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A monetary economics view of the demonetisation

Money is the lubricant of the economy; a shock to the money supply disrupts the economy and could lead to recession

SNAKES & LADDERS

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Cash is used in India for a large array of transactions in the informal sector and in the formal sector. Denotifying ₹500/₹1,000 notes was a large shock to money supply. This monetary shock is likely to have an adverse impact upon the economy. It is imperative that stable monetary conditions are rapidly restored.

There is a tiny part of India where most activities can be done without cash. The rest of India uses cash for effecting transactions. This includes some activities of the formal sector and it includes all transactions in the informal sector. Financial sector reforms have made little progress in the fields of banking and payments. As a consequence, currency notes dominate transactions. The share of electronic transactions in total transactions in India is the lowest in the world. The size of cash relative to GDP is the highest in the world.

"Money supply" is the pool of liquid assets which can be used to make payments. The denotified ₹500/₹1,000 notes were 86 per cent of the total volume of cash in the country. Depending on how you define money supply, on November 8, India experienced a shock to money supply of 86 per cent or 53 per cent.

For a comparison, a famous episode where faulty monetary policy led to bad outcomes was in the US in the early 20th century. At the time, mistakes by the US Fed gave a decline in money supply of 30 per cent from 1929 to 1933. This large shock triggered off the Great Depression. By this yardstick, our money supply shock, a sudden decline of 53 per cent or 86 per cent, is a big one.

How does a shock to money supply play out? Money is the lubricant of the market economy. It is how payments are made. If we did not have money, we would be reduced to barter. It is very difficult to find the double coincidence of a baker who wants to exchange bread for shirts and the tailor who wants to exchange shirts for bread. In ordinary times, we do not notice money, because it just works. But when money is disrupted, the working of the market economy is disrupted.

As cash dominates transactions in India, the 86 per cent decline in cash adversely impacts upon the ability to transact. There are people in Mumbai who want to ride in taxis, and there are taxis who are keen to have customers, but the twain can often not meet as there is no currency which can be used to make the payment at the end of the ride. This adversely affects the income of the taxi driver (a demand shock), and adversely affects the mobility of the would-be customer (a productivity shock).

For many small firms, the loss of a fortnight of income is a large shock. Some firms will tide over this using equity capital and credit. But among small firms, who are more likely to use cash transactions, there is little equity capital which can be used to absorb shocks. For many people who are adversely affected by the monetary shock, there is weak access to formal finance and formal mechanisms of credit. In these turbulent times, lenders will also worry about whether the firm is sound. Some firms will have inadequate financial depth, and will fail.

The firms that fail will exert a ripple effect through reduced purchases of goods, services and labour. The firms that do not fail will also reduce their "burn rate" to the bone, so as to survive the hard times. This gives a demand shock: A ripple effect in the economy with reduced purchases of goods, services and labour.

The shock will propagate through the economy. All firms are experiencing a reduced pace of purchases. The formal sector is not immune. As an example, the health of the informal sector matters to the firms selling two-wheelers. We will see a decline in sales of two-wheelers, which will then further ripple outward as reduced purchases by the makers of two-wheelers.

These problems will be greater in the parts of India where there is more informality. I am able to use my debit card to buy meals at restaurants, and my Mobikwik wallet to pay for Meru rides. My ability to do this bolsters demand for restaurants and taxi drivers. But in regions with more informality, cash is the only way to effect transactions, and the monetary shock will map to big reductions in restaurant revenues. Roughly speaking, this translates to a bigger economic shock in the Bimaru states. This shock will also propagate out into the rest of India through reduced purchases by the backward states, of goods and services from firms in the West and South.

Is this just a temporary shock? Will the economy just bounce back when monetary normalcy is restored? The key question is firm failure. All firms absorb shocks using financial depth that is obtained through credit and equity capital. When the problem persists, the shock overwhelms the financial depth. Then firms start failing. This disrupts organisational capital. Once firm failure has happened, it cannot be undone. You can turn an aquarium into fish soup, but you cannot turn fish soup back into an aquarium. Flooding the economy with money supply afterwards would not bring back those firms to life. If a significant scale of firm failure were to come about, it would convert a temporary shock into a deeper and more long-term recession.

The output of the economy is reduced in each disrupted day because production is lowered. And, there is a race between restoration of normalcy in the monetary system versus the ability of firms to survive the storm by using financial depth. To people who think about the real economy, the role of money and finance is often underrated. The arguments above show why money is a veil, but when the veil flutters, real output sputters. It is imperative that stable monetary conditions be restored with the shortest possible delay.

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