

Demonetisation 2.0

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My last column (IE, January 3, 2017) was on demonetisation. After spending three more weeks in India, the politics and economics of demonetisation have become clearer. It can be bluntly stated that Prime Minister [Narendra Modi's](#) withdrawal of 86 per cent of the nation's currency had no economic rationale. The motivations were entirely political.

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Economic theory and comparative historical experience point to three reasons that might provide legitimate justification for demonetisation. The first is hyper-inflation. In the second half of the 20th century, some Latin American and African countries experienced exorbitantly high inflation rates. If the inflation rate is, let us say, 15,000 per cent, the value of the currency changes virtually every day, if not every hour; people don't wish to hold on to domestic notes; and the monetary function of the currency begins to collapse. Demonetisation, under such circumstances, is a way out of the economic crisis. Second, if a substantial part of the currency is counterfeit, it makes sense to demonetise. It restores integrity to the monetary system. Third, rarely used in routine transactions of citizenry, high-value notes primarily help the operations of smugglers and criminals. As an attack on organised crime, such high-denomination notes can be decommissioned without hurting law-abiding citizens.

None of these conditions obtained in India on November 8. India's inflation rate is low; the estimated size of counterfeit currency is small; and the crime-fighting purpose of large-value notes was undermined by the issuance of new Rs 2,000 notes. Moreover, if only an estimated 6-8 per cent of the black economy was in cash, it is unclear how an overnight decommissioning of high-value notes meaningfully attacked the problem of corruption.

Finally, and this has not been adequately noted, economic policy in all democracies is debated in terms of costs and benefits, not in terms of loyalty and disloyalty to the nation. Historically, only Communist (or authoritarian) polities have tended to link economic policy with loyalty to the nation or polity, as Stalin did in the Soviet Union during the First Plan (1928-32) or Mao in China during the Great Leap Forward (1958-61). In democracies, a cost-benefit calculus is used for economic reasoning; the loyalty-disloyalty binary is deployed in times of war. Modi chose the latter narrative. Economic policy is not war.

All analytical roads thus lead to political motivations as the primary, or only, rationale for why Modi undertook demonetisation. Modi is an intense political being. Gujarat's economic progress gave people the impression that he knew economics well. But it is worth reconsidering that conventional wisdom. In May 2014, in his last election campaign speech in Varanasi, I heard him say that for balanced development (*santulit vikas*), he would turn the Indian economy into "1/3 agriculture, 1/3 industry, and 1/3 services". He repeated the same argument in another speech I heard after his 2014 election victory.

Agriculture now constitutes only 12-13 per cent of India's GDP. There is no branch of economics which argues that economic development calls for increasing the share of agriculture in the economy, let alone nearly tripling it. If anything, economic progress requires reducing the share of agriculture in a

growing economy, and creating jobs for the rural folk in non-agricultural sectors. No society has ever helped its villages by keeping people tied to agriculture. Getting one-third of the GDP from agriculture is a sign of poverty, not prosperity.

These incidents betray the paradox that even if Modi wishes to lift India economically (which he undoubtedly does), he does not always think economically. Economic policy for him is, more often than not, a political tool. Most political leaders are, of course, non-economists. But for economic policy, the advice of economists is always sought, though politicians normally reserve the right to pick among the alternatives offered. Never, perhaps, since Independence has India's political leadership reduced economists to such awful irrelevance. Their job now is to provide ex-post justifications for demonetisation, or deal with its consequences in the best possible way.

What, then, are the political motivations underlying demonetisation? Unfortunately, Modi rarely allows interviews, nor does he give press conferences. In democracies, these are the routine forums for asking leaders questions about policies. Nor was demonetisation issued as an ordinance. Had that been done, there would have been a debate in parliament, or the ordinance would have lapsed in six months. We only have declarations by the prime minister, no direct questioning yet.

Only Mrs Gandhi's bank nationalisation is a policy parallel, as has been widely noted. All of Nehru's economic policies were debated in parliament or in party forums. Significantly, even Nehru's plan to collectivise agriculture, which would have radically shaken the Indian countryside, was discussed — and defeated — in a Congress party forum in the mid-1950s. Nehru accepted policy defeat at the hands of [Charan Singh](#).

The probe into political motivations can thus only be presented as a set of

hypotheses, listed below. No single hypothesis may suffice. It may be that a combination of these motivations were at play.

First, Modi needs to win the Uttar Pradesh elections. The data collected by the Association of Democratic Reforms makes it clear that compared to the BJP, the election funding of the BJP's two main rivals, the SP and BSP, depends much more on unaccounted money. Sixty-five per cent of the BJP's income comes from unknown sources, whereas that figure is 83 per cent for the SP and 100 per cent for the BSP. Demonetisation was aimed at hurting adversaries disproportionately.

Second, though he remains popular, Modi needs a new grand narrative to re-energise his political prospects. Swachh Bharat (clean up India) is not working; achche din (good days) haven't yet arrived; digital India and smart cities can't win elections. Attacking black money, a promise made in the 2014 campaign, could in principle provide a new narrative to fire up upcoming campaigns.

Third, Modi wishes to reduce the BJP's dependence on the RSS, which remains obsessed with old ideas of Hindu revival. The turning point was the cow protection campaign, which Modi vehemently criticised, but the RSS did not disown. Religion and culture fuel the organisational energy of the RSS, not economic policy.

Who knows which of these hypotheses constitutes the true motivations? But it is manifestly clear that demonetisation, a giant economic policy move, was politically driven.

The writer is director, Centre for Contemporary South Asia, Sol Goldman Professor of International Studies and the Social Sciences, Watson Institute for International and Public Affairs, Brown University