THE HINDU CENTRE
for
Politics and Public Policy

Demonetisation 2016: 'India's Worst Self-Inflicted Economic Policy Disaster'

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Nov 8, 2017

HYDERABAD, Telangana, 08/12/2016: On December 8, 2016, one month after Prime Minister Narendra Modi announced demonetisation of Rs. 500 and Rs. 1000 currency notes, the wait at ATMs had not come down. File photo: G. Ramakrishna.

A year after the Prime Minister announced demonetisation of high denomination currencies on live television, most of the initial fears have been proven to be well-founded. In what he terms as an 'initial post-mortem', ***Palanivel Thiaga Rajan****, a Member of the Tamil Nadu Legislative Assembly representing the Dravida Munnetra Kazhagam (DMK) and a former investment banker, points out how the programme was filled with First, Second and Third Order flaws which were disastrous to the economy. Any successor Union government, he says, should carry out a comprehensive examination of the hastily announced demonetisation policy and its aftermath, in order to extract lasting lessons, and use such learning to implement robust systemic barriers to any possible repetition.*

On November 15th 2016, just over a week after the momentous declaration of demonetisation, and a day after the first relaxation of certain conditions imposed earlier, I wrote 2 short essays[1] stating my concerns and fears about the government's approach to seemingly laudable goals.

In the intervening year, my fears have proven to be well-founded, and significantly understated in terms of the scale and scope of the actual disaster that was to unfold. In my defence, it never occurred to me then that such a complex program would have been contemplated, let alone undertaken, without basic preparations (e.g. neither having enough of the new notes printed ahead of the announcement, nor having adequate printing capacity to replace the stock in a reasonable time frame).

So many others (a shining example: Manmohan Singh in the Rajya Sabha last year [2], and recently in an interview to BloombergQuint [3]) have eloquently covered the many negative economic consequences of this disastrous policy. Others have highlighted the humanitarian tragedy to devastating effect [4]. James Wilson @jamewils, who is an engineer by profession rather than an economist, has used publicly available data – mostly from Government sources – to debunk the many self-proclaimed goals scored by the government after shifting the goalposts so often they became blurred [5] , [6] .

To avoid covering similar ground, I focus on the design and implementation features alone – leaving aside any consideration of the consequences of the policy. As someone with education and experience in Engineering, Systems Analysis, Psychology, Consulting, Banking and Financial Markets, I have been fascinated at the cascading effects of various design flaws and policy limitations as demonetisation took full effect.

That the policy was both not fully thought through, as well as rushed prematurely into execution is evident from some fundamental design flaws. Let us start with what I would label First Order Defects: the fundamental design problems that led to both direct and induced problems in the implementation. Perhaps the most elegant quote on a First Order flaw came from the inimitable Raghuram Rajan, who stated in an interview that "I think the view of any monetary economist would be that you first print the money and then do the demonetisation [7]." That is of course, a common-sense suggestion at some level, seemingly not worthy of the experience and wisdom of such an accomplished economist. However, the sheer extent of the unpreparedness of the Union government and the Reserve Bank of India (RBI) [8] makes this seem sage advice. Not only were the notes not printed, there was no reasonable hope of printing them within any reasonable timeframe like 50, or even 100 days – given the limited

capacity and functionality of the available presses. To make matters worse, reports suggest that the required stock of raw materials (paper and ink) was neither already in inventory, nor even on order.

Everyone is familiar by now with some more First Order flaws of serious consequence. The decision to change the dimensions of both the new notes (Rs. 2000 and Rs. 500 denominations), without any prior action to create the appropriate cassettes and pre-fit ATMs for these dimensions debilitated the distribution capability of the whole banking system—as there were then about 2 lakh ATMs in operation, compared with less than 1.4 lakh branches—and ATMs generally serve customers much faster than tellers do.

Further, the decision to first print the Rs. 2000 denomination notes (printing of the new Rs. 500 denomination notes were not even started till after the Nov 8 declaration), under the logic that greater value could be printed in a shorter time failed to deliver the fungibility of value that was expected. Without adequate value and supply of smaller denomination notes (as 86 per cent of the total value of currency in circulation was rendered useless) many people found it difficult to use these new Rs. 2000 notes for total transactions sizes in the 100s of Rupees (such as when shopping for vegetables or groceries, or buying necessary medicines or paying for a doctor consultation in a small practice).

