Black Wealth, the Real Deal

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The Supreme Court was bang on when it said on Tuesday that the government's hit on black money "appears to be carpet-bombing and not a surgical strike". The collateral damage has certainly been huge.

Demonetisation is usually associated with decrepit economies with hyper-inflation, such as Zimbabwe recently and Argentina in the past. Fiji and the Philippines also have demonetised their currency in the past. British India demonetised its currency in 1946 ostensibly to hit war profiteers. But this was largely seen as a wealth grab by an outgoing colonial administration.

India demonetised again during the 1978 Janata Party government under Morarji Desai. But by all accounts, it did not bring any lasting dent on black money. So it is surprising that a reform-minded popular prime minister has resorted to demonetisation, an instrument with an odious history.

Much of 'black wealth' sits in gold, real estate or is offshore. Demonetisation only affects black money, not black wealth. It's hard to estimate how much of black wealth is in cash. But estimates from previous raids show it to be 5-6% of black wealth.

So about 1-1.5% of the GDP is held in black money. If the government nets half of it through the demonetisation scheme, it's 0.5-0.7% of the GDP. This is not insignificant. But it still leaves the bulk of black wealth untouched.

The collateral damage can be huge both economically and politically. The poor are already suffering, especially those without easy access to banks and post offices. But the even more long-lasting damage can be to trade and business in sectors where much of business is conducted in cash, especially in the informal sector that makes up close to 40% of the GDP. So, the hit on economic growth could be as high as 0.5% of GDP, which will neutralise any one-time gain from demonetisation.

India's cash-to-GDP ratio is estimated to be too high, at around 11%. But comparisons are made with countries at much higher levels of development, with much smaller rural and unbanked populations. China has a ratio of around 9.5%, Germany 8% and the US around 7.5%. So at India's stage of development, we can't conclusively conclude that India's cash-to-GDP ratio is too high.

In any case, there appears to be no correlation between corruption and this ratio. It should be reduced to under 10% of GDP. But this will require much more financial development. It should be done through incentives to shift to cashless transactions and better tax enforcement. The current move will hit fake currency production. But the challenge is to produce better currency that makes it more costly to reproduce.

It would have been better to go after sectors in which black money is known to be in heavy use — real estate, the film industry, gold and jewellery shops, weddings, etc. New notes could have been introduced with old ones gradually phased out. To weed out black wealth, more comprehensive reform is needed.

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