OCEAN DIAL

Prime Minister Modi plays his TRUMP card

In the ongoing fight to reduce corruption and eradicate black money from India's economy, on Tuesday (8th November) the Prime Minister again seized the initiative, announcing the immediate de-monetisation of all 500 (c.£6) and 1,000 INR notes, equating to 85% of currency in circulation or approximately US$215bn (c.10% nominal GDP).

This follows on from the recent voluntary disclosure scheme (VDS), in which the Indian Government raised an additional US$4.5bn of fiscal revenue by incentivising citizens to declare untaxed income. This latest announcement has also been timed to coincide with the end of India's festival season, to minimise the impact on the masses.

This is ground breaking stuff that has immense positive consequences for private and public consumption, tax collection, and overall transparency, whilst speeding up the digitalisation of the economy, itself a crucial step in weeding out corruption and formalising the economy.

Thus, with immediate effect (with a few exceptions such as hospitals, crematoria) these notes have been cancelled as legal tender. Old notes can be swapped for new (INR500 and INR2,000) at all banks up until year end, and subsequently until end March 2017 with the Reserve Bank. Limitations have been placed on cash withdrawals at Banks and ATMs in the meantime, in order to manage the short term disruption caused by the change; these will be gradually eased as new notes are printed and circulated in the economy.

Initial thoughts

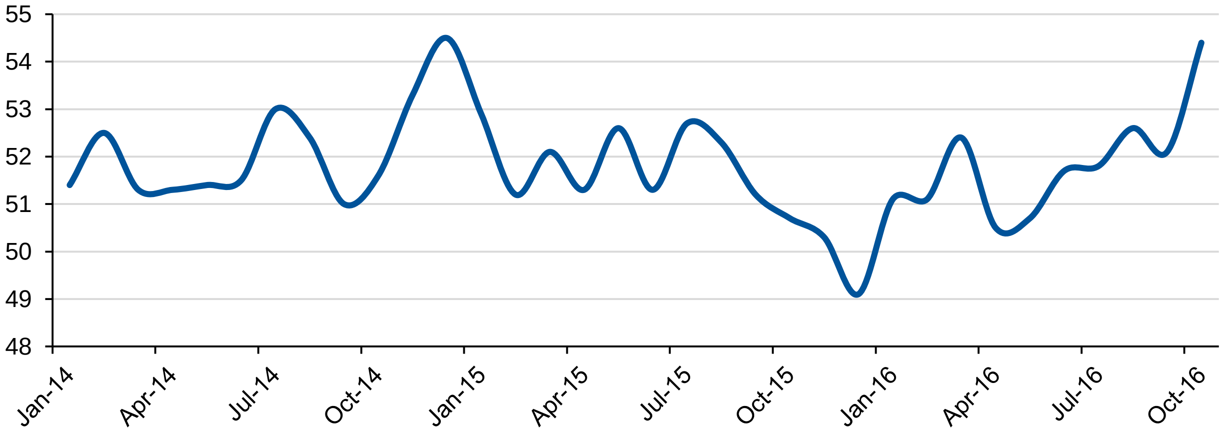
- Disruption in cash based supply chains such as consumer staples, pharmaceuticals, toll booths. A "transactional freeze" denting growth, short term
- Structural impact on cash orientated sectors such as real estate and jewellery, with knock on impacts to steel, cement; banks' asset quality may suffer, short term
- Non-banking finance companies and micro finance companies may suffer disruption to collection cycles, short term
- Some wealth destruction inevitable as cash is foregone by those wishing to remain beyond the formal economy
- Rural consumption will see a negative impact, short term
- Sectors such as IT, utilities and telecoms unlikely to be affected beyond some potential delays to bill payments, short term

Impact

- Compels areas of the economy such as Real Estate and Infrastructure, previously thriving in the cash economy, to formalise, i.e. pay tax, levelling the playing field for all sectors
- As cash is lugged to banks across the country, bank deposits will grow, in time passing through the economy productively
- Compels household savings into the banking sector and in time passing through the economy productively, whilst also widening the fiscal net
- Boosts consumption, as bank accounts become more active, whilst the onset of "Fin Tech" creates revised spending habits
- Boosts fiscal revenue (from both corporate and personal tax), improving Government's finances, which will be productively utilised via increased public spending or a lower fiscal deficit
- Makes corrupt practices harder, across the board

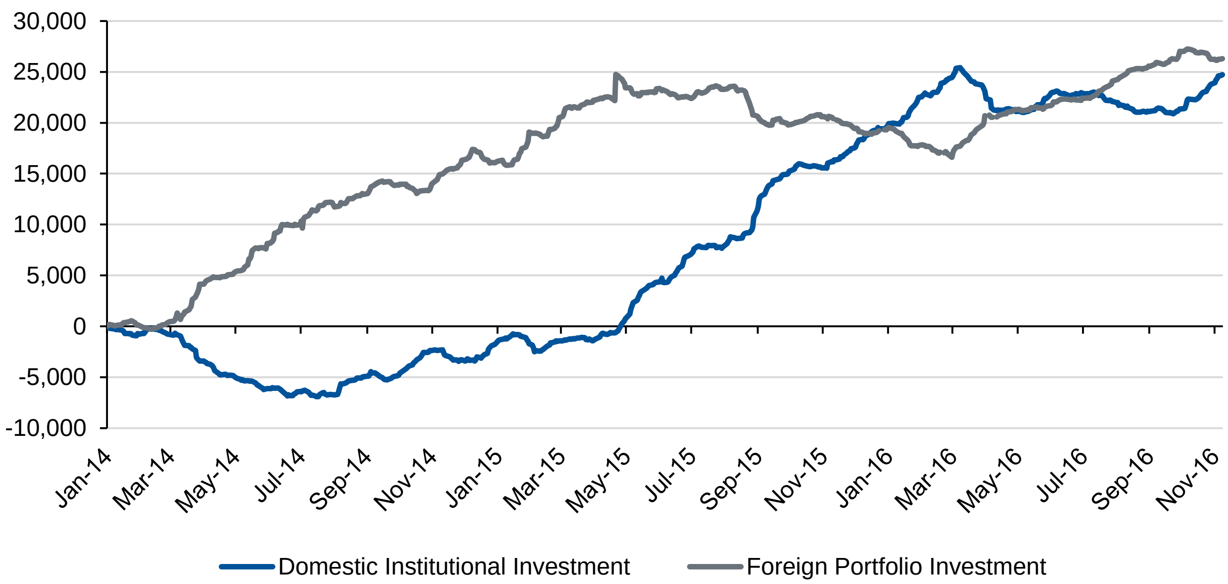
Whilst inevitably causing short term uncertainty, this is as significant a reform measure as has been implemented since the BJP came to power, and confirms our view that the passage of the GST Bill has emboldened Ministers to fuel further the fire of reform, which will only strengthen. It comes at a time when the underlying economy is clearly on the mend, as evidence by better corporate results and rising composite PMI's, a point not being overlooked by domestic investors, whose participation in the market is also increasing. Expected short term impact on growth maybe quickly offset easier monetary policy, as the Reserve Bank's hand improves as the benefits of these reforms percolate into the economy.

Chart 1: Manufacturing PMI



Source: Bloomberg

Chart 2: Domestic Institutional & Foreign Portfolio Investment (US$m)



Source: Bloomberg

David Cornell
+44 20 7068 9874
davidc@oceandial.com

Tim Adams
+44 20 7068 9877
tima@oceandial.com