



Currency "Reform" Under India's Narendra Modi: Wrecking The Economy To Save It?

Doug Bandow

January 3, 2016

The biggest international disaster of November 8 might not be the election of Donald Trump as America's president. It could be Indian Prime Minister Narendra Modi's destruction of 86 percent of his nation's currency. Some of his countrymen wonder if he will end up wrecking India's economy rather than reform it.

Modi's party won a dramatic victory in 2014, and much was expected from his promise to free Indian business. The ground is well-prepared. The International Monetary Fund forecast growth of 7.4 percent this year and similar rates through 2020. Inflation is below the rates in other supposed economic leaders such as Brazil and Turkey. The Economist Intelligence Unit figured India's "country risk" to be below that of China. Within a decade India will have 69 cities with at least one million people. The McKinsey Global Institute expects India's "consuming class" to triple in size over the same period.

Yet with this extraordinary opportunity before it, the Modi government has made at best slow progress in clearing the way for a more entrepreneurial, wealthier, and dynamic India. Many of those who had the greatest hope for Modi have ended up among the most disappointed. For instance, *Business Standard* (New Delhi) columnist Shankar Acharya wrote: "Economic reforms have clearly lost momentum and there is a sense of drift in economic policy." *The Times of India* (New Delhi) warned that "the government hasn't pressed the pedal hard on reforms" and "implementation of projects" had been slow.

Despite taking some modest steps to relax regulation and streamline taxation, Modi's most dramatic economic action has been to demonetize most of India's currency. People had to wait in line, sometimes for hours, to deposit their cash, with few or no new bills available in return. Much of the money will be confiscated by Modi's apparatchiks if its owners can't prove its legitimate provenance to the government's satisfaction. Some people preferred not to try and simply abandoned their cash. The result has been chaos, including some suicides by those whose livelihoods were ruined.

In his New Year's address the premier downplayed the impact and announced: "My effort is to take the banking system to normalcy as fast as possible in the new year. I have asked all concerned officers in government to focus their attention to this task." But the problems were far greater than anticipated by those same officials, so few Indians expect normalcy to return any time soon. Modi also urged banks to lend more to the poor and middle class, though if doing so was easy and would make money banks would be doing so already.

India is a highly cash-oriented society. Poorer Indians rely almost entirely on cash, despite the Modi government's pressure to get most of them to open bank accounts. Reliance on credit and debit cards as well as electronic payment methods is far more limited than in the industrialized West.

No doubt, it would be more efficient if more Indians used the latter services. However, such a shift isn't particularly easy in a poor, populous, and largely rural nation. Moreover, use of cash is a matter of personal choice. Not that the Modi administration appears to care.

Kalraj Mishra is Minister of Micro, Small, and Medium Enterprises, which suggests that he should be concerned about micro, small, and medium businesses, which have been hardest hit by the currency "reform." However, he dismissed the sometimes catastrophic losses as "nominal and temporary," and predicted "industrial momentum will be back" as soon as sufficient currency is restored. No doubt, he is feeling positive since his salary still is being paid.

Unfortunately, more than a few economists predict that the economic effects—the government as yet makes no prediction when cash withdrawal limits will be lifted and the currency withdrawn will be replaced—could persist for months, reducing the growth rate next year by a percent or two.

So Modi has been forced to play the populist card. In his New Year's address, for instance, he charged: "In this fight against corruption and black money, it is clear that you would like to walk shoulder to shoulder with us. For us in government, this is a blessing.

No doubt, for those in government who desire more power demonetization is a blessing. But that doesn't mean it will help anyone else.

In fact, money is one of India's weakest economic performance areas. In the 2014 Economic Freedom of the World rating, the most recent available, India ranks 112 in the world, down from 102 the year before. Among New Delhi's worst sectoral ratings are credit market regulations (139) and sound money (130). Yet Modi has put far more effort into his cash destruction program than into economic reform dealing with those areas or most any other.

Yet he may be preparing to double down. The *Financial Times* reported: "Mr. Modi is expected to intensify his campaign against black money, or income illegally obtained or not declared for tax purposes. His next target is likely to be property purchased with illicit wealth and not registered in the true owners' names. Speculation is rife that he is also seriously considering other dramatic and unusual reform measures, including possibly abolishing the income tax and

replacing it with a banking transaction tax.” Ironically, the latter would encourage Indians to turn even more to cash deals.

Modi’s fixation with putting the Indian people’s financial affairs under government surveillance suggests that he, despite his reformist image, is a social engineer with little interest in what his people actually desire. He wants a more efficient economy and prosperous country, but believes those will result from expanding his and his ministers’ power to engage in the right kind of economic manipulation.

