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I have opinions about economics, finance and public policy.

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India's Great Bank Note Switch Increases Bank Capital Requirements, Not Decreases Them

One thing that I'm seeing about the Great Bank Note Switch in India is the idea that this will increase the level of capital that the banks have. This isn't how it works I'm afraid, the actual effect is the other way around, it will increase the amount of capital that the banks must hold.

As we all know the Rs 500 and 1,000 notes have been declared to be no longer legal tender (effectively, if not precisely). A small amount of cash, up to Rs 4,000, can be changed at a bank. Larger sums must be deposited into a bank account. The aim is to clear up the "black money" that so swirls around the Indian economy. There are various minor parts to this, trying to prevent terror financing through forgeries for example, but the big aim is to get the stacks of cash that have been circulating untaxed into the formal and licit part of the system. Once the cash has been through a bank account, even if it is then withdrawn again in the new cash, that money is now traceable. The bank account has a name on it, it's possible to go and ask that named person how they got their money and to ask that they show they paid tax on it.

This isn't going to be perfect, there's going to be leakage and yet it's probably a worthwhile thing to do in order to clean up that illicit economy. One little linguistic thing here, which is that this is all called "black" money in India and the more general economic name for it would be "grey and black" money. The grey economy, grey money, is people doing things which are legal in themselves but not taking part in the taxation system as they do so. So, it's legal to buy and sell houses in India so buying and or selling a house is not a black activity. But if some part of the price, as is common, is registered and taxed and another part of the price is in cash and not registered nor taxed then that makes it a grey transaction, not a black one.

We generally use "black" to mean activity which is illegal in and of itself. So, say, dealing in drugs. That's just flat out illegal whether you pay tax or not. And it's possible but somewhat unlikely that someone does trade drugs and then pays taxes on their profits but we generally assume that they won't–the black market is also grey but the grey market isn't necessarily black.

Everywhere has a black market and we've no particular reason to believe that it's worse in India than anywhere else. But we do believe that the grey market is larger than elsewhere. People doing legal things but outside the tax system–and that's what this change is aimed at. Yes, I know, Indian usage is to call all of this black money but allow me to make the differentiation for readers outside India.

As to how effective it is we've one number given to us, that there's been some Rs 2 trillion deposited into the banking system during and as a result of this change. That's a lot of cash of course but is it really a lot? An interesting question I was asked this morning and by the standards of these things yes, that is a lot. Here's the Reserve Bank of India numbers on the money supply. Cash in circulation is some Rs 18 trillion. So we've got perhaps 11% of all cash hitting the banks as a result. Yes, that is a big number.

Nothing, at least no one action, is going to entirely solve the grey economy problem. Any one plan can at best hope to make a dent in it–and we do seem to have evidence that a substantial dent is being made here.

Which brings me to that headline–several commenters have stated that this will aid the banks in their capital requirements. No, sorry, this will work the other way around. The cash is being deposited in the banks. To a bank that's a liability–don't worry, everyone gets confused with the mirror image accounting of banking when they meet it for the first time–and a bank's assets are the amounts that are owed to it. Deposits are liabilities, loans are assets. And the more liabilities and assets a bank has the more capital it needs to back those. Thus more cash flowing into the banks means that they require *more* capital, it does not aid in meeting their capital requirements at all.

All in all and as far as we can see so far it looks as if there's a substantial response to this bank note switch. It's not going to entirely solve the problem but then no one action is.

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