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December 6, 2016 | Saurabh Chandra (<http://www.infracircle.in/author/saurabhchandra/>)

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Demonetisation: The way ahead



The report has suggested tax refund for consumers using digital payment up to a certain proportion of annual income.

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he demonetisation of 500 and 1,000 rupee banknotes is done and dusted. The country has to learn to live with it.

This decision has been fiercely debated. The debate ranged from its moral, strategic, political to economic implications.

The protagonists of the morality of this move have carried the day. It is perceived as a strong measure against corruption and black money. Strategically, with counterfeit currency out of the way, cross-border terrorism and insurgency is expected to go down. The Left-wing extremism is also likely to be hit.

The political debate will probably lose steam with the verdict of the Uttar Pradesh, Uttarakhand and Punjab elections. But only the mandate of the next general elections will settle the dust. This debate not unexpectedly will revolve around the interests of the common man and promises plenty of confusion, since both sides, those for and against this move, will claim to be championing the cause of the common man.

The macroeconomic effect, though difficult to predict, is envisioned to last longer. However, there is unanimity about short-term pain. How long this would last and whether in the long term benefits would exceed costs is at best a matter of conjecture.

A wave of schadenfreude swept the country immediately after Prime Minister Narendra Modi on 8 November 2016 set in motion a chain of events which forebode a change in the economic landscape, like never before. The gloating by the 'have nots' on the perceived misery of the 'haves' is a sad commentary on the state of the nation after 70 years of Independence. It arises out of a feeling that the system is fundamentally unfair, sustained by a nexus between the resourceful and the powerful with the dice loaded heavily in favour of the rich, corrupt and the strong. This perception has been shaped by growing conspicuous iniquities. While the poor exult on the travails of the rich, farmers revel on the tribulations of rural moneylenders who also masquerade as traders. But like history, economics takes no prisoners. Since the hard ground realities will soon overtake sentiments, the need to minimise the downside of demonetisation's disruptive effects is imperative. Time for action is short. It does not take long for frustration emanating from unfulfilled expectations getting manifested in the form of aggression and destruction.

The task is complicated and difficult because a demonetisation exercise on this scale, in similar circumstances and short period has no precedent. The outcomes largely fall in the realm of known unknowns. The actual quantum of cash that will go out of circulation will be known only on 30 December 2016 while its velocity when it was in circulation in the parallel economy will at best remain a matter of guesstimate. Any ameliorative strategy will have to factor in uncertainties associated with such an exercise.

Short-term trends are known—the cash in circulation will decrease and money velocity will reduce. With issuance of currency lagging behind that which has gone out of circulation, uncertainty has gripped the market—a condition which encourages hoarding. Add to it, the limited utility of 2,000 rupee banknotes arising out of a shortage of intermediate denomination notes between 100 and 2,000 rupee banknotes. The reduction in money supply and lower velocity of money is envisioned to affect the gross domestic product. The informal sector, where cash was king, will take a beating. In particular small enterprises and the farm sector are most vulnerable. Demand contraction has already taken a toll on their turnover. Their ability to survive in a downturn is limited. Pink slips are a natural corollary. Hence saving existing jobs in a country, reeling under large-scale unemployment, is vital. The other immediate priority is to cushion agriculture production and productivity from the impact of constrained liquidity. The alternative recourse being informal credit sources which would only accentuate the problem of rural indebtedness. This has to be avoided at all costs.

The immediate necessity is to reintroduce cash into the market and revive consumption. With demonetisation in its fourth week, only about 25% of the outlawed currency has been reissued. At least Rs.1 trillion has to enter the market every week till 30 December 2016 to restore confidence and meet the essential demands of trade, commerce and industry. More importantly, the majority of the notes should be in 500 rupee denomination.

The banks are flushed with funds. This position is likely to continue in the foreseeable future. Hence before lowering of the interest rates on loans, identical to the cut in the interest rates on deposits should be the norm. For village, micro and small enterprises, the interest on working capital should be brought on par with that of agriculture sector at 7%. Across board, cash credit limits could be enhanced by 50%, to start with, for a period of six months. Norms governing non-fund based support have to be liberalised. The temptation to increase spreads to shore up balance sheets, reeling under the impact of rising non-performing assets has to be discouraged. Farmers have to be increasingly brought into the formal credit system through easy access and availability (for example increased coverage by kisan credit cards) to weaken the hold of moneylender-trader nexus.

The challenge posed by demonetisation provides an opportunity to reform the factors market (in particular credit and labour) and reduce the regulatory burden. The anticipated increase in revenue receipts provides an opportunity for boosting infrastructure spending to reduce the

deficit in the targeted expenditure for infrastructure during the 12th Five-Year Plan. These are all necessary conditions to help small enterprises remain competitive and survive as they transit from an informal to the formal economy.

A policy choice has been made. It is disruptive. As Clayton Christensen said "'Disruption' is, at its core, a really powerful idea. Everyone hijacks the idea to do whatever they want now." The choice is acceptance and managing change in the face of uncertainty.

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