Theory and Practice of Demonetization

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Abstract

Demonetization, or D-M, is the National Democratic Alliance government's most divisive policy move. A few months prior to the state assembly elections in Uttar Pradesh in 2017, the D-M surprise revelation worked in favor of the BJP, enabling them to win a stunning 325 seats. In this background, it is imperative to revisit the impact of D-M on Indian economy from the view point of theory and practice both. This article is intended to examine two important issues. First, is there any theoretical ground behind this move and what do theories say about impact of D-M on macroeconomic variables? Does this move guaranteed a more equitable society than hitherto, will redistribution of wealth and resources take place in favor of common man? This article concludes that the unprecedented move have neither been any well being effect on common man nor for the economy as a whole. Mainstream economists and traditional policy makers will remember this move as fundamentally flawed and mistaken.

Keywords: Demonetization, Macroeconomics, Equity, Economic Theory.

Introduction

Demonetization, or D-M, is the National Democratic Alliance government's most divisive policy move. A few months prior to the state assembly elections in Uttar Pradesh in 2017, the D-M surprise revelation worked in favor of the BJP, enabling them to win a stunning 325 seats. The decision to demonetize (D-M) had significant effects on India's social, political, and economic life. Both proponents and opponents of this choice were present. There were several reasons to support D-M. Few of them are (i) black money free economy (ii) check on terrorism and serious misconducts (iii) remove counterfeit currency (iv) Enhanced tax collection (v) promote cashless and digital transaction . In addition to these, it was also suggested that it would slow the rise in real estate and other service costs, potentially making a dent in the nation's economic disparity. So, the advocates predicted what D-M's long-term advantages would be. Officials from the ruling party and the administration, however, did not completely rule out some short-term detrimental effects (Mof 2017).

Supporters claim that this is a pro-poor action. The critics, on the other hand, are louder and more obnoxious when they discuss the economy's unfavorable future prospects. They first claim that there was no economic ideology present in the decision, making it illogical. To put it another way, neither theoretical nor practical considerations were made when making the decision. According to their proposition, as a result of D-M the country suffered loss of 1-2% GDP in growth rate along with slowdown in employment, investment and production. The most hurt sector was unorganized sector. Therefore according to critics, this was an anti poor move. Therefore for critics and followers both, poor are at central stage.

In light of the foregoing, this paper aims to look at two significant issues. First, does this decision have any theoretical support, and what do theories indicate about the effects of D-M on macroeconomic variables? Does this action ensure a more fair society than one has existed in the past? Will money and resources be redistributed in favor of the common man? In a nutshell, the purpose of this study is to investigate the impact of demonetization on both efficiency and equity.

Theoretical Grounds

Macroeconomics is a very significant and relatively recent field of study in the economic sciences. Macroeconomics' primary focus is on the study of how changes and growth in the overall national economy take place throughout time. The topic of macroeconomics includes the effects of any policy initiative on factors such as national income, employment, general price level, and investment, production, distribution, and resource allocation, among others. The two main stages of mainstream macroeconomics are classical macroeconomics and Keynesian macroeconomics. The objective at hand is to use classical and Keynesian economic theories to analyze the viability and possibilities of D-M. The question is whether this shift is theoretically possible, and if so, whether it is economically desirable.

D-M and Classical Macroeconomics

Orthodoxy economics is another name for traditional macroeconomics. The market system can operate without government intervention, according to orthodoxy. The imbalances created are self-correcting. Any interference with the market system's operation causes improper resource allocation, which places the economy in a less-than-ideal situation. Demonetization is therefore not permitted by the classical framework because it is viewed as a significant intervention in the market system's operation. Assuming full employment in the economy (MV=PT), traditional theories further assume that prices (P) are directly proportional to the money supply (M), where T stands for the total number of transactions. The price level will increase in proportion to the money supply as well as fall in proportion to M, respectively. Further, money supply alone does not decide the general price level. The functioning of money market and commodity market is complex and interdependent. There are several other factors which determine the direction and degree of the price level. Few example of this will be discussed in the next section of this article.

In Indian economy, V (velocity of money) is not constant, P unchanged therefore reduction in M translates into reduction in income and output (Kumar 2017). The implication is that though inclined towards market oriented economy, the policy makers are even failed to follow up or respect those principles on which the market based system works.

