Cleaning Up the Old Economy

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In a move that seemed innocuous at first, the Reserve Bank of India announced, on 22 January 2014, its decision to withdraw from circulation currency notes issued before 2005. The withdrawal process is to begin formally from April1, when holders of such notes are required to exchange them at banks for equivalent currency issued in 2005 or later. These preferred notes are easily identified since, unlike their predecessors, they have the year of issue printed on the reverse side. All those holding pre-2005 notes (in denominations that can vary from Rs.5 to Rs.1000) have been advised and would be eligible to exchange any number of such currency notes for new notes at any bank branch (public or private). However, this free and ostensibly anonymous exchange holds only till the end of June. From July 1, anyone seeking to exchange more than 10 each of notes of the value of Rs.500 or Rs.1000 would have to do so in a bank where they hold an account or provide proof of identity and of address of residence. That is, the notes concerned remain legal tender (as of now), unless and until the RBI chooses to declare they are not. But the ease with which they can be exchanged will be made more onerous from July 1, and the anonymity associated with the exchange will come to an end. While this two-step process is presented as a means of speeding up the exit of the old notes, it could have other implications or even motivations.

The features of the old note “withdrawal” process described above seem designed to underline the innocuous nature of the move. Yet, within days, the announcement seems to have triggered a sense of discomfort in some circles and panic in some others. The reasons are varied and different. One obvious reason for discomfort is the possibility that as a result of the announcement anybody engaging in a cash transaction would be unwilling to accept a pre-2005 note. So, those holding such notes or unwittingly accepting such ‘dated’ notes as part of a transaction would have to turn to a bank to be rid of them. While banks are duty bound to make the exchange through a special teller established for the purpose, the process is bound to be time and energy consuming, and could prove tedious in locations where queues in front of such tellers are long.

Since the period from now (when the process of exchange can in principle start) to 1 July, 2014 is not too long, the smoothness with which the transaction can be undertaken would depend on the volume of such notes that are in circulation. The RBI has stated that the volume of the banknotes printed prior to 2005 still in circulation today, “is not significant enough to impact the general public in a large way." Possibly true, but a random search of my wallet with not too many notes present yielded, for example, one 50-rupee note that did not have a issue year printed on it. What is more the media is quoting those ostensibly in the know to suggest that the volume of notes involved could indeed be large. Business Line, for example, quotes an unidentified chief of a public sector bank as saying that: “The currency involved could be upwards of Rs. 11,000 crore. I am sure up to 20-30 per cent of it could be black money because the norms were not that stringent at that time.”

If the sums involved are in that range then making the swap of old notes for new can be a problem. Would a central bank that sounds complacent ensure that there are adequate volumes of the new notes available with individual banks and their branches so that they have enough to both engage in the swap as well provide notes required for ATM and teller transactions? That, together, with the concern that every note received will now have to be examined to ensure that no 'duds' are in the pack are adequate cause for discomfort.

Such discomfort would of course be temporary and would wane as the volume of old notes absorbed by the central bank approaches those in circulation. That the problem is only frictional is what the RBI suggests when it argues that what is being done is not "demonetisation" or the abolition of notes of a particular value, but mere exchange of old notes for new. It has also noted that this is common practice in many countries and is aimed at ensuring that currency notes in circulation are those with better security features to prevent counterfeiting. And that there are no limits on the number of notes that can be exchanged, with even no requirement for identity proof if the swap is completed before 1 July, 2014.

Yet there are sections that, for good reason, need to panic. These consist of those who are saddled with dated notes because of recent transactions the value of which have not been fully declared, involving real estate, for example, or (of course) those whose incomes and wealth consists largely of "unaccounted" or "black" money. Bundles of currency engaged in such transactions or present in that economy are possibly not even opened on a regular basis, but recycled in other similar transactions, resulting in the circulation of notes of older dates. For these sections it may turn out that the volume of 2005 notes in the bundles they carry could be large. Exchanging these in small volumes is bound to be difficult.

Moreover, even in the unlikely event that the bank does not demand some proof of identity and evidence of address of residence, if the size of a single transaction exceeds Rs. 50,000 the current guidelines require that the transactor's PAN number will have to be quoted. And, if the swap exceeds Rs.10 lakhs in volume the transaction will have to be reported under the Prevention of Money Laundering Act. Since the sums involved in the black economy are large, just keeping a watch on those trying to evade them through multiple transactions can help identify big offenders. It is perhaps with this in mind that RBI Deputy Governor K. C. Chakrabarty reportedly said at a recent event at the Indian Institute of Management, Bengaluru, that the decision to withdraw pre-2005 currency notes would weed out counterfeit currency, curb black money and act as a disincentive for cash hoarders. He has been quoted by many as proof that the RBI's implicit intent is wider than the explicitly stated objectives of its recent initiative.

However, the RBI's undeclared (and perhaps unintended) objective embedded in the initiative could be the latter's undoing, especially given its timing. With the country just 3-4 months away from the next general election, much hidden money is likely to be put to use to lubricate the electoral campaign of the leading parties in India's distorted democracy. None can believe that expenditures by individual parties and candidates or in specific constituencies are at or below the maximum set by the Election Commission. To add, reports of cash hoards being seized by the police and other watchdogs of the Election Commission are commonplace. But, if it becomes imperative to replace a set of currency notes that make up the bulk waiting to be spent, the RBI's note-withdrawal initiative can prove a constraint to using that money. This is bound to generate political opposition to the move as well, with opponents seeking to cash in on the inconveniences that may affect the common citizen burdened with dated notes to force the RBI to withdraw.

Things could be different if the real intention of the RBI is indeed that of simultaneously addressing the ills of counterfeiting and black money generation and circulation, as the statement of the Deputy Governor suggests. That would put the Reserve Bank of India in opposition to Black Economy establishment and leading political forces, besides making it appear an irritant to the ordinary citizen. Given the current role and character of the RBI it is unlikely to be taking on this role. In any case it has much else to deal with than taking on responsibilities that are actually those of the finance and home ministries.

So, if at all the dated-currency withdrawal manoeuvre has any impact on black money, it would be because it serves as a concealed amnesty for the declaration of unaccounted income and wealth by black money holders. If the note-swap process is delinked from the requirements of declaration of the client's permanent account number or reporting to the financial intelligence network even in the case of large transactions in excess of Rs. 50,000 and Rs. 10 lakh respectively, it can serve as an easy way of converting large volumes of black money into white. It may happen that to speed up the swap and make it easier to implement, the RBI does instruct the banking system to not treat the swap as a conventional cash transaction that must meet these requirements. Then, the swap process may win favour with the more powerful forces now in panic about what the dated money withdrawal means for them. The RBI would realise its objective of withdrawing less secure notes from the system, offenders holding unaccounted money in cash will be benefited and the only casualties would be the exchequer, probity and transparency. Hopefully, that is not the outcome this exercise would finally yield.

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