The Abysmal State of Economic Decision Making*

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The minutes of the Board meeting of the Reserve Bank of India just prior to the announcement that currency notes of Rs.500 and Rs.1000 denomination were being demonetized are now available in the public domain, thanks to an RTI query. And what they reveal is the abysmal state of decision-making on economic policy that prevails under the Modi government.

To be sure, economic decision-making has always been informed by class bias; but that is not what I am referring to here. Even when a decision is taken on the basis of the interests of the ruling classes, the argument for that decision, the justification provided for it, typically relies on some economic propositions which may be questionable at a deeper level but which are not palpably absurd. It is also the case under the present government that decisions are taken by one man, Modi, and the economic bureaucracy that is supposed to prepare the basis on which such decisions ought to be made, is asked merely to provide an ex post justification for Modi's fiat; even so however this justification, though questionable, is not supposed to be absurd.

But the minutes of the RBI Board meeting show that nowadays we are really plumbing the depths; official notes are so stamped with obvious absurdity that one is simply amazed.

The Finance Ministry apparently wrote a letter to the RBI in November 2016 which was endorsed publicly by intellectuals of the Right like S.Gurumurthy and which put forward an argument for demonetization along the following lines (The Wire March 11). Between 2011-12 and 2015-16, the GDP of the country had increased by 30 percent while over the same period the growth-rates in notes of Rs.500 and Rs.1000 denominations were 36 percent and 109 percent respectively; this discrepancy was because of an increase in black money, whence it followed that the demonetization of such notes would deal a blow to the black economy.

What this Finance Ministry document failed to notice is that the increase in GDP referred to was in real terms, not in nominal terms, and there is absolutely no reason why there should be any constancy in the ratio between the real GDP and the nominal money supply. If the finance Ministry note had compared nominal GDP with the nominal money supply, i.e. compared like with like, then it would have found no increase in the currency-GDP ratio. In fact the nominal GDP between 2011-12 and 2015-16 increased by about 54 percent (and not 30 percent which was the figure for the real GDP); and the currency with the public, i.e. total currency minus what is held by the banks, increased by 56 percent over the same period. The two magnitudes in short increased more or less in tandem.

But then it may be asked: if the nominal money stock increases faster than the real GDP then surely that is bad for the economy, as it would cause inflation. This question can be answered at four different levels: first, inflation is caused by a mismatch between the demand for and the supply of goods, and not all the increase in money supply is necessarily spent on buying goods, so that a non-synchronous increase between real GDP and nominal money supply is not necessarily inflationary. Secondly, if perchance it is feared that such a non-synchronous increase between money supply and GDP has an inflationary potential, then the remedy in such a case is supposed to lie in the pursuit of a restrictive monetary policy, which brings down the growth of money supply. And thirdly, if synchronousness is at all insisted upon for preventing inflation, then it has to be between money supply as a whole and real GDP, and not between specific components of money supply, such as Rs.500 notes and Rs.1000 notes and GDP. And fourthly, all this has to do with inflation; it has nothing to do with black money or with demonetization (which is hardly the instrument to be used even for controlling inflation).

No gloss in other words can possibly be put on the Finance Ministry's note. It was absurd, plain and simple, based on an elementary error, which even an undergraduate student in a university would be severely marked down for committing. It confused real GDP for nominal GDP, and made out a case for demonetizing 85 percent of the currency stock of the country on the basis of such a misunderstanding! And the entity making the error was no less than the Finance Ministry of the country!

Besides, when such a note is prepared for submission to the RBI, it passes through several desks in the Ministry, and is examined by several tiers of the Ministry's bureaucracy; the fact that none of them spotted such an elementary error speaks volumes about the level of competence in the Ministry. Or may be perhaps, because Modi wanted demonetization, most bureaucrats took it as a fait accompli and did not even bother to read what exact argument was being used for it, expecting that the RBI too would not bother to read it and would just rubber- stamp it. But in either case what it reveals about the functioning of the Modi government is quite staggering.

It is to the credit of some of the RBI Board members that they did raise this question. They also questioned the arguments in favour of demonetization put forward by another note prepared by the Revenue department, titled "White Paper on Black Money". This Note had referred to the rapid growth of the black economy according to the World Bank data, and also to the fact that counterfeiting of currency was on the rise, with the amount of counterfeit notes being Rs.400 crores.

These arguments too were so absurd that the very fact of their being used at all speaks volumes about the government's functioning, the amazing extent to which it is marked by either ignorance or cynicism. Members of the Board, also to their credit, pointed out that Rs.400 crores were a trivial amount compared to the currency stock of the country, and to demonetize Rs.16 lakh crores of currency notes, as proposed, just to incapacitate Rs.400 crores of fake currency, was wholly unwarranted. They also argued that demonetization of currency was not the way to cripple the black economy since wealth in this economy was typically held in the form of physical assets of all kinds rather than in the form of currency notes.

Remarkably however at the end of the discussion the RBI Board decided to go along with the demonetization decision! This is hardly surprising: out of the ten directors of the RBI at the time only three were "independent directors"; and only two of these were present at the meeting. And of these two one was a retired officer from Gujarat and the other was from the corporate sector. The government therefore had no problem in getting the Board to rubber-stamp its decision. The striking thing however is that the RBI whose decisions affect the lives of millions of working people (as indeed the demonetization decision did) did not have a single representative of the working people on its Board.

This entire episode demonstrates the quality of decision-making in the country today. When such facts come out, the typical clamour is for “autonomy” of the RBI. But what “autonomy” typically means is that instead of a bunch of Finance ministry officials deciding on RBI policies, a bunch of IMF or World Bank executives, on loan from those agencies, should do so. The demand for “autonomy” which is raised in the media and elsewhere never mentions that while the RBI should be autonomous of the government it must be answerable to the people and the parliament. And one way of ensuring this, to start with, is to have representatives of the workers, peasants, and agricultural labourers, on the RBI Board.

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