

Modi's cash call: political genius or recklessness?

Blog post by Chief Economist Gregor Irwin, 09 November 2016

It is an interesting week to be in Delhi. While everyone is trying to work out the implications of Donald Trump's shock victory, Indians are also coming to terms with their own domestic political earthquake.

On Tuesday evening, while the US polls were still open, Prime Minister Modi cleared the Indian TV networks so he could make a very unusual political broadcast. He began with some pretty conventional stuff, railing against corruption and the black economy. But then he dropped a political bombshell.

He announced that from midnight 500 and 1,000 rupee notes would cease to be legal tender. Today the ATMs would be closed. People holding these notes could either deposit them in their bank accounts or lose them. They would not be allowed to exchange them for new bank notes, soon to be issued, once the ATMs can be restocked.

It is fair to say I was a bit miffed, having just withdrawn cash from an ATM. As a former central banker I was also shocked, as trust in the currency is supposed to be sacrosanct. I was also more than just a little curious as to why my middle class Indian friends were so delighted by the announcement.

The aim of the policy is, quite simply, to shut down of the black economy. And to do so overnight. No one knows how big the black economy is, but everyone agrees it is huge and holding back India's development.

By forcing money into the banking system - where it can be scrutinised by the tax authorities - Modi hopes to kill off the illicit and untaxable transactions that are common place for property and many business deals. My friends were pleased, as they know just how unfair the system is, with many fortunes in India being sustained by the black economy.

But what of the risks? One is the classic central banker concern that it will reduce confidence in the currency. A more immediate risk is that it will reduce demand, as the shock the black economy is likely to be much sharper than the initial boost to the legitimate economy. Another is that there will be innocent victims: not everyone holding a 500 rupee note (worth about £7) has a bank account, although the government has made progress in increasing financial inclusion.

The majority of the Indian public and large businesses are, however, likely to be behind Modi, which is exactly why he chose to make the announcement himself. It is the sort of bold policy move that currently plays well in Indian politics. Moreover, if the policy does what Modi says it will do, it is equally clear that the short run slowdown will be a price worth paying to get higher growth in future.

But perhaps some business leaders and foreign investors might be more than just a little bit nervous about this style of government. Closing ATMs and rendering currency illegal overnight are not policies found in the manual of good government. It may turn out to be a stroke of political genius - and Modi would argue that a seemingly intractable problem requires an extraordinary solution. But for anyone relying on a stable policy environment in India, it signals that political risk is now at least a little higher than it was before.