

Modi on Demonetization*

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On the fourth anniversary of demonetization, Narendra Modi has claimed that it succeeded in curbing black money. He probably believes he can get away with making this claim because of the passage of time. But most people in the country know this to be a lie for a simple reason.

For demonetization to curb black money, there must be some mechanism through which it can be shown to do so. Otherwise it would be no different from claiming that the Olympic Games of 2016 curbed black money in India. Besides, since the fact of black money being curbed is itself not established, specifying a mechanism through which this could have happened, will enable us to check the veracity of at least some of the intermediate steps in the chain.

The Modi government had actually specified such a mechanism at the time of demonetization. This stated that demonetization of currency notes will force the holders of such notes either to come out into the open to exchange them for new notes, at which point they have to explain how they managed to hold such large stacks of money; or to avoid such exposure by simply letting their currency notes “die”, which would be a blow against black money.

Since currency is the liability of the Reserve Bank of India, if a part of it “dies”, while the RBI’s assets remain unchanged, it can print new notes in the place of the old ones and hand them to the government for use in any manner it chooses. So sanguine was the BJP about the “killing” of black money in this way that it went around talking of distributing a sum of Rs. 3 to 4 lakh crores, expected to be incapacitated thus through demonetization, among the poor households.

Thus the modus operandi of demonetization against black money was supposed to be through the “killing” of the latter as it would not surface to be exchanged for new notes. In fact however 99.3 per cent of the demonetized notes came back for exchange, which underscored what a fiasco it had been as a measure against black money. But, simultaneously it had struck an immense blow against the informal sector, including peasant agriculture, which accounts for 85 percent of the country’s employment and 45 percent of its GDP.

Modi, like Trump however, is not one to accept defeat. He is now not only repeating the claim that black money has been curbed, but is taking pride in the destruction of the informal sector. The Chief Economic Advisor K.Subramaniam has also jumped to his defence in an article in the Economic Times (Nov.9).

The term used by both is “formalization”, by which they mean that “informal” activities are getting replaced by “formal” activities as a fall-out of demonetization. But this, far from being an achievement, is precisely the problem with Modi’s economic measures. Formalization, far from being a good thing as they claim, is a disaster for the people, since it creates unemployment. Formalization of informal sector activities might constitute an improvement in the state of affairs if the number of jobs did not decline because of it. But it does, which is precisely why everyone outside of Modi’s crowd is so concerned about it.

Consider an example. Walmart replacing lakhs of small traders is obviously a formalization of an informal activity, namely retail trade. This may cause more credit card payment compared to cash transactions, more systematic keeping of accounts, less scope for evading taxes (let us assume this to be true), and so on. Even so however this replacement can make sense only if the number of jobs created by Walmart is at least as many as the number of jobs destroyed by it. When there is net creation of unemployment because of it, formalization is a disaster. Since the Modi government does not recognize this elementary fact, it is claiming credit for something which everyone else sees as a disaster. The CEA talks of formal jobs replacing informal jobs; what he remains silent about is that only 50 formal jobs might have replaced 100 informal jobs.

Ever since India's independence there has been a broad consensus, no matter how violated it may have been in practice, that jobs had to be protected in the informal sector. The reservations of certain categories of cloth for production by the decentralized sector was a reflection of this. Gandhiji of course encouraged craft production; even the Mahalanobis strategy visualized the decentralized sector providing employment while overcoming the consumer goods shortage that inevitably arises when resources are diverted for investment goods production. The Left has been a consistent defender of the decentralized sector and was stoutly opposed to the entry of Walmart on grounds of employment loss.

The BJP is the first political party in the country that applauds formalization without any concern for the unemployment it generates. The one consistent characteristic of its government has been an attack on the informal sector, whether through demonetization, or the GST, or the agriculture bills just enacted. Its lack of explicit concern about unemployment might perhaps be explained by its ignorance in economic matters; but the CEA's unconcern is as mystifying as it is disturbing.

The claim that formalization will curb black money has also no basis to it. The argument advanced for it goes as follows: the use of cash is the main factor behind aiding the black economy. If cash use can be replaced by digital transactions or even cheques drawn on bank accounts, then evading scrutiny becomes that much more difficult; and this curbs the black economy. And formalization is associated with a shift from the use of cash to the use of digital or bank transactions. In fact Modi specifically referred to India's becoming a less cash-based economy as an achievement of demonetization.

The claim that greater cash use is associated with less transparency and hence a larger black economy is totally without any foundation. Advanced capitalist countries like Germany and Japan are heavily cash-using countries but one cannot say that the relative size of their black economy is greater than India's. On the other side, Nigeria has a very low degree of cash use but no one can claim that Nigeria has rid itself of a black economy. The Modi government's partiality for firms promoting digital transactions has been evident for long. Whatever the reasons for this partiality, justifying it as a means of curbing black money cannot stand scrutiny.

Besides, even the claim made by both Modi and the CEA that formalization has led to lesser use of cash is invalid. In fact the claim that cash use has gone down in India as a sequel to demonetization is plain wrong, and one is amazed that the Prime Minister makes such a wholly baseless statement. The economy may have become more

formalized in the sense of having a lower weight of the informal sector (which precisely is the criticism of measures like demonetization), but cash use in India has not reduced an iota owing to demonetization.

The currency-GDP ratio, which is the measure of cash use, fell sharply in the aftermath of demonetization but recovered thereafter and has now reached its pre-demonetization level. The Reserve Bank of India's Annual Report for 2019-20 has this to say about the currency-GDP ratio (where CiC refers to Currency in Circulation):

“Overall CiC growth of 14.5 per cent was slightly lower vis-à-vis 16.8 per cent a year ago; however the currency-GDP ratio increased to its pre-demonetization level of 12 per cent in 2019-20 compared to 11.3 per cent a year ago.” Hence Modi's claim about India having become a less cash-based economy because of demonetization is even factually incorrect.

This is hardly surprising. Digital transactions, unlike cash transactions, involve a cost which is why they are not very prevalent in the informal sector that operates with small margins anyway. Exactly the same is also true for the formal sector which would rather resort to costless cash transactions than digital transactions for which a payment has to be made.

The CEA talks of the numerous “shell companies” that have closed down in recent months, thereby making the system supposedly more transparent. Let us assume that his figures are correct and also that all these closures are because of government measures, starting with demonetization. The benefits from such closures however have to be visible in terms of the behaviour of some macroeconomic variable. The closure of shell companies per se does not generate employment (if anything it does the opposite), or alleviate hunger or improve people's lives; it can do so, if at all, by affecting some macroeconomic variable which has these effects. The CEA does not cite a single macroeconomic variable that has been stimulated by demonetization; indeed he cannot. But the distress of the informal sector, the unemployment in this sector that demonetization caused, have been revealed by several case studies by scholars. Modi and the CEA will gain much by taking a look at some of these studies.

* This article was originally published in the [Peoples Democracy](#) on November 15, 2020.