The Great Indian Experiment

Demonetisation has set off chain reactions in banking, real estate, the wedding industry...

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The immediate consequences of the demonetisation of 500 and 1000 rupee notes and their replacement by new 500 and 2000 rupee versions have been widely discussed. This change has less obvious intermediate and long term consequences. Policy interventions set off many chain reactions which are difficult to foreclose but here is an attempt to do that.

The number of bank accounts, their balances and the number of transactions will rise sharply. A fraction of the new bank accounts will belong to people who had no accounts in the past, or had dormant accounts with few transactions. This heretofore unbanked population will become more aware of their financial opportunities and try to become more literate and numerate to protect their wealth and interests.

Numeracy and literacy - financial and general - will not rise overnight and thus will create opportunities for unscrupulous employers, banks and others to exploit people. Banking industry will find it necessary to educate its new customer base in the basics of banking, accounting and interest, and revise its own standard operating procedures to accommodate its new clientele. Schools may also open their adult literacy classes to cover financial literacy.

The informal entrepreneurial banking sector may lose some business to formal banking. However, banks' difficulties in serving the new clients through their bureaucratic structures will leave space for informal banks. The corruptibility of bank employees who cut corners, and the resultant scandals, will generate organised pressure to grant the entrepreneurs (who do not have to rely on rules of a bureaucracy) a semi-regulated status, creating a new class of "banks".

Initially, there will be a rise in better transactions but this will die down due to the substantial inconvenience. Better tracking of electronic transactions will make it more difficult to avoid income, property and general sales tax. Higher tax compliance and tax revenue should lead to a reduction of tax rates and ease state government budget constraints over the long run. With fewer places to hide black money, there will be downward pressure on real estate prices. A centralised registry of property ownership and transactions will be created in a few years.

The increase in the number of tax payers will require a significant increase in the number of employees engaged in tax collection and auditing. Business firms in electronic payments, password protection and management and fintech will see improved opportunities and growth.

Since a significant proportion of the demand for luxury goods and extravagant spending on weddings etc. is driven by black money, the demand for such goods and services will decline. This means a temporary dip in retail sector employment, lower collection of import duties, lower rental rates, and higher vacancies and loan defaults on commercial real estate.

The frequency of usage of electronic methods - credit and debit cards, Paytm, mobile phone, etc. will increase both retail and labour markets. Complaints about unauthorised electronic transactions arising from misunderstanding, inadvertent errors and malfeasance will also rise sharply. While hackers flood the field, their activities will raise the demand for better protections from electronic fraud and hacking of accounts as well as for legal protections for defrauded consumers.

In the medium term, contributions to political parties will decline. However, in the long run, India will have to develop its own legitimate system to finance elections through white money. With the diminished role of black money, elections will become less expensive and allow more opportunities for independent and minority candidates.

Lower corruption in civil services and politics will result in lower and possibly better equipped applicants for civil service jobs and party election tickets. Lower corruption in the business sector may place greater value on merit and talent in labour markets and help improve the quality of goods and services.

In education, the inability of families to pay capitation fees will force a temporary cut in the price of education. This drop in prices will force a drop in admissions, closure of some medical and engineering schools, and some rise in the average quality of education. It will also drive out some diploma mills from the higher education sector.

The rise in bank deposits will make more money available for lending and put downward pressure on interest rates unless RBI scaled up the extra liquidity. The difficulty of conducting routine retail transactions until a sufficient amount of new currency becomes available will cut the rate of economic growth for one or two quarters. Only a part of these raised transactions can be made up later. In the long run, the lower cost of open transactions will allow the economy to grow. The quality of socio-economic data will improve and serve as a basis for better decisions.

The justified anxiety of currency replacement may induce political realignment of parties who wish to hitch their ant-corruption train. Corruption is often cited as a lubricant for the economy, whether this theory holds water would be known in the next few years.

Finally, this Indian experiment is being watched closely all over the world. If it succeeds, there will be requests for advice on how India implemented demonetisation. Consequences of replication, in absence of surprise, would be quite different.

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