The Truth About Demonetization*

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After months of dilly-dallying the Reserve Bank of India has finally come out with the figure that nearly 99 percent of the currency notes demonetized in November 2016, came back to the banking system. The total value of demonetized currency, in the form of Rs.500 and Rs.1000 notes, was Rs. 15.44 lakh crores, of which Rs.15.28 lakh crores came back to the banking system, which is 98.96 percent. Since a few small windows are still open for the return of demonetized currency, the final figure will certainly exceed 99 percent, which puts paid to the government's claim that demonetization would deal a crippling blow to the black economy.

This claim, it may be remembered, was based on the argument that while demonetization would entail honest people depositing cash with banks, the black economy operators would not dare to do so, since they would be scared that questions would be asked about where they got all the cash they were coming to deposit. The absurdity of this argument now stands exposed. According to this argument the test of the success of demonetization in crippling the black economy lay in the fact of demonetized currency not coming back to the banking system. A figure of Rs.3.5 lakh crores was mentioned as the amount which the government expected not to come back to the banking system.

Indeed on the basis of this expectation, all sorts of claims were made at the time: that this amount could be simply distributed among the people, since the RBI's reduced liabilities, owing to the disappearance of this amount of currency, could be made good with impunity by printing equivalent new currency; that this amount could be simply given to the government for spending through the budget without any additional debt being incurred on its part; and so on. Well, it now turns out that that the value of currency not returned till now is only a paltry Rs.16000 crores, and most of it no doubt from honest people who could not meet the deadline for turning in their old currency notes: it amounts in other words to a sheer loot of honest people by the government.

But even this is not all. The cost to the RBI of printing new currency, and of mopping up, through Reverse Repo operations, the unwanted liquidity of the banks, which had to pay interest on deposits that brought in this liquidity without earning anything in return on such liquidity, was Rs.30000 crores. This was far in excess of the Rs.16000 crores that was snatched from the people. The RBI which is supposed to have got enriched by demonetization, thus ended up incurring a net loss on account of this exercise, which entailed a loss of fiscal resources.

An enormous shock was thus administered to the economy for no rhyme or reason. It dealt a heavy blow to the informal economy; it boosted unemployment among the poorest segment of labourers; it caused massive hardships for common people who had to stand in endless queues to get just a fraction of their own earnings that had been deposited with the banks; it caused the deaths of 103 persons; and it led to a net loss of fiscal resources. The excuse for all this, that it would cripple the black economy, was palpably bogus to start with; its bogusness is now exposed by the RBI's own data.

But the government's temerity it would appear knows no bounds. Finance Minister Arun Jaitley who till the other day was gloating over figures of how much money he expected to be disabled by demonetization, has now done a complete about turn, and is celebrating the figures of how little has been disabled. The success of demonetization he now claims consists not in the fact that demonetized currency did not return to banks, but in the fact that it did. Demonetization according to him succeeded in "flushing out" currency from the black economy operators who were forced to deposit it with banks.

Now, if black economy operators simply exchange old notes for new ones, then that does not hurt the black economy one iota. Jaitley's argument would have some basis if two conditions were satisfied: first that black economy operators who deposited old notes could not obtain new notes in exchange; and second, that black operations demanded exclusively currency transactions. Neither of these conditions holds. But let us for argument's sake assume that all transactions by black money operators have to be carried out exclusively through currency notes. (This is obviously untrue, for when a black money operator buys an air-ticket for himself, he does not pay for it with a wad of currency notes; but let that pass).

The first condition requires that re-monetization should not have been complete, for if it is then everybody is back with the same of value of currency that he or she had deposited in the first place and there is no question of black economy operators being inconvenienced. Now, it is certainly the case that re-monetization has not been completed; but the government's own Eonomic Survey said that it had been, implying not that 100 percent of the surrendered currency had been put back into the economy but that the degree of non-remonetization more or less corresponded to what people would voluntarily wish to relinquish, that the demand and supply of currency in the economy were now more or less matched. But if this is the case then there is no question of black economy operators being strapped for cash, and therefore there being any dent in the size of the black economy.

In other words the mere "flushing out" of old currency from black money operators is of no consequence whatsoever; the only thing that matters is whether such "flushing out" causes a shortage of cash in the black economy which can incapacitate it to a certain degree. And such a shortage, by the government's own Economic Survey, does not exist.

What is more, such a shortage of cash for the black economy simply cannot exist for two reasons. First, "black" economy operators and "white" economy operators are not two completely separate entities. The same person who operates in the "white" economy also engages in "black" activities: for instance a mine-owner who extracts larger undeclared mineral resources has one foot in the white economy and another in the "black". Now, even if we assume that re-monetization is not complete, in the sense that the currency-bank deposit ratio with the "public" is less than it would desire to have (unlike what the Economic Survey believes to be the case now), all such operators straddling both the "black" and the "white" economies, could easily ensure that the currency requirements for their "black" transactions were adequately met, by economizing on the currency requirements for their "white" transactions. In other words, they could always ensure that any shift from currency to bank deposits forced upon them by the government could be made to impinge to the required extent on their “white” transactions and not on their “black” transactions, so that their total business, taking both “white” and “black” operations together, was not affected.

But let us take a case that is even more favourable to Jaitley’s argument. (Though Jaitley himself has made no such argument, we are attributing to him a semblance of a reasoned argument in order to see its fallacy). Suppose the black economy operators constitute a completely separate entity from the white economy operators, and suppose they cannot do any transactions without using currency, which is in short supply for them because re-monetization is not complete. In other words the currency-bank deposit ratio in the economy as a whole has fallen and they are the primary victims of such a fall to start with.

In such a case they would simply suck out currency to the extent they require from the “white” economy, in particular from the informal economy, by offering an appropriately higher interest rate, if not directly then at any rate through intermediaries. Any such sucking out would entail partly a reduction in the amount of currency required per unit value of transactions in the informal economy (what economists call a rise in the velocity of circulation of currency), and partly a reduction in the value of transactions themselves, through for instance a cutting back in the holding of commodity stocks by small shop-keepers, and so on. This latter effect would be recessionary for the economy as a whole. The “black” economy would not be affected by any currency shortage in such a case but the informal economy would, which would have overall recessionary consequences.

It follows then that even if we breathe some logic into Jaitley’s argument, which is clearly advanced in desperation in the face of an embarrassing revelation for the government, it still makes no sense.

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