A trend for the future?

The demonetisation will favour black markets

Everything and its contrary has been said about the demonetisation of the ₹100 and ₹500 banknotes. Let me try to shed some light on the murky debate – being dispassionate from any political affiliation.

The international trend
Many countries have decided no longer to issue the highest denominations of their banknotes. The reason was exactly what Prime Minister Modi was saying: not to facilitate money laundering or ‘black money’. It is laudable and should be applauded.

Europe is no longer issuing €500 notes, equivalent to about ₹36,000. The larger denominations of the dollar have been abandoned for a long time ($1,000 banknotes existed) and the maximum is now $100 (about ₹6,700).

Why ₹500 and ₹1,000?
These banknotes represent 86 per cent of the banknotes in circulation. They are equivalent to about $8 and $15, which looks ridiculously low. Does the finance minister really believe that Indian black money would be in such small denominations?

The paradox is that the ₹1,000 banknotes was not even affected. It was much more likely to serve for money laundering than the smaller ones. The natural move for ₹500 black money will be to convert them in ₹1,000.

The ₹2,000 banknote, an incentive
The issuance of ₹2,000 will be the biggest support of banknote money laundering. It will take only four ₹500 banknotes to get them, reducing the cost of holding bank notes by 25 per cent.

I was surprised to see that no comments have been made on that particular aspect of the demonetisation that demonstrates that, in fact, the government of India was using the black money speech to cover another operation: making money out of banknote exchanges that will allow it to add to the RBI balance sheet the value of the non-redeemed bank notes.

There was no urgency
Every single demonetisation process takes time and needs to be prepared. The conversion of Eurozone currencies into euros was prepared for two years and the circulation of ‘old’ money was extended over six months.

The run on the banks was entirely engineered by incompetent advice to the Prime Minister. A quick look at past experience would have allowed the Reserve Bank to execute this transaction in a much less dramatic way.

Flawed execution discredits policy
The non-convertibility of the rupee has been for a long time a sour problem in foreign exchange markets. The defensive policy of the RBI has been criticised and India is the largest country to be in limbo. Even China developed a market for RMBs outside China, with the bond markets developed on that basis.

However, until now, the monetary policy, arguable as it is, has been shifted to the government, adding political calculation to incompetence. While it was not well-publicised in the last months of Raghuram Rajan as governor, RBI, this demonetisation has added to the scepticism of foreign investors in the conduct of India’s monetary policy.

Prime Minister Modi tried to transform self-flagellation into a religious cause. Should we consider this as a trend in Indian monetary policy?

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