

Demonetisation: Little Gain and Severe Pain?

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There have been enough discussions, appreciations and criticism about the recent move of scrapping the currency notes of ₹500 and ₹1000 in India. Initially, it was lauded by many, even the common people despite the suffering they had due to the liquidity crisis. But as time passed, with imparted uncertainty by the Reserve Bank of India (RBI) and the Central Government in their currency replacement mechanism, people gradually came to terms with the reality of cash crunch seeming to be never ending and this probably led to challenge the belief that the move was really a welcome policy to punish black money holders.

We will mainly focus on the gains and pain points of the policy. There are some widespread misconceptions about black money. Someone's legal income, not taxable, or the gifted money saved in ₹500 and ₹1000 notes are mistaken to be considered as black money, but actually they are not. Black money may arise from two sources, viz. the part of taxable income (e.g. of self-employed persons) or illegal income not reported to the tax authorities and fake currency in circulation. The move is aimed at the stock of black money and does not target to curb the generation of new black money. While the move will wipe out the fake currency at one go, the benefit regarding the unreported part is not very clear. It will depend on the amount of unreported income held in cash that comes back to the banking system. There is serious doubt on that as one will be exposed of having black money, given the restrictions on converting the black to white money. Given past experiences, the demonetisation can at most remove only around 6-7 percent of the unreported money¹, which is nothing but the tip of the iceberg! The possible economic gains and losses from demonetisation are presented in Table 1:

Table 1: Possible economic gains and losses from demonetisation

Gains	Losses
The tax to the Central Government as a portion of black cash converted into white	Potential GDP loss (especially in unorganised sector) due to <ul style="list-style-type: none"> - Reduced demand - Reduced production
Complete eradication of old fake notes of ₹500 and ₹1000 denominations	Revenue loss of the Central Government due to loss in GDP
Increase in deposits of banks, hence lendable money increases	Cost of printing new currency notes
	Loss of revenue for state governments

¹NIPFP (2012), Report on *An Account of Unaccounted Money in India*.

In the medium to longer run however, the move might inflict certain 'structural' changes in the economy like increasing awareness on digitization, apprehension about holding assets in cash etc.

Let us try to understand, in light of the traditional Keynesian macroeconomic theory, how the move leads to the fall in GDP growth. Firstly, one needs to clarify that the policy declaration is not 'demonetisation' per se. It was not intended to suck money from the system and should not be inferred as a contractionary monetary policy; it has however, changed the composition of the money supply dramatically - a major portion of the cash-in-hand (i.e. currency in circulation) has been converted to bank deposits. This may include a chunk of the "black money (unreported money held in cash)" that was otherwise in circulation. Hence, there is no reason to believe that the broad money supply has changed significantly.

In the very short run, when there is limited scope for the price and supply of output to adjust, the real money supply in the economy remains the same, i.e. the real purchasing power does not change. But, it has shrunk the demand for money for transaction purposes since a portion of the money kept for transaction is no longer a legal tender and the pace of replacement of the old notes is yet to catch up. A significant chunk of this cash holding has been deposited to banks. Large banks with such a deluge of deposits have purchased more bonds and the rate of interest has fallen.

Interestingly things may change in the medium run with the entry of 2000 denomination notes. It will reduce the velocity of money, i.e. the average number of times a currency note changes hands. Moreover, price of goods and services will fall as the consumption demand has fallen. Eventually, sluggish demand will cause the supply to fall as firms will produce less as they know they would not be able to sell.

Now, there may be more demand for loans owing to falling interest rates, but this channel seems to be working too sluggishly due to the weak growth perceptions. So, despite the greater lending potential of the banks due to increasing deposits, they will not have the scope to lend. Thus, both output and price will fall.

From this analysis, it seems that the gain from this move will be far outweighed by the pains, at least in the short and medium term. The move has targeted only the black cash, but not the black assets held in terms of gold, real estate and the like. If one compares the costs and benefits of the policy, the price the common people and the economy are paying for the move is not justified, at least, by any economic logic.

Ramifications in the Rural Economy

Although the epicentre of the black economic transactions was not the rural periphery, in comparison to its urban counterpart due to several obvious reasons such as lesser concentration of economic activities, the brunt of the blow of demonetisation has been more severe on the former. This is because, concentration of bank branches and ATMs that replaced the notes withdrawn, are significantly low in the surrounding of the rural belt as compared to the cities and suburbs. The digital literacy is yet to catch up in India, in general, not to speak of the rural segment. Therefore, the troubleshooting exercise in the form of a shift towards 'less-cash' online transaction mode, has been less successful and accommodative in this region.

Nonetheless, triggered by demonetisation, one can dream of a fast catch-up in the digital literacy and digitisation in the so far neglected rural economy, along with the innovations in the 'offline digital payment mechanism' that are in its early stage of inception.