Demonetisation: Illusory Gains, Enduring Damages

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The demonetisation of Old High-value Denominations (OHD) announced on the 8th of November, with effect from midnight is surely the 'Great Event' of the times. The 1000/500 notes constituted 86 percent of the 17.8 trillion cash economy in the country has been sucked out overnight. Earlier instances of currency demonetisation in India in 1946 and 1978 had been of high denominations, which were not used for transaction by common people. Similar steps in other countries have always been driven by special circumstances, hyperinflation in Zimbabwe or abolition of colonial currency after independence as in Singapore or Fiji (Currency Demonetisation has precedence in India, elsewhere, The Hindu, November 10, 2016). The 8th November demonetisation is unprecedented in terms of its scale and the lack of any substantial rationale.

The demonetisation move lack rationale as this does not curb the myriad activities that generate a black economy but only destroys that part of the black economy that is held in cash, as a temporary holding before it is thrown back into the economy. The latter constitutes a miniscule part of the black economy, simply because it does not make sense to keep the 'black money' idle without earning any return, unless it is waiting to go into funding of political parties or it is money lying in a warehouse due to very recently concluded real estate deals. It makes greater sense to convert the black money into property, precious metals or put it in the international financial system through money laundering channels, which earns some return on the money.

While the measure will destroy the purchasing power of such idle 'black cash', the government does not by any means recover this money for redistribution in the economy. Counterfeit money in the banned denominations will also go out of circulation. This, though, will be a short-lived phenomenon till it re-appears in the new denominations since the networks that generate fake currency has not been tracked down and acted against. On the other hand, the costs of this drastic measure can be significantly high, not only in the short-run like printing of new notes or transporting the physical cash to various parts of the country, but also due to the un-estimated cost of economic and social damages done in the long run.

A Logistical Nightmare:

Let us look at some figures related to the process of supplanting the old notes with new ones to comprehend the logistical nightmare into which the government has plunged the economy. We assume that all commercial bank (1.3 lakh branches approx.) and post offices (1.55 lakh branches approx) in the country function with the highest efficiency and are open for all days of the week till December 31st (which is clearly not a possible scenario)[i]. The original plan (on day 1) to exchange the demonetized currency (Rs. 15.3 trillion) with a limit of Rs. 4000/day, would mean an average footfall of 268 per branch per day across the country.

Assuming that 60 percent of the cash economy was in semi-urban, urban and metropolitan cities (with a total of 0.78 lakh commercial bank branches and nearly 16000 post offices) and keeping the other assumptions unchanged, the average footfall per branch per day in non-rural areas would be nearly 470 till the end of December . Needless to say, all branches, particularly the post offices, would not be able to operate with adequate supply of cash and with supreme deftness on all days during this period, so it will be all the more difficult to replace the circulating currency.

The announcement that one can deposit up to Rs. 2.5 lakh in bank accounts without coming under any tax scanner can boost deposits and suck in the liquidity faster with less stress. Assuming that half of the liquidity is deposited into accounts while the rest has to be exchanged and with the other assumptions made above, the average footfall in the country can come down to around 136 per branch per day for the country and to 239 per branch per day for non-rural areas . However, this hardly eases the pressure on the banking system, as this will be subsequently followed by long queues for withdrawing the deposited money from the branches and ATMs. The bulk of the deposited cash is not savings or hoarded illicit cash, as wrongly imagined by the government, but money being used for transactions in the cash economy.

While this means long and persistent queues daily in the banks and ATMs in urban areas as we are already witnessing, the situation in the rural areas might be worse. In rural areas, it is a greater challenge to reach the new currency in adequate quantities, particularly in remote areas. Also, the average distance to bank branches for the rural population is much higher and will consume higher man-hours to reach and deposit/exchange the banned notes.

The fear of the long queues have already caught on with the government, which has now announced that old currency worth Rs. 2000 can be changed only once and customers will be marked with an indelible ink. This is being implemented in the metropolitan cities. While, it may be true that people with large and illegitimate cash can get their cash exchanged through contractors (earlier supplying daily-labour) supplying large number of poor money-changers for a commission, not everybody coming back to the banks everyday belong to this category. Migrant labour without bank-accounts or unbanked women who have saved money in small amounts over a long period in their households may have to return to the banks several times to exchange their money. The millions of small and marginal farmers in rural India without banking facilities will also be in a similar helpless situation if this is extended to rural areas. The indelible ink is a cruel denial of access to the fruits of their own labour!

From the above, it is clear that the replacement of the demonetized currency will be a tedious and protracted process with the very real possibility that it will not be completed by the end of the year. This will push people to look for alternative shadow markets to get their money changed through medium to large agents or ‘cash on hand’ firms, which have sprung up overnight, with the payment of commissions. The drastic step of the government will only generate newer kinds of black activities in the economy, even when it recovers none of the ‘black money’ held in cash.

