**Uncertainties Ahead**

Although costs of demonetisation have been outweighing the benefits, so far, voters have been willing to back PM Modi because they feel that he is doing a good job and is trying to clean up a corrupt system. If the problem persists and black money is simply recycled into new deposits and currency, however, the ruling party could suffer losses in the forthcoming state elections in five states -- Uttar Pradesh, Punjab, Uttarakhand, Goa, and Manipur. Besides black money is held not only in high denomination bills but also property and gold.

The implementation of the goods and service tax (GST), a key effort of the government to transform Asia’s third largest economy into a single market by April, could also be delayed. This is because protests against the demonetisation policy by the members of the opposition parties have led to serious disruptions and delays in the parliament.

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