

The Demonetization Fiasco*

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The demonetization of 86 percent of the currency of the country, a virtually unprecedented measure anywhere in the world, has brought immense hardship to the working people of the country, and will damage their living standards permanently (since the Modi government plans not to replace the entire value of the demonetized notes by printing new ones). Many however believed that it was a step being taken for the greater social good, for achieving certain important social goals.

Three of these goals were mentioned by the government from time to time: to attack black money, to replace counterfeit notes, and to encourage a shift to a cashless economy. The last two of these goals could have been achieved through a gradual withdrawal of old notes rather than a sudden demonetization of the sort that the government actually effected. The last of these goals is even a pernicious one anyway, since it pushes people from costless transactions, which cash transactions are, to more costly digital transactions. Only a government committed to transferring incomes from the working people to firms providing digital services, would consider this a worthwhile social goal and even use coercion for achieving it. The goal which appeared most persuasive to people was the attack on black money.

Most economists in the country, belonging to diverse ideological backgrounds, had argued that demonetization would not achieve this goal, that at the most it would only be a pinprick for the operators in the black economy, for which causing such mass distress was totally unwarranted; but even these critics had accepted that demonetization would administer a pinprick to the black economy operators.

It now turns out however that demonetization has not even administered a pinprick to the black economy; it has been an utter fiasco with regard even to this one goal it was supposed to achieve, which most people had considered both worthwhile and pressing. With its failure to administer even a pinprick to the black economy, even the last fig-leaf of an argument in favour of demonetization has collapsed. Let us see why.

The case built for demonetization was that with the 500 and 1000 rupee notes no longer being legal tender, the cash held in the form of such notes in the black economy would cease to have any value. While the common honest people would come to the banks to exchange or deposit the demonetized notes in their possession, the black money operators would not dare to do so, for fear of exposing themselves for investigation. As a result, the notes held in their possession would simply get extinguished, which would be a major loss for them. The difficulty of recovering from this loss would deal a huge blow to the black economy.

In other words the mechanism through which the black economy was supposed to be hit was through the extinguishing of the 500 and 1000 rupee notes held by it; and the success of demonetization in crippling the black economy was to be measured by the value of the currency so extinguished. The government reportedly had expected that 3.5 lakh crores of rupees would get extinguished in this manner; and economists emphasizing the futility of demonetization as a weapon for combating the black economy, had argued that even if this happened, since the sum of 3.5 lakh crores of

rupees was a small fraction even of the profits of the black economy, its extinction would not make much difference to this economy, though they had expected the actual value of extinguished currency to be much smaller than this. This however was the figure for the extinction of old notes that the government had expected.

So sanguine had the government been about the extinction of a sizeable amount of old notes, that it had even promised substantial largesse to the people on the basis of such extinction. The argument had gone as follows. Since the extinguished currency constituted a liability of the Reserve Bank of India, the extinction of this liability would be tantamount to an accrual of an equivalent sum as a windfall profit to the RBI. As the RBI was wholly-owned by the Government of India, its profits constituted the income of the government, so that the value of the extinguished currency would ipso facto constitute budgetary resources for the government and hence be available to it for spending. And BJP leaders went to town claiming how this “masterstroke” by Modi had enabled the government to spend huge amounts of money for the people’s welfare or for direct distribution among them.

This argument of course was wrong. The extinction of some liabilities of a government-owned institution does not ipso facto constitute profits of that institution and become available for spending by the government. For if that was the case, then the non-performing assets of the nationalized banks, by the same logic, should cause a reduction of an equivalent amount in the government’s expenditure, which is absurd. The balance sheet and the profit-and-loss accounts of any institution are separate, though related, entities; but one of them cannot be directly translated into the other.

But the following more plausible argument could nonetheless be advanced. The extinction of a part of the liability of the RBI enables it to reduce its assets to an equivalent extent, through simply writing off government debt to it. In that case the government could freshly borrow an equal amount from the RBI, without its overall indebtedness going up. In other words though the government could not claim the value of the extinguished notes as its income, it could certainly issue fresh debt of an equivalent amount with impunity; even international finance capital, opposed to fiscal deficits, could be persuaded that fresh borrowing of a value equal to that of the extinguished notes, did not constitute an increase in the fiscal deficit.

All such hopes and claims however have been dashed, since it now turns out that by the December 30 deadline for depositing old notes, the banks had got back as much as 97 percent of value of the demonetized currency, either for exchange against new notes (a facility that was subsequently discontinued) or as deposits. Against Rs.15.4 lakh crores which were demonetized, nearly 14.9 lakh crores have returned to the banks, leaving only forty-odd thousand crores of extinguished currency. The question of larger government expenditure because of the reduced liability of the RBI therefore simply does not arise, since the magnitude of reduced liability is such a trivial sum.

More importantly however the impact on the black economy is almost nil. In the forty-odd thousand crores of rupees which have been extinguished, a fairly large amount would belong to people who have nothing to do with any black activities, but who, for various reasons ranging from illness, to infirmity, to procrastination, to confusion arising from the government’s frequent, bewildering and illicit changes of rules and deadlines governing the return of demonetized currency, could not turn in their old notes in time. The extinguishing of old notes belonging to the black

economy, which the government had expected to be around Rs.3.5 lakh crores when it embarked on demonetization, is virtually nil.

The demonetization measure, while causing immense distress to the people, and severe damage to the economy that is not just immediate but would linger into the future, and not just to the informal sector but to the formal sector as well through the reduction in the informal sector's demand for its goods, has produced nothing, literally nothing, by way of curbing the black economy, which was its commonly believed *raison d'être*. Most economists outside of the government, and of private institutions currying favour with the government, had emphasized the misconceived nature of this measure; but it turns out to have been even more misconceived than what its staunchest critics had imagined. And this is so, as already noted, by the criteria that the government itself has been proclaiming till now.

Needless to say, even this government whose brazenness is unprecedented, has been discomfited by this figure of the return of old notes. Its initial reaction was to question the data, though they came from none other than the RBI itself, by bringing in a lot of red herrings. But fresh rounds of data continued to pour in about the absence of extinction of the old currency; so finally, it has announced that until a thorough check is made, all these data should not be taken seriously. It has thus prepared the ground for "doctoring" the data in the name of a thorough check; but all such "doctoring" will be of no avail and its effort to hide the truth will come to naught.

The return of virtually the entire demonetized currency to banks is indicative both of the fact that the supposition of there being large cash-holding in the black economy was wrong, and also of the fact that black economy operators are always capable of taking steps to evade any such measure, while it is the poor working people who become its victims. Both these facts were known to most people; now they have been borne out by the government's own statistics. The evasive measures taken by the black money operators have ironically led to a proliferation of the black economy, while the purported objective was to curtail it.

Demonetization has been a fiasco in achieving its stated objective, apart from being a disaster for the people. The Modi government, however, true to its character, will never admit its mistake, never make a self-criticism, never consult the Opposition on how to redeem the situation and ameliorate the unnecessary distress it has caused. On the contrary it will pile on even greater agony for the people in its attempt to cover up what it has already done.

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