When India’s money helicopter flew the wrong way

In the annals of economic experimentation, India’s cash ban will stand out.

Not because it was ill-advised, poorly executed or unsuccessful in achieving its original aims.

Prime Minister Narendra Modi’s move to outlaw 86% of his country’s currency a year ago today was all those things. What made it remarkable, though, was the way it flew against the zeitgeist.

While the US, Europe and Japan have been fixated for the better part of the last decade on ways to put more money in people’s pockets in order to put idle resources to work, India—with significant slack of its own—decided to go the other way, and freeze out a bulk of its citizens’ purchasing power.

What was supposed to be a surgical strike against tax cheats and counterfeit currency became an attack on a large informal economy that ran almost entirely on cash. The hardships caused by a shortage of new legal tender, and the rush to deposit old Rs500 and Rs1,000 rupee notes in bank accounts before the 31 December deadline, took a heavy toll. More than 100 people died in bank and ATM queues, although it’s impossible to confirm if the deaths from heart failure or exhaustion were directly a result of demonetisation.

Since this was “helicopter money” in reverse, there was enthusiastic talk of a $45 billion fiscal windfall. The thinking went that people who had unaccounted-for money would be too scared to deposit it in bank accounts; and the central bank, for which cash in circulation is an accounting liability, would write off unreturned currency to pay the government a special dividend. Using that bonanza, state-owned banks, in terrible shape from soured corporate loans, would be recapitalized.

In the end, almost all of the cash came back.

And, since the central bank spent resources on both mopping up the deluge of liquidity in the banking system and printing of new currency notes, its dividend payment to the government fell by more than half. Banks, in worse shape now than they were a year ago, are finally being recapitalized by special bailout bonds. This could as easily have been done last year—or the year before. There was absolutely no need to demonetise the economy in order to recapitalize lenders.

The impact on aggregate consumption, meanwhile, was staggered. Companies such as Hindustan Unilever Ltd greased their wholesale supply chain with extra credit to prevent a collapse in sales. The auto market, however, sputtered quite early; and property transactions, which in India tend to have a large cash component, ground to a virtual halt.

The Indian central bank, recently vested with an inflation-targeting mandate, erred on the side of caution and triggered a robust debate about whether it was choking growth by keeping real interest rates too high.

The more enduring effects of the demonetization experiment were felt in asset prices and in supply chains.

After a short-lived bout of jitters, Indian stocks jumped. The price-to-expected-earnings multiple for the BSE 100 Index has swelled to almost 19 from a post-demonetisation low of 15. Corporate earnings may have stagnated, but the cash that the rich would otherwise have used to finance property or jewellery purchases, or deployed in lengthy working-capital cycles of informal businesses, has gotten corralled into equities. A $400 million inflow into Indian mutual funds in January, just two months after demonetisation, was double last year's amount. In March, when investors usually withdraw cash, outflows were less than $300 million, the smallest in nine years.

The pressure on non-believers is huge. Foreign investors, who started balking at the stratospheric valuations of Indian stocks earlier this year, are being forced to return to a market where domestic money managers, flush with funds, are calling the shots.

One year after demonetisation, its supporters are still hopeful of a virtuous transformation of India's largely informal business landscape. It's no coincidence that a new goods and services tax (GST), implemented after a decade of haggling between federal and state governments, carries within it the DNA of that zeal. The GST was supposed to create a common nationwide market by removing a complex web of local taxation. But when it became operational this July, the single market became a side show, and the tax itself became an enforcement mechanism.

The stock market doesn't care about the struggles of small, unlisted businesses, which generate the vast bulk of India's employment. Like in the West, where a decade of monetary adventurism has altered people's portfolio choices and made risky assets frothy, India has reached the same end point, though by flying the money helicopter in reverse.

Moreover, unlike quantitative easing, which is a reversible stimulus for the demand side of the economy, India's cash ban—and now the GST—are seeking to permanently alter the supply side. An ebullient stock market is merely betting this experiment will succeed. **Bloomberg Gadfly**

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