**Time to demonetise?**

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THE spike in oil prices and the ensuing balance-of-payments crisis during the First Gulf War in 1991 forced India to dismantle its licence-permit-raj economy. The dif ficult task fell to Manmohan Singh, India`s finance minister, who aptly quoted Victor Hugo as he announced structural reforms in his budget speech: `No power on earth can stop an idea whose time has come.

Recently, the idea of demonetising the 5,000-rupee note has been gaining traction.

Before policymakers plunge head first, they may want to gauge whether the time has truly come for demonetisation by assessing its benefits and costs.

In demonetisation, governments take out particular banknotes, while sharing mechanisms through which the demonetised currency may be exchanged or deposited in banks demonetised currency no longer remains legal tender. High denomination currency notes are often used for corruption, tax evasion, drug traf ficking or financing terrorism. Different countries have tried to clamp down on these illegal activities by going through demonetisations. The US demonetised $500 bills in 1969. India not only demonetised 86 per cent of its currency in 2016, there were demonetisations in 1978 and 1946 as well.

Proponents of demonetisation consider it an ef fective tool for catching black or illicit wealth created through corruption that is being stored as cash. One World Bank calculation for this region indicated that illicit income (flow) per year could be as high $75 billion, while the black wealth (stock) could be around $200bn in Pakistan.

Another benefit of demonetisation is its positive impact on revenue collection through increasing the tax base. The government could severely limit over-the-counter exchange for the 5,000-rupee note, forcing people to deposit and thus declare their hoarded cash. After examining these individuals` income footprint, they could then be corralled into the tax base. Increasing the tax base is now all the more important as the tax-to-GDP ratio in Pakistan has slipped under 10pc.

Demonetisation would also assist with increasing digitisation as people would use various payment platforms to make large payments. The State Bank has already taken major strides in this direction by introducing the payment system Raast.

Increasing digitisation will bring about a number of benefits, including small enterprises` access to banks and formal finance.

Most importantly, demonetisation could provide a fillip to the development of a sovereign digital currency PakRiyal, if you will that could enable the State Bank to stimulate the economy, all by itself.But, before we rush to get rid of the 5,000rupee note, there is a flip side too.

Demonetisation, like it did in India, will constitute a monetary shock to the economy.

In a monetary shock, money supply or liquidity plummets creating a cash crunch in the economy. The shock could become so severe that cash needed to perform everyday transactions like paying salaries may disappear. Where the amount of the 5,000rupee note in circulation is much lower than the 86pc of the currency demonetised in India, the overall negative effect on the economy would still be substantial. And, given the poor outlook regarding economic growth this year, this may not be the best time to go down this path.

The negative impact on the economy notwithstanding, there are questions about how effective a demonetisation actually is.

For it to assist in catching black wealth, a significant portion of the demonetised currency should not be returned.

Demonetisation was not successful in India as 99pc of the demonetised currency wase y e n t u a lly returned.

Then there is also the argument that demonetisation is not the best tool for catching black wealth as a very small percent-age is stored as cash. Additionally, despite the noble intentions, demonetisation may actually backfire due to the lack of planning and preparedness. The 2016 demonetisation in India is a case study in the lack of preparedness as banks ran out of money, ATMs broke down and many small businesses closed due to lack of currency.

It is thus evident that no clear picture emerges regarding demonetising the 5,000rupee note. Given that the jury is still out on such a move, policymakers need to keep two things in mind. First, the experiment next door shows that demonetisation has a higher probability of reaching its goals if only large denominations like the 5,000-rupee-note is taken out after proper planning and preparation. Second, demonetisation would go a long way in curtailing corruption in Pakistan if it is implemented just prior to the next general elections so that black wealth does not get to influence public policy.  The writer completed his doctorate on a Fulbright scholarship. He teaches economics and public policy at Habib University, Karachi.

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