Hurting the masses:

The government, led by the Prime Minister, has appealed to the citizens to bear the ‘minor inconveniences’ caused in the short run till normalcy is restored. Some of the short-run impacts though can be debilitating for large sections of poor people. What appears as a ‘cash crunch’ in the economy has the potential of soon transforming into ‘commodity shortages’. This is a real possibility as the cash shortage will cripple transactions in the commodity supply chains, something already evident in the functioning of wholesale mandis since 9th November. The transport system of commodities across the country is heavily dependent on cash transactions and will be severely incapacitated in the short-run. Apart from consumers, those trading in perishable goods like fruits, vegetables, fish, etc. will be harshly affected. The payment for services generated by the unorganized sector will also be similarly disrupted. The bulk of casual labour has been without work and income over the past week. Goods and services provision can still continue for some time on credit, based on mutual ‘trust’ between the economic agents, but the longer it takes for the circulating cash to be replaced, there is an ominous possibility of that ‘trust’ breaking down.

Simultaneous with this depression in income-generation, we can have speculation in commodity prices. In a context when people are starved of cash, this would be much more than ‘inconvenience’ for poor and lower-middle class population. This potentially can intensify panic among people and lead to social unrest.

Further, in the short-run, millions of labour hours are being lost in queuing up in front of banks and ATMs. One can observe primarily poor people in these lines, the rich having found other illegal ways to get rid of their old notes or having passed on to the poor the difficult job of exchanging through organized agents or by using social hierarchies. There are instances when domestic workers have been given advance salary for a couple of months in old notes by their employers in urban areas. In other instances, they may have not been paid at all. Contractual labour within the organized sector is also faced with similar situations.

In rural areas, where farmers accrue their entire annual income only during the post-harvest season, the despair is greater. Currently, at the end of the kharif season, either they have their whole or half of annual income post sale of crops in old demonetized notes or they are unable to sell their harvested crops. Their requirement of inputs for the subsequent cultivation season may either be disrupted or be provided on credit basis with oppressive and onerous conditions, exploiting regressive social divisions that are already prevalent in rural areas. The widespread distress and stagnation that most of agricultural income has been subjected to over the last two decades will be further intensified by this shock and will worsen the incidence of hunger and under-nutrition. One cannot even rule out the possibilities of triggering of acute food shortages in the most backward parts of the country.

In a nutshell, the demonetisation measure will initiate several rounds of downward cycles in economic activities over the next few months affecting the incomes of millions of people and not only the absolute poor. However, more importantly, all these adverse effects on the economy are not going to be restricted to the next few months as the government has mistakenly assumed. In an economy, where bulk of the population are engaged in the informal economy, a massive shock of this nature will lead to a restructuring of the markets in the favour of the ‘big’.

While organized retail companies can absorb losses for a long time, thousands of small- to medium-scale petty retailers may be ousted from the market over the next couple of months. Petty roadside retailers have already started to disappear. Similarly, the millions of marginal and small farmers, already at the bottom of the distribution of land and associated natural resources, may find themselves losing access to their remaining tiny pieces of land and other assets, during this protracted period of 'cash starvation'. With already high levels of indebtedness, further 'distress loans' taken by them can alienate them from their assets and irreversibly impoverish them. An increase in the concentration of productive assets in the hands of the dominant ruling classes and castes in rural India is very much on the cards in this present situation of mayhem. Again in the most backward areas, it would not be surprising to find re-emergence of old feudal institutions of 'bonded labour', where labour is pledged to payoff loans.

The large-scale loss of means of production, small businesses and livelihoods would ensure that there is a more durable squeeze in the purchasing power of the masses in both rural and urban areas. The depressive economic cycle that has been immediately generated will not be mitigated within a few months as the government establishment seems to believe. It will have longer and deeper consequences for inequality and under-development in the Indian economy.

Given the mind-boggling scale of the difficulties that common people in the country will face, it will be prudent for the government to revoke the demonetisation step immediately. Currently, the government by making moral-nationalist appeals to bear with the situation is way off the mark in recognizing the full economic and social consequences. Rather by appealing to the masses to use this opportunity and move to a cashless economy, they have abandoned a large majority of the citizens in the country in favour of the aspirations of the elite. This, undoubtedly, will have serious consequences for the 'trust' that people put on their elected governments.

[i] The data on bank branches are the latest published by the Reserve Bank of India in its Basic Statistical Returns of Scheduled Commercial Banks, while the data on post office branches are taken from www.indiapost,gov.in. Cooperative Banks and Regional Rural banks are playing a negligible role in currency replacement.

Presently, semi-urban, urban and metropolitan areas account for 90 percent of the deposits in the country reflecting the skewed nature of economic activities towards non-rural areas. Taking into consideration, that access to and use of banking is also higher in urban areas, we assume conservatively that 60 percent of the cash economy is in urban areas. Adjusting this assumption either way will accordingly change the estimation of bank footfalls.

The assumption that half of the currency will be deposited is informed the fact that 53 percent of Indians have bank accounts, though only 15 percent were active users of banking (175 million new bank a/c in India in three years: World Bank, The Hindu, April 16, 2015)