Talking Points
India's Demonetization – A long-term positive

November 2016

The event…
Earlier this month, the government of India announced its decision to demonetize the Rs 500 (~US$7.50) and Rs 1000 notes (US$15.00). These notes account for ~86% of the currency in India, a country where 75-85% of the financial transactions are conducted in cash[1].

The public has until 30 December 2016 to exchange for newly-printed notes[2] or deposit old currency into authorized banks and post offices (with a specified daily withdrawal limit)[3]. In other words, the old currency notes will become worthless if no action is taken by 30 December. At a time of exchange or deposit, people with over Rs 250,000 (~US$3700) will need to explain the source of funds.

What we think…
We welcome the government's decision to demonetize. The move was bold, revolutionary, and unprecedented for any country in recent history. Although there will be some temporary social disruptions and increased market volatility in the near-term, we believe this was a decisive move by Modi to tackle the problem of black money, which will at the same time, bring positive impact in almost all economic fronts over the long run.

Swiping out 'Black Money'
The idea behind the demonetization move is to push black money to the surface – such as undisclosed income from small medium enterprises, self-employed individuals, lawyers and doctors. According to the Reserve Bank of India's (RBI) estimates, there is currently Rs 17 trillion (~US$251 billion) worth of currency in circulation.[4] However, about one-third of the business in India is tied to black money[5]. Taxpayers account for only 1% of India's total population[6], and its tax-to-GDP ratio at 11% is amongst the lowest in the world[7].

The people who go to a bank or post office to exchange new notes with more than Rs 250,000 (~US$3700) in cash will need to explain the source of money to the tax authorities (and will be taxed if the explanation is unjustifiable). We expect some black money will just 'go down the drain', but the majority is expected to flow back into the formal economic system.

Positive economic impact on multi-fronts over the long term
In parallel to combatting the black market that has been plaguing the economy, we believe this move will bring far-reaching benefits to the economy on multiple fronts over the long term:

- **Strengthen government's balance sheet with income tax collections**– With a good portion of the previously unaccounted money now flowing back into the formal channel, the government stands to benefit from increased income tax revenue (large deposits to the bank are going to be subject to tax scrutiny). This will increase fiscal revenue to support future growth in areas such as government infrastructure spending. It can also strengthen the government's balance sheet and provide a cushion for India's fiscal deficit.
- **Boost deposit base and improve banking system liquidity**- The previously unaccounted cash in the economy will translate into significant deposits in banks. Between 10-18 November, RBI indicated that banks have already received a total of Rs 5.45 trillion (~US$81 billion) of deposits and old notes submitted for exchange. This will structurally boost the deposit base as well as financial savings, and thus, improve the banking system's liquidity condition over the long run.

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[1] Source: NY Times, as at 14 November 2016
[2] Note: Rs 1,000 notes (~US$15.00) will cease to exist as legal tender. The government will print new Rs 500 (US$7.50) and Rs 2,000 notes (US$29.00) with enhanced anti-counterfeit features.
[3] Source: NDTV.com, as of 14 November 2016. During the initial days of implementation, there was a daily withdrawal limit from ATMs of Rs 2,000 (subsequently raised to Rs 2,500) and a daily exchange limit from banks of Rs 4,000 (subsequently raised to Rs 4,500). As more new banknotes are made readily available, we expect these limits will be gradually be relaxed.
[4] Source: Hindustan Times, RBI, as of 2 November 2016. The US dollar amount is calculated using the INR/USD exchange rate as of 15 November 2016.
[5] Source: NY Times, as at 14 November 2016
[6] Source: India Express, as at 1 May 2016. Based on latest data disclosed by the government for assessment year 2012-13.
[7] Source: International Monetary Fund, Government Finance Statistics Yearbook and data files, and World Bank and OECD GDP estimates, as at Nov 2016 (based on 2012, latest available data). .

- **Reducing lending rates will boost economic activities-** With a flood of deposits into the financial system, we have already seen State Bank of India (SBI) reduce deposit rates and this will continue in the next few months. This will lead to a decline in lending rates, which will boost economic activities over the medium term.
- **Strengthening financial inclusion-** 255 million bank accounts have been opened since the introduction of the Financial Inclusion Scheme in August 2014[8]. Despite the stellar growth in account openings, the share of these accounts in the total deposit base remained low at under 1%[9]. The demonetization initiative should give a push to cash deposits, helping to instil better banking habits amongst the large unbanked population in the country.
- **Positive role in curbing inflation-** India's inflation will also be lowered over the medium term due to less money growth, since a portion of the black money will be taken out of the economic system.

Near-term challenges
In the near term, there will be disruption to daily transaction flows that could post challenges for consumption and business activities in India. To avoid tax cheats, the government minimized the number of people involved and chose to not print new bills until after the announcement. Long lines at banks formed following the announcement with people waiting for cash for basic transactions like food, fuel and other necessities. With new money printing underway, the government established daily withdrawal limits to avoid having banks run out of bills. It is estimated that it will take around three weeks for bank activity to return to 'business as usual'.

The demonetization move will also have knock-on effects for cash-intensive sectors such as real estate (black money in cash has historically been used to buy properties), construction, jewellery, and consumer household related sectors in general. These concerns have already been reflected in the share price declines of some consumer related companies following the announcement. We expect near-term market volatility will also persist. With a temporary slowdown in consumption, corporate earnings will be affected in the upcoming quarter. We believe there is a possibility that the government may introduce incentives to boost consumption spending in the near term. We expect to see earnings to normalize in due course, with pent-up demand helping to lift consumption. Looking at the bigger picture, we believe the long-term benefits for GDP growth by far outweigh the short-term transitional impact on growth.

Conclusion
The demonetization move, together with the GST bill reform announced in August this year, are two landmark reforms in India that will have profound positive implications on India's economy going forward. We expect to see visible economic benefits in the next 1-2 years. Making good on his promises, Modi has shown his commitment in cracking down on the black money that has been deeply rooted in the country. Looking ahead, the improvement in transparency and tax compliance in India should further enhance the attractiveness of the asset class for global investors.

[8] Source: Government of India: PM Jan Dhan Yojana. Data as at 9 November 2016
[9] Source: The Huffington Post, as at 11 Nov 2016

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