DEMONETISATION SUCCESS : EXPLAINED IN NUMBERS

In the backdrop of the RBI's report stating that 99 percent of the demonetized cash had come back into the banking system, the government today released data to substantiate its claim that note ban has achieved all its objectives.

INDIA'S HIGHEST EVER DETECTION OF BLACK MONEY

- Scrutiny of suspected 18 lakh accounts done
- Cash deposits worth Rs 2.89 lakh crore under investigation
- Advance data analytics tools identified 5.56 lakhs new suspect cases
- 4,73,003 suspicious transactions detected
- Undisclosed income worth Rs. 29,213 crore detected and admitted.
- Black money worth Rs 16,000 crore did not return post demonetisation
- **21 per cent reduction in currency in circulation**

UNPRECEDENTED INCREASE IN TAX COMPLIANCE

- 56 lakh new tax payers added
- Number of returns filed increase 24.7 per cent compared to 9.9 per cent in previous year
- Advance tax collections of personal income tax grow at 41.79 per cent over same period of last year
- Personal income tax under self-assessment tax grow at 34.25 per cent over same period last year.

CLEANSING INDIA'S FINANCIAL SYSTEM

- Transactions of more than three lakh suspected shell companies under the radar
- 2.1 lakh shell companies de-registered
- Around 450 companies delisted and 800 untraceable companies to be further delisted
- More than 400 benami transactions identified and market value of properties attached more than that of Rs 800 crore

SLEW OF BENEFITS TO THE COUNTRY

- Deposits in the banking system increased around Rs 3 lakh crore
- Additional liquidity helped reduce interest rates by 100 basis points
- **Digital payments increase by 56 per cent from 71.27 crore transactions in October 2016 to 111.45 crore transaction in May, 2017**
- **More than one crore workers added to EPF and ESIC system post-demonetisation**
- Bank accounts opened for about 50 lakh workers to get their wages credited directly in their accounts

Source:https://timesofindia.indiatimes.com/india/demonetisation-success-explained-in-numbers/articleshow/60310546.cms

THE TUSSLE BETWEEN RBI AND MINISTRY OF FINANCE: A DIFFERENT DIMENSION

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The popular belief about the tussle between RBI and the Ministry of Finance is that it is an issue of the trade-off between inflation and economic growth, with the former more focussed on controlling high inflation and the latter emphasising high growth. However, according to Gurbachan Singh, there is a different dimension to the story; the Ministry doesn't fully appreciate that RBI cannot ignore market forces while making announcements about interest rates.

There has been a tussle between the Ministry of Finance (MoF) and the Reserve Bank of India (RBI) in the last three years, since Dr. Raghuram Rajan has been the Governor of the RBI. It is about the level at which the RBI should set the repo rate. (Contrary to what many believe, the RBI is not an independent central bank; according to the Constitution, the Government of India controls the RBI). The recently released book by former RBI Governor Dr. Subbarao now confirms that there had been a similar tussle during his five-year term (2008-2013) as well. The usual view on such a tussle is that it is an issue of the trade-off between high inflation and high economic growth. The MoF emphasises high growth whereas the RBI is more focussed on controlling high inflation. However, there is a very different dimension to the story.

INTEREST RATES: CONVENTIONAL WISDOM AND NEW THINKING

Very briefly, the usual view is that the central bank sets the short-term interest rate (the repo rate in India and the federal funds rate in the US). The economy then somehow adjusts, sooner or later, to the dictated short-term interest rate. This may seem straightforward and even obvious. However, Nobel Laureate Eugene Fama has challenged this view (Fama 2013). He argues that the Federal Reserve System (Fed) has little power to set, what is commonly known as, the 'federal funds rate'! He uses empirical evidence for the US to show that the Fed has hardly any power to determine the short-term interest rate – notwithstanding all the noise about how the Fed decides that rate every now and then. It is hard to dismiss that view, given the facts.

Let us elaborate a little more on the situation in the US. The common view is that the interest rates are generally low in the US at present because the Fed has dictated a low federal funds rate. The alternative view is that it is low because that is the market outcome. At the end of the day the Fed simply goes along with the market level of interest rate.

