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March 2017

# Newsletter

Welcome to the East Asian Bureau of Economic Research (EABER) and South Asia Bureau Research (SABER) Newsletter.

EABER and SABER strive to be the premier economics research forums and to provide a single point of reference for the economics, finance and governance research community throughout the region and beyond. Through building research capacity and partnering initiatives, EABER and SABER facilitate high-level analysis and forward thinking on issues of importance to the East and South Asian economies.

## Analysis

### The goals and outcomes of India's demonetisation

**Ashima Goyal**

It has been over three months since the November 2016 surprise demonetisation of 86 per cent of India's currency in circulation. The short-run costs of the measure are becoming clearer. India's industrial production sector, for instance, has been hit hard with negative growth in December 2016. Overall, the aggregate growth cost of the demonetisation measure is expected to be up to 1 per cent of GDP.

On 8 November 2016, the Narendra Modi government removed high denomination 500 rupee (US$7.50) and 1000 rupee (US$15) bank notes from circulation in a bid to tackle corruption and unaccounted wealth. These were to be replaced with new 500 rupee and 2000 rupee notes. Indians were given until the end of last year to deposit illegal cash holdings into bank accounts, making assets more transparent as well as broadening the tax base.

Stories are also trickling in of output and job losses in the informal sector. But as the demonetisation is a temporary measure, the persistence of these losses depends on whether small production units shut down or only send workers home temporarily, and if investment projects are cancelled or only postponed.

Multinational corporations are also facing difficulties. Profits fell as sales of consumer goods slowed in rural areas. But some industries such as intermediate goods and crop planting proved quite resilient. Truck movement showed a v-shaped recovery. Since low-income earners cannot afford not to work, the worst hit informal sector establishments may reopen quickly.

January 2017 showed further improvements as money came back into the system. By mid-February the Reserve Bank of India (RBI) had reintroduced 55 per cent of the total value of demonetised notes. Since the required cash-to-GDP fell as consumers substituted away from cash, normality was more or less restored.

Despite official agencies insisting that costs are temporary, real human costs such as job losses were worsened by poor planning and implementation. The budget did offer a few tax cuts to worst affected lower income groups and small firms. Demonetisation alone cannot make an appreciable dent in black money and corruption. But it can contribute as part of a sequence of related moves. The budget had further initiatives for moving towards a formal economy with modern laws and regulation, suggesting the government is focused on such a path.

In the continuing absence of official estimate of old notes deposited in the banking system, media speculation is that, including counterfeit notes, more than the 15.5 trillion rupees (US$231.7 billion) worth of notes have come back into the banking system. This suggests the government will not achieve its aim of writing off black cash hordes. Notes that did not come back would have been extinguished.

## Paper of the Month

The most viewed paper for the month of February 2017 was 'China–Australia Economic Cooperation and the Belt and Road Initiative', co-authored by Peter Drysdale and Dong Dong Zhang in association with CCIEE.

## Events

CSIS hosted a public lecture and Q&A session, 'De-globalization or re-globalization?', with Mr Pascal Lamy on 23 February.

On 3 March, CIEM in collaboration with the Graduate School of Public Policy at the University of Tokyo organised the 2017 Vietnam–Japan Emerging Researchers Forum on 'Enhancing Vietnam–Japan Industrial Cooperation to Effectively Implement the Regional Comprehensive Economic Partnership Agreement'.

PIDS hosted a seminar on 'Asia and the Philippines: Approaching the end of the export-led growth story?' on 16 March with Dr Ganeshan Wignaraja.

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On a positive note, tax compliance should increase. In a population of over 1 billion people, fewer than 40 million currently file income tax returns. This is widely seen as unfair. India's tax-to-GDP ratio of 16 per cent is among the lowest in the world and acts as a constraint on government expenditure.

Some tax has been collected through a new amnesty scheme that runs till end March. The income tax department is questioning sources of deposits of over 500,000 old currency notes (roughly US$7500) — which altogether amount to about 3 per cent of GDP. Because of this information, the number of tax returns filed in India is expected to double to 75 million, yielding about 1 per cent of GDP in tax revenue. But good results will depend on effectively linking different databases, including information sharing from G20 initiatives against tax evasion, while minimising the discretion of tax authorities and the harassment that can result.

That the Indian public has accepted considerable pain in order to support action against tax evasion suggests that society may be ready to transition to a system where paying a fair share of taxes is the accepted norm. To give a decisive push the government should further simplify regulations and reduce tax rates. For example, clear property titles and lower stamp duties would reduce black money in the real estate market. There are signs the political system will also be forced to reduce the use of cash, and therefore black money, in elections.

India's currency-to-GDP ratio averaged 8.4 per cent during 1975–2000, but rose to an average of 10.8 per cent in the last decade. While the Indian government is not aiming for a cashless society, it would like to move the currency-to-GDP ratio towards the 5 per cent standard of most economies. Data show a large rise in digital payment modes post demonetisation and some of this will stick. The government continues to provide incentives and infrastructure for the shift, such as the Unified Payments Interface that reduces costs of digital bank transfers. Going digital is also an attractive business opportunity for banks, who can save branch expansion costs.

Further adoption of digital payments will increase the tax base as well as tax compliance, which will in turn allow the state to increase spending. What's more, digital payments leave data trails that can be used to reduce tax evasion. With more of their transaction data available, banks will also be able to lend to smaller firms, shrinking the informal sector, which accounted for 45.4 per cent of output over 2011–2015, and about 70 per cent of non-agricultural employment. A transition to the formal sector will raise regulatory burdens for small firms but also create benefits such as easier credit.

It is often argued that monetary transmission does not work in an economy like India's with a large informal sector. And demonetisation has emphasised the lingering importance of cash for India's informal sector. As large amounts of cash were deposited in banks they did reduce interest rates. Transmission will also improve as cash leakages from the banking system reduce.

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EABER is grateful to the Japanese Ministry of Finance and the Australian Agency for International Development (AusAID), who provided grants to assist with the establishment of EABER in 2006-7.

SABER is supported by an Australian Research Council Industry Partnership Grant with Australian Aid (DFAT).