There were other First Order flaws which did not get as much attention. Consider the very likely scenario that when the RBI is finally done counting all notes, **over 100 per cent of the value of Notes in circulation could well have returned**. This is a likely outcome, as the RBI's August 2017 [9] report states explicitly that all but about Rs. 16,000 Crores (that is Rs. 15.28 lakh crores out of the total Rs. 15.44 lakh crores in circulation) were tendered and counted by then, and further that this tendered total does not include the notes held by the District Cooperative Societies, which were yet to be counted at that time.

In any event, it has long been rumoured that the reason the RBI suddenly and inexplicably ceased reporting the value of notes on December 8 was that they recognised the real possibility of such a seemingly inexplicable outcome! If return of more than 100 per cent is true (and large quantities of counterfeits are clearly not a valid explanation), then it stands to reason that at least some of the old notes were deposited "more than once." And if that is true, the most likely explanation is that the "reverse-supply chain" of delivering the deposited notes back to the RBI for counting and disposal, sprung "leaks." Now at some level, even the best-designed and managed supply chains in India are subject to "leak-risk" as it were. So that fact that this "reverse-supply" likely resulted in substantial leaks is not just plausible, but likely,

given the unprecedented nature and scale of such an operation in the cash management system.

A reasonable way to reduce this likelihood would have been to insist upon some form of systematic defacement of the note—ideally perhaps a “CANCELLED” stamp in indelible ink. If that was not possible (for logistical/supply of stamps and ink reasons), the RBI could have simply asked all deposit takers/counters of notes deposited into ATMs to punch holes in the notes in a specified location/pattern using widely available paper punches. The failure to institute this kind of safeguard, despite over 71 notifications of programme changes announced over the 50-day period, must surely be listed as a near-fatal First Order flaw.

Beyond the flaws inherent in the system, one incident stands out in my memory as an extreme example of the reality-disconnect that seemed to affect some of the senior officers overseeing the demonetisation program: that of the then Revenue Secretary announcing one morning that all bank branches would start marking the fingers of those exchanging notes at a bank counter with indelible ink, starting almost immediately! Now leave aside for a moment the fact that the exchange-at-counter rules had already been changed many times before this announcement with respect to frequency of accepting notes, size of transaction, and others. Think instead of a system already overburdened with not being able to either print or supply new notes rapidly enough to bank branches, not to mention the logistics of getting the cancelled notes returned without leaks. What manner of delusion would lead a senior Union government official, presumably well-informed and well-aware of this at-breaking-point status of the system, to even contemplate the possibility of managing the logistics on such short notice of, ink manufacture, procurement, distribution, and training of staff in roughly 1.4 lakh branches (who had never done anything like this before), and putting in place system checks to ensure they were doing it properly. And, it was proposed that this would come into effect within a day or two! There was a greater likelihood of first-ever snowfall in Chennai that week, than of successful implementation of this announcement. As expected, this whimsical notion was dropped rapidly, and replaced with a total ban on all counter-exchanges.

Let us move on to Second and Third order negative consequences, some of which I already mention in my essay of November 15, 2016. Consider the unintended consequence on India’s banks (already under severe earnings and capital pressure due to the massive volume of bad loans) that were stuck holding all these unwanted interest-bearing deposits (value of the of old demonetised notes), solely due to the inability to pump out new notes anywhere near the pace at which the old notes came in. For every Rs. 1 lakh crore of forced deposits, the then (RBI/Govt. mandated) savings bank interest rate of 4 per cent per annum, meant that banks

were paying out roughly Rs. 11 crore in incremental daily interest. No wonder then that the banks demanded the government issue additional bonds (under the Market Stabilization Scheme) of up to Rs. 6 lakh crores in early December, to absorb the roughly Rs. 50 crore a day in incremental interest they were collectively forced to pay daily by then.

