"Demonetisation" not the most effective tool to weed out corruption and black money

The currency demonetisation scheme 2016

The currency demonetisation scheme of 2016 has invalidated approximately INR 14,180 billion worth of high value currency, which is almost 86% of the total currency in circulation (31 March 2016: total currency in circulation INR 16,454 billion).

The immediate effects of the demonetisation scheme are significant and manifold. The banks are raining deposit collections, which will eventually have a positive cascading effect on the economy as a whole. However, the unexpected and sudden announcement of the "demonetisationscheme" has had a "knee jerk" reaction on the level of economic activity in the country. All the cash dependent consumption led sectors, such as retail, wholesale, jewellery, hospitals, healthcare, diagnostics, trading, restaurants, transport, logistics are severely affected. Real estate/construction transactions, which are partly done in cash, have been affected jeopardising millions of construction jobs. A large proportion of the country's labour force is employed in these sectors collectively. Therefore, the biggest concern of the demonetisation exercise is its far reaching consequences on India's cash economy!

India's cash economy

India is a cash intensive economy with a whopping 12% of GDP existing in the form of currency notes and coins in circulation. The ratio of money held in currency notes and coins to the amounts held in bank deposits is 51:49. Indian citizens and businesses still prefer cash to other modes of payment. Cash transactions are free, final, irrevocable and instant. Cash is the preferred mode of payment due to habits, poverty, illiteracy and most importantly, lack of easy access to the banking system. Most Indians lack the means to use non-cash payment alternatives due to the low penetration of banking facilities in the country.
As per the World Bank estimates, approximately 35% of the Indian population above the age of 15 years have an account with a bank. Population having debit/credit cards are way below 10% of the total. These ratios further go down in case of "rural" population and "female" population segments. Within the 35% having an account with the bank, many are dormant accounts as the distance to travel to the bank branch; the travel time and the cost thereof are significant.

Year 2015 statistics suggests that 87% of the total transactions in India were in cash. This just suggests that we have sucked out most of the cash from the economy, leaving the cash economy gasping for breath!

Not all transactions in cash have a colour. It acquires colour only when cash is exchanged for illegal or contentious transactions or for undisclosed factor income (mostly to evade taxes). The cash economy, although highly susceptible to transforming into black, is extremely low cost and efficient and thus vibrant. The beauty of cash economy is in its speed and resiliency! Much of the rural and semi urban India thrives on cash economy, which gives them extremely efficient options of earning their livelihood despite lack of infrastructure. For example, the key source of cash transactions in India is its 10 million plus retail outlets. A very small percentage of these retailers have "Point of Sales" (PoS) systems. Much of them neither have internet connectivity nor can they afford the transaction fees of operating the financial cards and hence prefer cash as a mode of payment.

Effects of demonetisation on cash economy

The question is can we risk putting the cash economy on a halt, although temporarily, in view of the fact that significant amount of labour force is employed therein and does not have access to banking services? If we are depriving the tiny retail stores, roadside vendors, low paying job workers without employment contracts, of currency and demanding them to undertake miniscule transactions through financial institutions on digital media, we are taking away their source of daily income and slowing down the economy significantly making it highly inefficient. Are we ready for a digital transformation? Even if our political ambition says we are, it will take a very high amount of time and costs to get them all on the digital banking platforms and educate them on the transactions, which may far exceed the benefits. Also, there are no alternative arrangements for the survival of the population.

The Administration has claimed that the demonetisation scheme is intended to combat tax evasion, counterfeiting, wide spread corruption and the resultant black economy. But what quantum are we talking about?

As per the Indian Statistical Institute, Kolkata, counterfeit currency in circulation is estimated to be INR 400 crore, 0.028% of the demonetised currency. As per the World Bank estimates, India's black economy is in the range of 21% to 23% of its GDP (World Bank estimate 2007: 23.2%). In present GDP terms, the black economy could be approximately INR 6,800 billion (2016 3rd quarter estimate of GDP INR 29,628 billion). However, approximately 70% of the black assets, INR 4,800 billion are estimated to be parked overseas, leaving approximately INR 2,000 billion in the country, of which 5% to 6% are held in cash (data compiled from Income Tax raids).

Through "demonetisation" we have targeted the miniscule of the big whole, disturbing the natural flow of the cash economy in the country, which is very much a part of the main economy! We also need to understand that currency demonetisation is a monetary tool, which will drain off existing stock of counterfeits and cash hoardings at one time but is incapable of targeting the structure and source of corruption and counterfeiting. As widely understood, black money is not equal to corruption; it is the result of corrupt activities, which are very wide in nature. Demonetisationwill not prohibit people from undertaking corrupt activities unless the tendencies and opportunities are rooted out. Corruption will continue with resultant assets merely changing their form and destination.

Therefore, demonetisation of the currency at the cost of cash economy is not the most effective strategy to eliminate or control black economy! Instead, the Government should consider establishing infrastructure to track large financial transactions in key sectors, create a robust mechanism to identify and arrest tax evasion and focus efforts on penetration of the banking infrastructure in the country along with proper education. The key is to reduce the cash intensity of the economy not to suffocate it!

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