

## Demonetisation: How India can make the best of its big cash bust

Almost exactly one year ago, Prime Minister Narendra Modi went on national television to announce that, in a few hours, existing Rs500 and Rs1,000 notes would no longer be legal tender. This came as a complete shock to most; the weeks and months that followed featured long queues at bank tellers as hapless Indians tried to exchange old notes for new, and at ATMs where they tried to withdraw enough cash to keep going. The sudden drought of cash made it increasingly difficult for small and medium enterprises to operate, as they relied on piles of cash for working capital. Many estimated that economic growth would slow as a consequence and events seem to have borne out this point of view.

One year on, there's little that can be said in defence of demonetisation: It was a poorly conceived policy with muddled goals that was horrendously implemented. That said, even bad policies can have good, if initially unforeseen, outcomes. The Indian government provided multiple different justifications for its action at various points—from the prevalence of counterfeit notes, to the problem of terror financing, to the fight against so-called black money. The one it has finally zeroed in on, however, is that by pushing citizens away from cash and toward digital transactions, demonetisation will in the long run benefit the Indian economy. And, certainly, that's a worthy goal, even if demonetisation may not have been the best way to go about achieving it.

The Indian economy has long suffered from being excessively "informal"; too many Indian enterprises are small, below the regulatory and tax radar. Meanwhile, Indians have traditionally had a preference for gold or real estate as destinations for their savings, instead of the financial sector. This meant, first, that the government was constantly strapped for cash and, second, that too much capital was tied up unproductively. There's much to be said for an economy in which more transactions are clearly observed, in which taxes are paid more regularly and transparently, and in which the financial sector is allowed to do its job of allocating people's savings efficiently. I myself laid out, a few months before demonetisation, the many arguments in favour of a cashless economy.

The government's propaganda about demonetisation and "digitalization" may be typically breathless. But it's likely that its actions have forced more Indians to at least become familiar with cash-free methods of payment, with mobile wallets and with digital payments. That can only be a good thing.

Instead of trying to win a political argument about the manifold benefits of demonetisation, the government would be wiser now to focus on its positive effects and expand upon them. If people have been exposed to the possibility of digital payments, how can that be used to promote real behavioural change?

One way would be to make digital transfers much easier. Opening a bank account online, or using it to transfer money, should be made practically effortless. The problem is that the government has locked itself through demonetisation into a narrative where the fight against unaccounted cash is paramount. This means that it's willing to maintain more bureaucratic hurdles to online banking than are necessary. Onerous know-your-customer requirements should instead be eased and, at least for relatively low-value digital transactions, be made frictionless.

In some parts of the world, such as East Africa, local mobile phone dealers do most of the work that bankers do elsewhere. In China, opening an online account that provides most of the benefits of a "real" bank account requires just a smartphone and a few minutes. Procedures in India are far more cumbersome. The government should look around the world and adopt the simplest procedures that have worked elsewhere, even if this means that regulatory structures have to

shrink. Paranoia about tax evasion will not serve anybody at this point. The goal must be to get transactions online and thus visible, and then the tax base will expand organically.

Furthermore, digital transactions must be made not just easy but cheap. Remember, cash works because each transaction is, essentially, free—other than the opportunity cost of interest foregone by holding the cash needed for that transaction. The cost of a digital transaction should never be higher than that opportunity cost, if people are to voluntarily choose online payment mechanisms. That isn't the case at the moment. The mobile prepaid wallets that became popular after demonetization, for example, take away between 3 and 4% of whatever cash you transfer between your wallet and your bank account. It's thus hardly surprising that people switched back to cash when it became possible to do so.

The Indian government can still salvage something from the wreck of its signature policy. Digitalization of payments is a goal well worth pursuing—through steady deregulation and cost-cutting, not through boastful rhetoric and disruptive actions. **Bloomberg View**

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