Demonetization as the Basis for a Fiscal Stimulus*

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A bizarre argument is doing the rounds these days. It states that the cash which gets disabled in the "black economy" because of the government's demonetization measure, would enable the government to undertake an equivalent amount of expenditure with impunity; it can therefore spend more on infrastructure and other essential areas, or simply provide cash transfers to the people. BJP spokespersons who have been putting forward this argument, are promising transfers to everyone, in a manner reminiscent of Modi before the Lok Sabha elections, when he had promised that "black money" from Swiss Banks would be brought into the country and distributed among the people. Figures of how many thousands of rupees can be given to every family as a result of the present demonetization are being bandied about. The obvious aim is to divert people's minds from the extraordinary distress they are currently facing because of this demonetization, by dangling before them the prospects of a bonanza about to come their way.

Let us see exactly what this argument is. Since even before demonetization the Indian economy was saddled with unutilized industrial capacity and surplus foodgrain stocks, there was nothing to prevent the government from providing transfers to the people then; such transfers certainly would have had no inflationary consequences. Even today, no matter how much "black money" is disabled, i.e. not converted to the new legal tender or deposited in banks, the government can still spend more, or provide cash transfers to the people. This, apart from being desirable on distributional grounds, would also be beneficial for the present recession-hit economy, by injecting more cash, and simultaneously more purchasing power, into it. Why then is the issue of providing cash transfers to the people being linked to the amount of "black money" that would get disabled? Where in other words does demonetization enter the picture as the thing that makes such transfers possible?

The answer lies in the fact that if the government spent more on infrastructure or on transfers per se, then, unless it raised more tax revenue (which let us leave out for the time being, since it is not germane to the present argument), it would run a larger fiscal deficit. Such a larger fiscal deficit, as just mentioned, would have no damaging consequences; on the contrary it would help ameliorate some of the distress caused by the government's measure. But it would put off globalized finance, since the latter would consider it fiscal "irresponsibility" (especially if the larger fiscal deficit was on account of transfers to the people). The argument about disabled cash being "used for" (i.e. being offset by) larger government expenditure derives its rationale from this: such expenditure will not have to be financed by a larger fiscal deficit. No government bonds will have to be placed with the Reserve Bank of India or with commercial banks for obtaining from them the funds needed for such larger expenditure.

The argument here goes as follows. If some currency gets disabled in the "black economy", then there is a reduction in the amount of liabilities of the Reserve Bank of India (since more or less all currency is the RBI's liability). In the RBI's balance sheet therefore, while assets remain the same, liabilities go down, giving it a bonanza, a windfall profit. As all profits of the RBI constitute an income for the government, which the RBI is obliged to hand over to it, the government's income goes up, and it can spend an equivalent amount, without having to incur any additional fiscal deficit. The RBI in short can simply hand over to the government an amount in new currency notes, which is exactly equal in value to the old currency notes which become completely defunct after December 30, the deadline for their being turned in.

This argument however is based on a misconception. A sudden decline in the value of liabilities relative to assets does not ipso facto constitute profits, just as a sudden decline in the value of assets relative to liabilities does not ipso facto constitute a loss. If the latter were the case, then against the non-performing assets (NPAs) of nationalized banks, the government would be having to reduce its expenditure, since such NPAs, on this reasoning, would be treated as losses of nationalized banks and hence of the government. But this is not what happens; and to argue that it should happen this way is to set a very dangerous precedent, since government expenditure would then become directly dependent upon the shenanigans of all those scallywags who borrow from nationalized banks and then abscond abroad.

When there is a reduction in the value of liabilities relative to assets, its impact on the balance sheet, which must always balance, is to increase the reserve fund of the RBI. The strengthening of the balance sheet, as reflected in larger reserves, enables the RBI to expand the size of its portfolio, i.e. give out larger loans. It is these larger loans that fetch it a larger profit, which the government can obtain as its income. In other words, it is not the disabled currency itself that is supposed to constitute profit, but what can be earned by expanding the RBI's assets because of this disabled currency.

The asset side of the RBI has mainly three elements: foreign exchange assets, loans to the government, and loans to the banking system. Now, when the RBI decides to increase its assets side, it would not be buying foreign exchange assets. In fact at this moment when the rupee is sliding against the dollar, its doing so would only worsen the depreciation of the rupee. It would also not be giving out larger loans to banks, since banks themselves are flush with funds, because people have been forced to deposit cash with banks under the government's demonetization scheme, and the banks do not have any "creditworthy" borrowers (from their point of view) to whom they can lend these additional resources. The only entity therefore to whom the RBI can lend is the government itself.

If the government does indeed borrow more from the RBI because of the larger reserve fund at the latter's disposal, then the interest it pays on such loans will simply accrue back to it as its own income, since these interest payments would boost the RBI's profits that come to the government as a matter of course. Its larger borrowing would in effect therefore have entailed a zero rate of interest. But that is true of all government borrowing from the Reserve Bank anyway.

The only difference in the present case would have been the following. Under the neo-liberal dispensation the amount the government can borrow in any year from the central bank has an upper limit, and for any borrowing in excess of this limit the government has to approach the "market". The RBI's having larger reserves at its disposal increases this upper limit. The government in the present situation, where a certain amount of cash in the "black economy" may have been disabled because of demonetization, can therefore borrow more at the margin at zero interest rate, while otherwise it may have had to approach the "market" and pay an interest cost on its additional borrowing. But beyond this, under the rules of business, and accounting practices, that govern the RBI and all such institutions, demonetization does not confer any extra benefits to the government in the matter of its spending, as is being claimed by the BJP spokespersons. Indeed, this is exactly what former governors of the Reserve Bank of India, such as C.Rangarajan and D.Subbarao have been pointing out.

The government may of course change the rules of business and the accounting practices, but globalized finance, whose "loss of confidence" the government fears, and because of which it dares not increase its fiscal deficit even in the midst of a recession, cannot be so easily hoodwinked; it would immediately treat any increase in government spending, incurred on the argument that its income has gone up because of the disabling of currency in the "black economy", as an increase in fiscal deficit, and respond accordingly.

For the disabled notes under demonetization to be the base for a fiscal stimulus, therefore, two requirements have to be fulfilled: first, the government would have to change the basic accounting practices that govern all such economic establishments, and this would have serious consequences, e.g. with regard to the NPAs as mentioned earlier. Second, it should be willing to risk facing the "loss of confidence" of globalized finance.

Now, even if the Modi government, with its penchant for acting as a bull in a china shop in economic matters, would be willing to change accounting practices to get some mileage with the people, it simply lacks the courage to face up to globalized finance. If it did have that courage, then it would have simply gone ahead and spent more in the current situation irrespective of how much cash is disabled through demonetization in the "black economy". But the fact that it has not done so only shows its lack of intent with regard to spending more.

The same Modi who has unleashed an assault on the common people through his demonetization move, has assured international finance that India would be the most "liberal economy" in the world, which means most open to global financial flows. And when that is his ambition, he is scarcely likely to provide transfers to the common people. Global finance does not like transfers to the people anyway; if transfers are to be made at all, then it would rather have transfers coming its own way, through tax concessions for instance. In addition, it certainly would not like accounting short-cuts to be used for making transfers to the people.

If the Modi government was serious about transfers to the people, then it would just go ahead and make them without even waiting till December 30. Simply talking about transfers is sheer deception.

* **This article was originally published in the People's Democracy on December 4, 2016**