The market interest rates in the US are, in turn, generally low possibly because savings increased and investment fell in the aftermath of the global financial crisis and the recession in and around 2008.

Cuts in interest rates by the central bank are sometimes not followed by cuts in lending rates charged by commercial banks and other financial intermediaries.

Why? The usual view is that the transmission mechanism is weak. However, there is, in my view, another possibility. The rate cuts by central banks in some countries may not be in sync with the market forces in which case the financial institutions will not – or - cannot apply rate cuts! The central bank can then, at times, have a good rationale not to reduce its interest rate to begin with.

RBI CANNOT IGNORE MARKET FORCES

With all this background, let us come to the specific case of India now. In what follows, I will argue that even if Fama (2013) is not applicable to India and even if there is no difficulty with regard to the transmission of the monetary policy, there is still a broad and general lesson from Fama (2013), which is that the RBI cannot ignore market forces. It is this premise that is not well appreciated in the MoF.

Dr. Subbarao faced the challenge that the inflation rate in India had crossed 10 percent. Under the circumstances, it was hardly possible for the RBI to decide on a low repo rate. If it had lowered the repo rate, it could have *raised expectations in the market* of higher and somewhat sustained inflation. That would have led to an increase, and not a decrease, in the nominal interest rates generally in the market (Friedman 1968). (Nominal interest rate is equal to real interest rate plus expected inflation.) Also, as the inflation rate keeps getting higher, there is a serious risk that the growth rate in the economy would fall. So, anticipating all this, it was hardly possible for the RBI to reduce its repo rate.

The inflation rate had somewhat eased during Dr. Rajan's term. So there was, on this account, scope for the RBI to reduce its repo rate. However, there was another issue. Dr. Rajan had to oversee the transition of the Indian economy from the long-term average inflation rate of around 7 percent to the targeted inflation rate of 4 percent under the new inflation targeting regime. This requires a decrease in the long-term growth rate of reserve money (Table 1).

This shows that the average rate of growth of reserve money in the recent time is less as compared to the average for the previous years. With tight monetary conditions till the economy stabilises at the 4 percent targeted inflation rate in the next 1-2 years, obviously *the general market interest rate* would be high – not due to very high inflation but due to the tight monetary conditions in the transition period. Under these circumstances, it is hardly feasible for the RBI to fix a low repo rate.

Table 1. Growth rate of reserve money (%), 2001-02 – 2014-15

Year	Growth rate of reserve money (%)
2001-02	11.09

2002-03	09.24
2003-04	13.90
2004-05	13.86
2005-06	15.98
2006-07	19.64
2007-08	27.49
2008-09	16.13
2009-10	09.04
2010-11	21.50<
2011-12	14.06
2012-13	05.99
2013-14	08.80
2014-15	10.12

Data source: Table 46, Average monetary aggregates, date: September 16, 2015, Handbook of Statistics on Indian Economy.

Contrary to conventional wisdom, the tussle between the RBI and the MoF can be about adjusting to new situations and new ideas (the MoF is often lagging behind in this matter possibly because its comparative advantage lies in fiscal policy and not in monetary policy).

Also, it needs to be realised that the powers of the RBI are less than what these are widely believed to be; the market forces cannot be ignored.

Notes:

- Repo rate in this context is the rate at which the RBI lends money to commercial banks.
- Low interest rates can encourage investment, which can increase growth in the economy. On the other hand, low interest rates go alongside more liquidity in the economy, which can be inflationary. So, low interest rates may promote higher growth but at the cost of higher inflation.
- Suppose that the economy is in equilibrium to begin with. Then the interest rate is changed. With this, the economy moves to possibly another equilibrium. This movement is referred to as adjustment here. In the process, there can be effects on savings, investment, asset prices, banks' balance sheets, exchange rate, and so on. These can in turn affect other variables
- Fama (2013) cannot be dismissed for another reason. Suppose the conventional wisdom is correct and the Fed can indeed fix the interest rate as it chooses to. This raises a

different set of issues. These are, however, outside the scope of this column. The interested reader can see Singh (2015).