Finally, consider the consequences of the disruption of the supply-demand equilibrium in many perishable goods (best exemplified by tomatoes), which linger even now. The cyclical glut in the production of tomatoes during the peak demonetisation period coincided rather unfortunately with the precipitous drop in demand for high-nutrient, low-calorie, food items like fruits and vegetables, as people struggled to maximise the calorific intake value of their greatly reduced purchasing power. Because of this exacerbated supply-demand imbalance, the price of tomatoes in most retail markets fell from about Rs. 30 a kilo to less than Rs. 5 a kilo – with devastating consequences for tomato farmers. But as surely as night follows day, this balance reversed dramatically one crop-cycle later (around March 2017) where the price of tomatoes spiked to about Rs. 75 a kilo or more in most markets. This time, however, the crop was much smaller than usual (most poor farmers had not been able to overcome the debt consequences of the previous crops failure in order to plant again) while the demand increased directly proportional to increased cash in circulation (three months of printing and distribution later). My best guess is that the planners of demonetisation did not factor in such consequences.

But over and above all these, there remains one ultimate effect, an insult added to injury, if you will, which summarizes the wide landscape of unintended higher order effects. In December 2016, the CBI arrested one J. Sekar Reddy, an alleged sand mining baron aka "Isakku Sekha" (Sand Sekar in Telugu) in Chennai, after finding over Rs. 170 crores in unaccounted holdings during raids on premises associated with him. This hoard included about Rs. 34 crores in newly printed Rs. 2000 denomination notes! This volume of notes in one location, while most of the country was on a cash-starvation diet, naturally raised many further questions. The Central Bureau of Investigation (CBI) and the Enforcement Directorate (ED) subsequently registered cased against Reddy which are ongoing.

However, an article in *The Hindu* recently stated that the case has hit a bit of a roadblock [10] . It turns out that due to the huge quantum of notes that had to be handled by the RBI during the hectic demonetisation period, as I'm sure you'll understand, the RBI has no records of notes of which serial number went to which bank between Nov 8, and the second week of December 2016 (when it suddenly realised the problems this might later create, and started tracking numbers again!). Consequently, the RBI cannot help the investigators identify from which bank Reddy may have obtained his unaccounted stash. Talk about unexpected help

from strangers! Of course, it also means that the nation has been trapped in a Kafkaesque circle of black money, where the very demonetisation programme intended to wipe out ***old*** Black Money has resulted in the RBI distributing many lakh crores of not-traceable-to-source money in conveniently storable bundles of RS. 2000 denomination notes - ideal for conversion and storage as ***new*** black money!

There is an old saying attributed to the poet and philosopher, George Santayana: “Those who cannot remember the past are condemned to repeat it.” That has perhaps never been truer in the immediate past than in the context of this disastrous demonetisation policy, where our senior politicians and civil servants either never knew the dismal history of such attempts, or completely forgot them when conceiving and developing their plans.

What is worse, the government seems to be repeating exactly this speed/secrecy at the expense of thoroughness/fail-safe implementation trade-off strategy yet again, during the ongoing implementation of GST. In an eerie reminder of the ghost of demonetisation, the GST rollout on July 1, 2017, was followed by many dozens of rates and procedural changes in the first 90 days after the rollout.

If we are to break out of this pattern of easily-forgotten history (and the associated consequences of such a pattern), we must have an exhaustive investigation of every minute aspect of this whole disastrous experience, including the detailing of the specific role of every single person in the allegedly microscopic circle of people who actively participated in the conception and development of this self-inflicted disaster. This is simply an attempt at a preliminary post-mortem. We must have a Government-led comprehensive one. We must extract lasting lessons, and use such learning to implement robust systemic barriers to any possible repetition.

While such an analysis may not be possible before a change in government, a regime-change will surely come at some point; in the next decade at the latest. It will then be the moral obligation of the incoming government to ensure such a post-mortem is done. As a nation, we owe it all those who paid the price, in fatal and non-fatal ways, during the worst self-inflicted economic policy disaster in the history of independent India.

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[All URLs were last accessed on November 8, 2017]

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8. I will use the Union government and RBI interchangeably going forward, as the past year has shown that any separation that once existed between the two has been obliterated.
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