Demonetization in India: One More Rock in the River

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Indian Prime Minister Narendra Modi took to the airwaves on November 8, 2016, to announce a plan that would destroy "black" money, a bane of the Indian economy. Large amounts of this cash linked to tax evasion had been sloshing around, subverting the law, fueling inequality, and helping underwrite the activities of criminal gangs. In its campaign against black money, the prime minister announced, his government had forthwith "demonetized" banknotes of the two highest denominations. All existing 500- and 1,000-rupee notes would have no value after December 30. It was expected that this measure would put an end to unaccountable stockpiles of cash. Modi acknowledged, of course, that legitimate "white" money could also be held in cash—and that people who had white-money cash holdings should not be penalized.

To separate black cash from white cash, the following strategy was devised. People would have an opportunity to bring in their old notes to bank branches and trade them in for a new series of 2,000- and 500-rupee notes. Alternatively, they could deposit old notes into their bank accounts. The population could exercise these choices until the end of the year, when, all of a sudden, the demonetized bank notes would turn to ash.

Availing themselves of these remedies, white-cash holders, the honest ones, would slip through the dragnet of demonetization. But the dishonest ones would be caught. A limit of 250,000 rupees (equivalent, roughly, to $3,500) was placed on the amount of cash that could be deposited in any account without inviting the attention of the tax authorities. Individuals who had been holding onto large hoards of cash—stuffed into mattresses and stored in bank vaults—would perforce lose any excess amount. That would eradicate black money, or so it was thought. But it seemed that not all the consequences of the measure had been thought through.

The prime minister's announcement had the effect of turning life upside down. The old 500- and 1,000-rupee notes made up more than 85 percent of the total supply of cash in a country where less than 5 percent of households have a credit card and more than 80 percent of all transactions are conducted in cash. All of a sudden, everyone had a problem. Because everyone in India holds onto cash.

CASH CRUNCH

Banks were required to work at a superhuman pace. There are a total of about 100,000 bank branches in India—40,000 in villages and 60,000 in cities. They serve a population of more than 400 million adults living in rural areas, and 200 million in cities. Almost all of them needed to trade in or deposit their cash. And not everyone could wait until the last day of the year; long before that deadline, just a few weeks after the prime minister's announcement, many businesses had stopped accepting the old cash.

Long lines of people who wanted to exchange or deposit the old cash and withdraw new cash formed outside bank offices. But there simply weren't enough new banknotes to satisfy everyone's needs. Banks rationed their scant supplies. Tight limits were placed on the amounts that could be withdrawn at bank counters. ATMs were shut down.

Many stood in line for hours just to withdraw the daily limit of 2,000 or 5,000 rupees' worth of new banknotes. When that paltry amount ran out, one had to go back and wait in line again. People waited for hours, only to be told the new banknotes had run out. Then they tried their luck at a second bank, and a third, and so on, until they had enough cash to buy milk and vegetables and could carry on with their lives. Nothing had higher priority for most people. Offices emptied out. More than a hundred people died waiting in lines outside banks.

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A cash crunch gripped the economy like a vise. Bigger businesses with larger inventories and easier access to financing could hold on longer, but many smaller businesses started falling apart.

In January 2017, two months into demonetization, I went to a village in central India, where I met Hiralal. About 50 years old, he owned a small business, building and repairing stone walls. Over the years he had acquired a reputation for high-quality work, and his business expanded, providing regular employment to four other masons. After demonetization, however, when "banks were letting account holders withdraw only two thousand rupees weekly, people held on to that amount for buying necessary things," he said. "They put off expenditures that could be put off. There was no one who had the money to pay for a wall."

For more than two months, Hiralal told me, he had not received a single commission. Since he could not pay them, his team of workers had dispersed. It would take many months to rebuild the business once the cash returned. Other small businesses in and around the village had suffered similar downturns.

How might it have been, I wondered aloud, if before launching its demonetization project, the government had been able to provide alternative instruments, like checkbooks or credit cards, to the millions of people in India who are forced to make payments in cash? If Hiralal and others like him had become accustomed to writing and receiving checks, demonetization would have caused much less turmoil.

I learned that in the months before demonetization, the government in fact had mounted a project of this kind. In just a few weeks, hundreds of thousands of new bank accounts had been opened by people who had never before used one. Hiralal had one such bank account. Still, his business had suffered because, like many others who set up an account, Hiralal had hardly any idea what he could do with it. No instruction was provided about the benefits of banking; for the government, it was enough merely to tally up the mounting number of accounts as evidence of success.

Inured to Inconvenience

The problems that have beset the demonetization scheme as a whole reflect either very bad implementation or very poor timing, probably both. Officials and experts I met in New Delhi had little idea how people in villages had experienced demonetization or if the banking project had helped cushion the blow.

Nor did the government make an effort to explain why, in the fight against black money, demonetization was its chosen route. Neither theory nor prior example was cited in support of this choice. The rhetoric of destroying black money overpowered the elements of policy analysis that were proffered.

Initially, the rhetoric resonated widely with the public. People suffered and muttered, but there was no rioting. The idea that the fat cats would be cut down to size struck a deep chord. When the prime minister spoke about the demise of black money, people cheered him on.

But a different sentiment arose a few weeks later, after people had suffered business losses and stood in lines for hours and days, yet it wasn't clear how much of the black money had been rooted out. No fat cats were in prison. More than 90 percent of the old banknotes made their ways into banks before the year was out.

Indians are no strangers to the capriciousness of the ruling classes.

Everyone knew enterprising people who had found innovative ways to protect their black-money stashes. Employers paid their workers in cash months ahead of time. Thousands of bank accounts belonging to laborers and small farmers that had held zero balances for months were suddenly full to the limit of 250,000 rupees, just below the tax man's radar. Informal exchanges emerged for trading the old notes at a discount. People waited for the government to take the next step in its campaign against black money. But it wasn't clear whether the government knew what the next step would be.

By the end of February, demonetization had been largely forgotten. In Bangalore, Mumbai, and New Delhi, there was little sign of the earlier turmoil. People shrugged off their demonetization experiences. Other and newer crises had arisen. A candidate for chief minister in the state of Tamil Nadu was put behind bars on a corruption charge. The media had moved on.

In the end, for most people, demonetization was nothing more than an acute but temporary inconvenience, of the type to which living in India makes one inured. Sometimes the bus to work doesn't arrive because supplies of compressed natural gas have been cut off; sometimes a vast market is shut down, as when the iconic Connaught Place in New Delhi, home to shops but also consulting rooms and offices, was precipitately declared a pedestrian plaza; sometimes you are prohibited from taking your car out on alternate days (a desperate measure to curb pollution and control traffic), and just as you have adjusted to this order you find that it has been reversed. Indians are no strangers to the capriciousness of the ruling classes. Experts will debate for a long time whether demonetization had effects that were good or bad for the national economy. For regular folks, however, it was just one more rock thrown into the river, another caprice they had to outlast. ■