Bad economics can bite

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Nand Lal, a former soldier who missed his spot in an ATM queue in Gurgaon and became the face of the demonetisation movement. The negative effects of demonetisation are much bigger than the 0.5% that is being talked about. (Parveen Kumar/HT Photo)
Milton Friedman, the great Chicago economist, argued that the Great Depression happened because of shortage of money. No one had more faith in free markets than Milton, but even he did not believe that a market economy can function when there is an acute shortage of money. Many years later, a group of economists including Ben Bernanke spelt out why a shortage of means of payment can have disastrous effects: put very simply the fact that Ram does not have the money to pay Rahim, means Rahim now does not have the wherewithal to pay Ruth, who in turn cannot pay her banker, and so on till it eventually rebounds on Ram. In other words, Ram now has even less money to pay Rahim. There is a cascading effect on transactions, with the result that the overall GDP shrinks by much more than the original shortfall in liquidity.

What Milton Friedman meant by money included checks and other forms of money that only live on the books for banks. But recall that USA even in 1929 was more financially integrated than India is now, where there is still a huge part of the population that transacts only in cash. If, for example, the middlemen who buy the crops start cutting back because they don’t have enough cash in hand, farmers will have less cash as well, forcing them to stop hiring labour and so on, and entire village economies could go into a tailspin.

Read: ‘Chaiwala is now Paytm-wala’: Mamata targets Modi over demonetisation (http://www.hindustantimes.com/india-news/chaiwala-is-now-paytm-wala-says-mamata-targeting-modi-over-demonetisation/story-RfLm5Kr4bv4WNoX0wVvGLN.html)

Of course, all of this depends on how innovative everyone is with finding ways to pay. Everyone has heard of the local pan seller who has Paytm now and the cycle rickshaw puller who is getting one, and Paytm seems to be doing very well indeed. There are also stories of increased informal lending. On the other hand, in a small survey of retailers and wholesalers we carried out a couple of weeks ago in a large Indian city, most said that their sales were down, often 50% or more. We have no way to know how representative that is, but if it is we are talking about negative effects that are much bigger than the 0.5% that is being talked about.

But of course this is meant to be short run pain for long-term gain. So what about the potential gains? There was initially a lot of talk about fake currency and terrorists, but that seems to have subsided, mostly because there seems to be much less counterfeiting than the original claims. I am still willing to believe that the ISI could be minting rupees to fund its operatives, but find it hard to imagine that terrorism would stop if we could have a better control on the currency, given that these operations cost peanuts compared to Pakistan’s defence spending. If it comes to that, the ISI can just buy the rupees on the world market.


Another argument is that it will reduce corruption. I am willing to believe that the corrupt have been stockpiling rupees, and even that some of that ill-gotten wealth will be sacrificed to avoid unpleasant encounters with the law. But presumably what the government really cares about is not the stock of corrupt money from the past but the incentive to take fresh bribes. And given that there will now be 2000 rupee notes that can be used to make the necessary payments, I simply don’t see why anything should change, unless we keep doing these surprise demonetisations every few months. But then we are talking about long-term pain.

The third argument is that it will promote financial inclusion. I am sure this is true, though not all the money that has now flowed into the jan dhan accounts will stick—a lot of them will eventually go back to their real owners, who just needed a place to park it. On the other hand it is clear that more people will use Paytm and its competitors. The evidence on MPESA, Kenya’s popular answer to Paytm, reported in a recent paper in the journal Science by Billy Jack from Georgetown University and Tavneet Suri from MIT, suggests that it had very substantial welfare effects—pulling 2% of the population out of poverty. My problem with this argument is that there are obviously less costly ways to get to this.

The last argument is that not all the cash will come back (since their owners won’t own up to having it) and therefore the government is in a position to print more bills without creating inflation. This, it is argued, can be a large windfall for the government.

Unfortunately, this argument forgets that a lot of the cash that will not come back was not in circulation to start with — it was more a way for the crooked to hold on to their wealth. Moreover, the recent adoption of other payment technologies means that the demand for cash has fallen. In other words, the transaction demand for cash was always less than the total amount outstanding and it has fallen further. Going back to the pre-November 8 levels of cash would almost surely create inflation.

And yet the reform, at least at the beginning, was popular. The same mini-survey that I mentioned asked people what they thought of it and the modal answer was that it hurts but it is good for the country. The positive sentiment reflected in part admiration for the chutzpah that the PM had so obviously displayed and perhaps more importantly a delight in the fact that the bad guys who usually get away with everything, were finally getting one in the neck.

For that reason, even if the whole thing is a mistake in pure economic terms, it could be worth it for the PM in terms of political dividends. On the other hand, it may not. Schadenfreude is a powerful sentiment, but bad economics often has a way to bite back.

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**The views expressed are personal.**