Monetary Policy Risk: Demonetization and the Real Value of Money

Money is the single most important infrastructure element of any economy. Termination and confiscation of money may therefore prove disastrous, and India's recent demonetization offers an excellent case study.

By Joe Pimbley

Recent monetarily stunning events in India have exposed a new dimension in global monetary policy risk. While this risk has always been present, the India demonetization is a forceful reminder that real-life events often do not comport with the possibilities one projects. The risk element is the *eradication of trust* in a globally significant currency.

Almost three years ago, we touted "monetary policy risk" as a fascinating, non-intuitive challenge for the risk manager. We discussed both inflation and deflation as looming possibilities resulting from unconventional monetary policy. Thinking only in terms of these two opposing, hypothetical future scenarios, we formulated balance sheet hedging suggestions.

The events that recently unfolded in India present an entirely different challenge. Let's now take a closer look at the implications of this new dimension of risk.

Recap of India Events

In November 2016, the India Prime Minister Narendra Modi announced abruptly that he had banned two denominations of the country's paper currency from circulation. These denominations, the Rs 500 and Rs 1,000 notes, comprised more than 80% of outstanding paper money!

Holders of these notes – essentially everyone, I would imagine – faced the obligation to redeem their voided notes within a constrained time period. Terms of the enforced redemption strongly encouraged net deposits into the banking system rather than exchanges for new paper currency.

The Prime Minister's stated motives are fiscal, monetary and political. I do not mean "political" in the sense of "under-handed" or "self-serving." Rather, the "political" motive is to improve the government's ability to achieve its goals of defeating tax evasion and corruption ("black money") while increasing oversight of citizen activities. The fiscal and monetary goals are to generate higher revenue and force more economic activity into the banking system.

I have never lived in India, and will therefore not pretend or attempt to take a governance or political view on the legitimacy or wisdom of this action. For example, distant colleagues will sometimes "volunteer" to me their political views of events in my home country. Not surprisingly, such views contain little understanding of context, history or associations to other topics.

Since my own country's politics is laced with nuance and "code" that non-natives simply do not perceive, I assume the politics of all other countries are similar. Thus, I have no views to state or impose regarding Indian politics.

It's challenging to find simple, straight-news reports of the demonetization. Perhaps the best is this GARP article that is generally supportive of the demonetization. Accounts from CNBC and the Associated Press are fairly typical in that they lay out the facts within a context of complaint. A critical, though worthwhile, opinion column probes the consequences and interpretations in detail. An expert's opinion of the monetary impact is also enlightening.

Immediate Deflation is a Consequence

Harking back to our earlier interest in "monetary policy risk," this action of the Indian government may be, unfortunately, an instructive test. Regardless of the nature of the banned currency (*e.g.*, whether it's associated with tax evasion or not), the large reduction must prompt a fall in prices – as well as an immediate decline in spending and investment.

As citizens redeem their worthless paper for bank deposits or new paper, economic activity and prices may return to old levels. However, as inflation has gripped India in recent years, the first impact will be diminished inflation.

The best-case scenario is that citizens suffer only the temporary inconvenience of replenishing banned currency. Under such a scenario, banks and government would be able to distinguish "approved money" from "black money" among the redeemed funds – and would assign consequences as appropriate. Moreover, to stem deflation and to balance any portion of banned currency that citizens never redeem, the *Reserve Bank of India* (RBI) would presumably create currency through open-market operations (OMO) or quantitative easing (QE).

Even in this best case, however, the demonetization is still a deflationary shock. As we wrote in our earlier *Monetary Policy Risk? Deflation!* column, deflation has "winners and losers," just as inflation does. Deflation harms people, small businesses and companies with financial debts supporting non-financial assets. That's a large group on which to impose losses.

Purposeful Coercion to Join Banking System

An unmistakable element of the Indian demonetization is the encouragement to citizens to hold less cash and keep more deposits in the banking system. In fact, given the stated limits on new currency issuance, the government action is nearly as severe as requiring all banned notes to be converted to deposits (with strong curbs on withdrawal of such deposits).

Prior to demonetization, the Indian public held cash equal to 62% of India's M1 money supply (see *India's Currency Cancellation: Seigniorage and Cantillon Effects*). In contrast, the U.S. public held less than 0.1% cash relative to M1 (see this *Federal Reserve* data showing $1.42 billion public cash and $3.34 trillion M1). That's a huge difference in the role of cash between these two countries! The Indian government likely believes that reducing cash relative to electronic (banking) transactions will boost the economy.

Killing Trust in the Currency

The greatest risk of India-style demonetization is that it may damage irreparably the citizens' confidence in the country's cash *and* payment

system. Money is the single most important "infrastructure" element of any economy.

When a government disrupts money, even for apparently benevolent purposes, it teaches the citizens that money has risk of termination and confiscation – *in addition to* the ever-present inflation risk of fiat money systems. With this discovery of new risk, money loses value and even loses its efficacy as money.

To be specific about the risk of money, Indian citizens must understand that its government may ban both the new printed currency and the existing non-terminated currency in the future. If it has happened once, there's no reason it cannot happen again. Indeed, banning specified denominations of currency could become another tool of monetary policy!

Holding deposits in the banks rather than holding cash does not remove the citizens' risk. By acting through the banks as it has, the Indian government has made banks its agents. On behalf of the government, these agents not only distinguish "black money" from "acceptable money" but also trace all financial dealings.

There appears to be no "wall" between the banks and the government that prevent the latter from confiscating assets of the citizens. Hence, bank deposits also lose value and efficacy as money.

The ideal (or is it the myth?) of the central bank is that it is *independent* of the country's government in order to prevent the government from degrading and destroying money. The unfortunate reality is that central banks cannot constrain government.

After all, the central bank *is part of* government, and it is the Indian government that imposed the demonetization with no assistance or obstruction from the RBI. Similarly, the *Federal Reserve* did not intervene as the U.S. government of 1933 forcibly devalued the dollar by 40%.

Our lesson in India is that "monetary policy risk" is not simply "inflation or deflation." Rather, it includes the termination and confiscation of money.

Numerous global political leaders favor the abolition of physical currency. However, in a world where all money is electronic and driven by bank deposits, citizens would not be able to escape the confiscation of negative interest rates or the levying of special taxes for, e.g., "bail-ins" or wealth or withdrawals or "black money."

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