Most political leaders of most countries are concerned about “black money.” The typical strategy, followed by the U.S., Europe, and India, is to crack down on people’s financial freedom. Tax-hungry politicians wistfully dream: If only the government could monitor every commercial transaction by every person.

A better approach would be to give people better value for their money. No one likes to pay taxes. But why would anyone want to pay taxes for a government bureaucracy that in 2012 was still rated the worst in Asia? A bureaucracy once renowned as the “License Raj” or “Permit Raj,” which decided whether individuals and companies could engage in the smallest economic activity? A government whose approval was necessary to import one computer?

Of course, the Indian government also provides “services” which must be paid for. But in his recent Cato Institute study Swaminathan S. Anklesaria Aiyar observed: “With almost no exceptions, the delivery of government services in India is pathetic, from the police and judiciary to education and health. Unsackable government staff members have no accountability to the people they are supposed to serve, and so callousness, corruption, and waste are common.” America’s legal system sometimes has unconscionable delays. India’s courts have a backlog of *31.5 million* cases, some of which take decades to resolve. Parties and witnesses often die before disputes are resolved.

No wonder Indians don’t want to pay high taxes.

The problem of “black money” is exacerbated by the size of the informal economy, which results from the Permit Raj and its regulatory descendants. If nothing can be done legally—or at least without great cost—then it is done illegally. Which makes the informal sector more vulnerable to unofficial government shakedowns. Reducing burdensome regulatory controls would naturally bring economic activity into the open and reduce the amount of “black money.”

Of course, officials want to believe that they are helping people, including those with the least opportunities. Thus, there is a miasma of restrictions on hiring and firing at the state and national level. Unfortunately, making it expensive to fire an employee makes it equally expensive to hire one. Typically Indian firms of at least 100 employees require government permission to cut staff. So companies stay small; some instead rely on “temporary” workers or hire out. That also goes on in the U.S. and especially Europe, but 90 percent of India’s workers are in the informal economy. No wonder Suraj Saharan of logistics start-up Delhivery, which employs thousands, speaks of “insane laws and regulations.” This has made it much harder for India than China to become a low-cost manufacturing center, for instance.

But the Modi government doesn't seem to understand that a growing economy providing increasing opportunities would most benefit its people. Then even low-pay jobs would be a temporary way station toward something better. However, the BJP appears to make the same mistake as its Congress Party predecessors, seeing the economy as a zero sum game: one unnamed official told the *Telegraph* (Kolkata) that "if it's a conflict between a corporate entity and its workers, we have to be on the side of the workers. We are a political party." Actually, those workers most likely would reward the BJP if they could move to new and better jobs, rather than be locked in low-grade, high-cost positions.

Indeed, the government demonstrates its dirigiste philosophical core by its commitment to the state's continuing large role in the economy. The number of parastatals increased some 60-fold from just five in 1951. The *Los Angeles Times* recently observed that India's "public sector still dominates major industries such as oil and mining, and the number of state-owned enterprises has risen by 70% since 1990." But the state also is involved in plenty of "non-strategic" enterprises. One of the many zombies is Hindustan Photo Films, a government operation picked for closure a decade ago but which continues to survive on borrowed money.

Alas, the result of such operations in India as around the world is massive waste to support a few dead-end jobs. Sadanand Dhume of the American Enterprise Institute reported that the five biggest money-losers cost Indian taxpayers \$2.5 billion in 2014. Air India would lose less money if it *didn't fly a single plane*. Yet the *Telegraph* reported in early 2016: "the Modi government has started to drum up the virtues of creating large state-owned assets in a throwback to a Nehruvian era of creating state monopolies in strategic areas."

In an attempt to mollify those whose livelihoods he had disrupted with his currency confiscation, on New Year's Modi also announced several populist benefits: mortgage interest rate discounts, cuts on interest for agricultural loans, guarantees for business credit, and incentives for digital transactions. How he would pay for these new government giveaways he did not say. Perhaps with cash confiscated as part of his demonetization campaign.

After all, Modi's overriding objective appears to be to give greater financial authority to the bureaucracy which has made such a hash of the economy for decades. Barun Mitra of the Liberty Institute called the currency operation "the single biggest assault on private bank accounts, on the presumption that everyone is corrupt unless they can prove their innocence." It is hard to imagine how the outcome could be positive.

India doesn't need better social and economic engineers in New Delhi. India needs a free economy which liberates people from the social and economic engineers in New Delhi. If the BJP won't provide such leadership, could the opposition Congress Party find political revival in a message of true economic liberation?

Doug Bandow writes about international politics, economics, and development.