D-M and Keynesian Macroeconomics

In contrast to classical economics, Keynesian economics permits significant government intervention if the economy enters a boom or a recession. For them, under such situations, the efficiency of fiscal policy is more important than monetary policy. The nation's economy was currently in a regular state, neither in a depressed nor booming state. Then, there was no discussion of government intervention, particularly through drastic D-M monetary measures. The national income (Y) under the Keynesian paradigm is split between consumption(C)and saving (S), that is Y= C+S(1)And also,C=f(Y) (2) S=f(Y) (3) Due to D-M, a significant portion of the initial six months' cash income was put in bank accounts, which forced the general people to reduce their consumer expenditures. The people's behavior also included a second method of retaining cash out of fear of ATM dryness and banking restrictions on withdrawals, which led to a fall in both household spending and savings. Ratings organization reports that the poor growth in household savings is what caused India's saving rate to drop to 30% at the end of March 2017 from 34.6% in FY 12 and 31.3% in 2015-16 (ET bureau 2018). Financial institutions' use of household savings as an intermediary is a significant source of the economy's investment funding. A decline in savings, reduction in consumption, drop in aggregate demand, and decrease in investment ratio all contribute to a decline in income growth. The GDP growth rate for the Indian economy in 2016–17 was 7.1% as opposed to 7.95% in 2015–16 (Mof 2018:2), and it fell below 7% in 2017–18. It is obvious that D-M slowed down economic growth.

Given that Keynes' General Theory also serves as a description of the monetary theory of production, the decision made by D-M without taking into account motives and decisions relating to the production and behavior of money is anti-Keynesian. According to this view, money has a significant influence on the economy's production choices. Money not only promotes trading but also controls all aspects of the economy. The structure of the economy is said to have been somewhat disrupted following the D-M, according to numerous reports. The automobile industry was the worst-hit organized sector. More of the unorganized sector was impacted than the organized. Unorganized sector in which major part of transactions are done through cash, facing severe fall in demand for their produce and supply of labor due to D-M. It was also reported that many of the small units were forced to shut down due to severe lack of currency crisis. The businesses and units that closed either migrated to another industry where transactions were more convenient or stayed closed, forcing those business owners to sell their services on the job market. D-M therefore led to an increase in the labor force's unemployment rate. Even more, the rural economy saw a rise in the work force as a result of the increased availability of manpower in the villages as a result of backward migration, which put downward pressure on rural wages. As a result, the structural makeup of the economy has dramatically changed. The interconnections of the economic variables and the economic mechanism, therefore, have not been seriously considered before the decision-making of D-M if the decision was centered towards the goals that government officials assert in favor of D-M.

D-M and Equity:

Any change in policy in a democratic nation like India is usually evaluated in terms of the welfare of the general public, especially the poor. The transfer of resources following the disruption caused by D-M will determine if this D-M is genuine or invalid in substantial part. Will the common person benefit? To examine this, we provide a few cases. One of the main arguments made in favor of D-M was that lower real estate prices, as well as lower pricing for many other goods and services, would surely assist the poor. However, it is definitely not the case in real life. There are no indications that the price of urban or rural real estate is going down. Even the owners of real estate who want to sell have delayed sales but are not prepared to sell for less. People's economic behavior has evolved significantly in the post-D-M period, and they are now able to find novel ways to get around the negative effects of the D-M and cashless transactions. Consider the situation of medical professionals. It is well knowledge that doctors report relatively little of their income to the tax authorities and heavily participate in the country's shadow economy. It was anticipated that doctors would no longer be able to increase their consulting fees. Therefore, it will benefit the poor to some extent. But in the mind of doctors, there is absolutely no fear of being caught or punished. This is our close observation that in many cities of Uttar Pradesh, consultancy fee has been increased more than 100 percent in post D-M. This is to say that they are now ready to pay higher taxes to authorities but not ready to keep constant or ease prices in order to provide some form of economic relief to patients. So, this move of government has increased fiscal capacity of government in the form of increased tax revenue that is certain. But that revenue base was used in favor of poor and needy, is a matter of further research. We use the second argument that encouraging a cashless society will help to lower the amount of illicit currency. Black money's nature is to drive up the cost of goods and services through greater levels of opulent consumption. Prices are currently being held in check by the decline in black money volume. Prices, nonetheless, cannot determine the welfare of the populace in a dynamic economy where many components are influencing macroeconomic variables. Even more significant is how income is distributed. If prices have a tendency to rise quickly while income distribution is stable, the poor will undoubtedly suffer more. As opposed to this, if income distribution is occurring more quickly in favor of the poor, there is no issue despite the rapid increase in prices. Every class will gain from this. However, the issue still exists because our economic and political systems have not been able to develop a mechanism to guarantee an equitable transfer of income from the rich to the poor. Therefore, the D-M hammer and its offshoot cashless transactions have unquestionably had a detrimental influence on equity in the short run as well as efficiency in the long run. The duty of the government was to restructure industries like agriculture, infrastructure, and the health and educational systems, particularly in rural and tribal areas, and to create jobs, among other things. Unfortunately, there is no positive correlation between D-M and these actual macroeconomic factors.

Conclusion

In summation, it has been noted that the extraordinary action has had no negative effects on the general populace or the state of the economy. Over 99% of the prohibited cash was deposited in several banks (RBI 2018). This means that D-M failed miserably to stop the flow and production of black money. The country's dark money's origins have not been seriously addressed (Sood, 2017). Traditional policymakers and mainstream economics will recall this action as being fundamentally misguided and incorrect.

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