

# Mint

Editorial

## **Narendra Modi's war on illegal wealth.**

The challenge now is to ensure that the creation of new black money is minimized.

Indians are among the most intensive users of cash. In terms of purchasing power, the supply of cash circulating through the economy is dominated by notes of high value. Data from the Reserve Bank of India (RBI) shows the stock of high-value notes having grown at around twice the growth in the total supply of cash in the three fiscal years to March 2016. In other words, the currency issue has been skewed towards notes of high denominations.

These numbers give us some idea about the impact of the decision by the Narendra Modi government to strip the old Rs500 and Rs1,000 notes of their status as legal tender. They are being replaced with a new issue of Rs500, Rs1,000 and Rs2,000 notes. This demonetization, or withdrawal of old notes, should be seen as part of a bouquet of policies against tax evaders. The decision extinguishes some of the stock of illegal wealth in India rather than the flow of new black money, though, as Shamika Ravi of Brookings Institution argued in these pages on Thursday, the cost of future illegal transactions has also been increased.

There are two compelling reasons why Indians have grown increasingly dependent on high-value currency. First, the recent inflation has meant that higher value notes are needed for daily transactions. Second, the growth of the black economy has increased demand for Rs500 and Rs1,000 notes.

To what extent will the decision to replace old notes with new ones hurt the black economy? Here is a rough calculation. The value of currency notes circulating in India is Rs.16.41 trillion, or about \$240 billion. Let us assume that a quarter of this is being used to store illegal wealth—or around \$60 billion. Most experts would agree that the size of the Indian underground economy is far bigger than that, though these are just guesstimates. The point is that the withdrawal of the old notes deals with only one part of the bigger problem of black money. But that does not reduce the importance of the decision.

The Modi government has clearly signalled its intention to move against illegal wealth. The currency swap deals with the stock of black money held by tax evaders. The challenge now is to ensure that the creation of new black money is minimized. There is no magic wand to solve what is a deep problem in India, but a committed government plus tax reforms such as the new goods and

services tax (GST)—which creates incentives for producers to seek bills from their input providers—will be part of the solution.

There are two more immediate issues. First, the Indian central bank should now reconsider the extent as well as the composition of its currency printing. Tight control over the issue of cash could push citizens to transact either through the traditional banking system or newer forms of digital payments. The National Payments Corporation of India's Unified Payments Interface—which is still facing some teething troubles—could have a profoundly important role in this context.

Second, as this editorial notes right at the beginning, most of the increase in cash in recent years comes from notes with high denominations. RBI should now consider switching the composition of currency towards Rs100 notes rather than Rs500, Rs1,000 and the new Rs2,000 ones. In other words, a majority of the value of cash in the Indian economy should be accounted for by Rs100 notes, backed by a greater use of mobile payments to avoid unnecessarily bulky wallets.

One final point. Many commentators have pointed out that the attack on cash transactions is a strategic blunder by the Bharatiya Janata Party, whose core base from the Jan Sangh days has been the trader community.

This view discounts the possibility that the rapid transformation of the Indian economy has changed the political dynamics. Is the ruling party now reflecting the interests of the national middle class and the rising neo-middle class that is harried by widespread corruption?

It is widely accepted that Modi has strangled corruption at the highest levels of government. The currency swap should hurt those who have been involved in retail corruption. Other policy initiatives such as the move to GST should also bring more producers into the indirect tax net.

Modi has perhaps understood the aspirations of his new voter base better than most people realize.