- Savings are positively related to interest rate and investment is negatively related to the interest rate. The equilibrium interest rate is where savings are equal to investment. Savings and investment depend also on factors other than the interest rate. If due to these other factors, savings rise and/or investment falls, then the equilibrium interest rate falls. However, it cannot fall beyond a point - say, zero. Then, the adjustment is through a fall in income as a result of which savings fall, and market equilibrium is attained at the floor level of the interest rate.
- Personal (household/individual) savings rate in the US has increased from less than 3 percent before 2008 to more than 5 percent in 2016. Also, the retained corporate earnings (part of corporate earnings that are invested in the corporation rather than being paid out to shareholders) have increased substantially. Investment fell from more than 23 percent of GDP (Gross Domestic product) to less than 18 percent in the aftermath of the recession in and around 2008; it is still far from full recovery.
- There are two channels by which interest rates influence inflation: First, lower rates are consistent with higher liquidity, which can increase inflation. This can, in turn, raise the expected inflation rate in the future. Second, the public associates low interest rates with high inflation; hence, lower interest rates can lead to expectation of higher inflation.
- When the inflation rate is somewhat low, there may be a 'static' trade-off between higher inflation and higher output (level or growth) in the short run. However, when the inflation rate is somewhat high, there is hardly any trade-off; instead, we can get high inflation and less output (level or growth).
- Reserve Money is the sum total of the currency in circulation in the economy, along with bankers' deposits and 'other deposits' with the RBI.

Source : http://www.ideasforindia.in/topics/governance/the-tussle-between-rbi-and-ministry-of-finance-a-different-dimension.html

4 YEARS OF THE MODI GOVERNMENT: TAKING STOCK OF ECONOMIC PERFORMANCE

On May 26, 2018, the BJP led by Prime Minister Modi completed 4 years in power. How have its economic policies fared since 2014?

In 2014, then-Chief Minister of Gujarat Narendra Modi campaigned on a vision for economic growth, good governance, and reforms. Four years later, as Prime Minister Modi and the Bharatiya Janata Party (BJP) head into the 2019 general elections, the National Democratic Alliance-led government has made significant progress on economic growth and reforms.

Indeed, the government's accomplishments on tax reform, insolvency and bankruptcy procedures, and FDI liberalization are incredibly impressive. However, when compared to the BJP's election manifesto released in 2014, the government has been unable to undertake crucial items in its promised reform agenda, particularly on job creation, as well as land and labor reform. As the BJP looks toward 2019, a comparison of the BJP's promises and achievements underscores a mixed record of remarkable progress and unfulfilled promise.

PROGRESS ON GROWTH AND REFORMS MADE…

Economic indicators under Modi's government have been trending positively going into its fifth year. Indeed, the *Hindustan Times* notes that "India is the fastest growing major economy in the world. This growth has not come at the cost of high inflation or fiscal deficit. At no point of time has the Consumer Price Index, the benchmark measure of inflation for Reserve Bank of India's inflation targeting agreement with the government, exceeded its targeted range."

However, beyond the headline numbers, the government has undertaken impressive economic reforms over the last four years. The overhaul of the nation's indirect taxation system through the goods and services tax (GST) remains one of the most significant accomplishments of the government. Although implementation of the GST has been less than ideal, given the inordinate complexity of the tax regime and numerous changes in how specific classes of goods and services were taxed, the passage of the reform was a crucial step in improving ease of business and removing trade barriers that prevented India from behaving as a single market.

Other major economic reforms also include the passage of the Insolvency and Bankruptcy Code, 2016, which created a uniform and comprehensive framework to oversee the financial failure and insolvency of companies and individuals. This much-needed and welcome reform also advanced the BJP's goal of improving the ease of doing business in India by ensuring early identification of potential insolvency and maximizing the value of insolvent assets for creditors, thereby providing relief to India's distressed credit markets.

The government has also pushed for greater liberalization of India's foreign direct investment (FDI) regime, particularly in crucial sectors such as defense, e-commerce, and pharmaceuticals, leading to a **record average inflow of $ 52.2 billion in FDI annually in the last four years**.

The creation of Aadhar, which has become the primary form of identification for most Indians, and the launch of the Pradhan Mantri Jan Dhan Yojana (PMJDY), which sought to bring millions of financially excluded Indians into the fold, are also major accomplishments although both still face significant implementation challenges.

Indeed, data shows that "inactive accounts now make up nearly 50 percent of the user base" for PMJDY, and Aadhar's security and constitutional challenges remain to be addressed.

…BUT CERTAIN PROMISES REMAIN UNFULFILLED

However, despite these notable achievements, the government has also been unable to act on a number of crucial reforms that it had promised. While the government had promised a greater formalization and digitization of the economy, the move to demonetize 86 percent of India's currency has seen nearly all of demonetized notes return to the RBI as cash continues to dominate India's transactions.

Moreover, non-performing assets have remained a major concern for India's economy; they have grown from Rs 2.52 lakh crore in March 2014 to Rs 9.62 lakh crore as of March 2018. In dollars, non-performing assets make up more than $150 billion, of which nearly 90 percent is held by public sector banks.

However, chief among the government's unfulfilled reforms are those related to labor and land acquisition. The BJP pointed to India's existing land and labor laws as holding back economic growth, investment, and development in India, but has been unable to advance legislation to enact necessary reforms in these sectors.

Indeed, in the first two years of the government, the BJP pointed to the Land Acquisition Act of 2013 as being a barrier to investment and development. The Economic Survey released in 2015 pointed to land acquisition as the primary cause behind the lack of progress in 161 government projects. Dr. Arvind Panagariya, the vice chairman of the NITI Aayog, also argued that "The Land Act, 2013 is an onerous Act under which by all calculations it will take up to five years for acquiring land assuming that all steps progress smoothly."

However, on August 31, 2015, Modi announced that a proposed ordinance drafted by his government that would amend the Land Acquisition Act of 2013 would be allowed to lapse, and would not move forward.

Similarly, the BJP, in its 2014 election manifesto had outlined that, if the party came to power, it would "review our Labor laws which are outdated, complicated and even contradictory." Indeed, India's labor laws are "convoluted, restrictive, and archaic, much of it dating to the Raj." Among the most onerous of such regulations include the requirement that any firm employing more than 100 workers must seek and receive government permission before dismissing any worker.

Employers therefore hire employees informally. As a result, 81 percent of India's workforce works in the "informal sector," preventing India from transitioning to a formalized and high-production labor force. While Modi and his government have pushed for labor reforms over the last four year, progress has remained elusive.

As a result, perhaps the biggest promise made by the BJP in 2014 — job creation — remains unfulfilled, particularly as there is no clear indication of how many jobs were created in India.

In its 2014 election manifesto, the BJP stated "The country has been dragged through 10 years of Jobless Growth by the Congress-led UPA Government. Under the broader economic revival, BJP will accord high priority to job creation and opportunities for entrepreneurship." The manifesto pledged, that "Job creation [will be] central to our economic model." Modi doubled-down on that goal, promising in 2013 that "the BJP would create 10 million jobs."

Since the government data only tracks job creation in the organized sector, there is no clear indication as to how many jobs were created or lost. As a result, varying and contradictory job growth figures for 2017 have been published and publicized, ranging from 1.4 million to 15 million jobs.

Despite the debate over the numbers however, the government is also battling a perception that its four years in power have been accompanied by jobless growth. Indeed, opposition parties have hit out against the government, especially as Modi and BJP President Amit Shah have stated that selling *pakodas* counts as employment. As the government heads into its final year, the narrative battle of job creation will be at the forefront of political debate.

The BJP has stated that it would publish a "report card" of its accomplishments in government and present it to the Indian people, leaving it upon them to judge its performance. While the government has made impressive strides in passing the GST, improving insolvency procedures, and liberalizing FDI, crucial other reforms and promises remains unfulfilled. The government has clearly taken steps to achieve the "Acche Din" it promised to Indians in 2014, but it must reckon with its mixed report card as it looks toward the 2019 elections

Source : https://thediplomat.com/2018/05/4-years-of-the-modi-government-taking-stock-of-economic-performance/