The Power of Surprise

Demonetisation – Modi's attack on "black money"

Three weeks have passed since Prime Minister Modi announced his Government's anti-corruption, anti-fraud, demonetisation scheme.

As yet there are no clear answers, but as the Government manages the crisis, greater clarity is emerging both on the economic effect and the popular response. Whilst long-term market support is clear-cut, the extent of the short-term damage and the speed of the recovery are as yet unquantifiable, and both vary by sector and on a geographical basis, urban versus rural, north versus south. Following the withdrawal of 85% of the cash in circulation (c. US$205bn) and given the high dependence of cash based transactions (c. 12% GDP), normal daily activity for India's masses was turned upside down overnight.

The necessity for maximum secrecy prevented the Government or the Reserve Bank from any preparatory action, hampering the logistical response, exacerbating the inconvenience factor and also fuelling Opposition criticism that demonetisation is causing severe hardship for those least able to manage it; correct no doubt, but this ignores the upside potential. Although the reliquefaction process is underway it will be months yet before normal business resumes, and despite the new INR2,000 note already circulating, using it is next to impossible since giving back the correct change is a challenge. Though bank queues have shortened and the initial fear factor is easing, still the recalibration of ATMs (there are over 200,000), combined with the logistical challenge of printing and distributing to rural areas, and the ensuing impact on consumer sentiment, prevents an immediate return to normality. At the more bearish end of the spectrum demonetisation could impact India's GDP growth by as much as 2%, whilst consensus estimates range between 0.5%-1.0%. Further moves to curb black money may lead to additional headwinds.

Notwithstanding these issues, reliable anecdotal evidence implies that the population is resilient and up to the challenge, taking heart from the Prime Minister's bold actions in tackling head on the issue of untaxed income and the parallel economy. Wisely the Government appears to be sensitive to these desperate situations showing, flexibility in sums that can be withdrawn from the banks for farmers to buy seed, wedding costs and certain outlets such as chemists and crematoria which can still accept old notes.

But nonetheless, the Government needs to work fast to restore stability or else sentiment will turn against them, potentially threatening their chances in the crucial State elections of 2017. Looking further ahead, it is imperative that the Government takes certain steps to deliver a better structure for the country in return for the tax it is compelling the people to pay, otherwise the reason to comply simply isn't there. Thus, areas such as primary education, healthcare and rural housing must be major recipients of any incremental tax take.

Consumption based activity has been hardest hit with companies reporting collapsing sales and weak pricing, food products included. However, according to local broker IIFL, some smaller "ticket item" volume sales are recovering; Amul, the dairy cooperative, reports that milk sales have almost fully recovered and though Nestle and Colgate indicate sales down 40% in aggregate, retail sales are recovering faster than wholesale channels. More uncertain is the expected delay in purchase decisions on larger ticket items, not just for practical reasons, but because of the expectation of further price weakness. Thus, consumer electronic sales have fallen 80%, with similar weakness in two wheelers and cars. Vendors are extending credit terms and cheque usage has risen hugely; informal credit markets are springing up all over. Either way, earnings forecasts will be cut for this quarter, but probably more so next as a slower sales will force de-stocking. Encouragingly a big move towards digitalised banking is already noticeable as e-commerce companies are forced to discount heavily, pushing customers towards cashless payment. All parties seem intent on "working around the issues" to minimise disruption, rather than outright protest. Purportedly, in some cities, 3-wheeler scooter taxis are now taking a digital payment straight from your phone. Given this is India, innovation happens in the blink of an eye, potentially delivering a V not a U-shaped recovery.

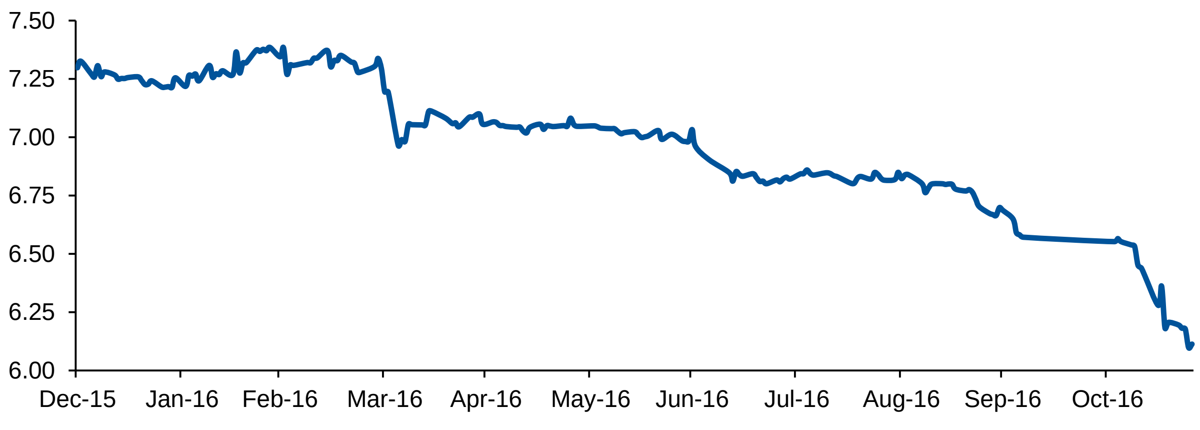
Outside of direct consumption, other sectors are witnessing a varied impact. Traditional recipients of black money, such as real estate and jewellery have been hardest hit, with the damage expected to be long term and structural in nature. Property prices, historically inflated owing to the sector's "ability to launder", will fall sharply, affecting asset quality for the banks and mortgage finance companies, with associated sectors such as cement and construction also affected. Further action on "benami" property sales (multiple purchases by the same buyer, but registered under a different name), is expected, further depressing prices and loan to value (LTVs), protracting problems. Other consumer loan repayments will also be affected given many monthly repayments are made in cash, impacting the non-banking and micro finance sectors. Here too the Reserve Bank has been proactive, relaxing NPA recognition norms for two months on all loans of INR10m or less (c. US$150,000) Link:

Reserve Bank of India

But whilst asset quality concerns are a reality, it is important not lose sight of the bigger picture. As the system "reliquefies", it is fair to assume that monthly payments on loans will recover and any missed payments made up. In the near future, this sector is going to benefit from lower liability funding for the capital providers much of which will be passed through to the consumer in the form of lower rates, driving fresh demand more than compensating for any near term incremental asset quality issues.

Staying with the banks and using data supplied by the State Bank, cash deposits received into the system 14 days to the week ending 25th November totalled US$104bn (52% of sum withdrawn), with US$32bn of that already "re-monetised" (16% of sum withdrawn), resulting in a collapse in deposit rates and bond yields; the polar opposite currently experienced by all other major economies. Further downward pressure is likely as additional funds enter the system, all of which will in time be channelled into the economy productively, one way or another. Recent fund data suggests that the equity markets are already seeing flows, a trend which could gather steam as the country's savings are intermediated into the formal system, structurally lowering the cost of capital. The billion dollar questions are by how much, how quickly and to what effect?

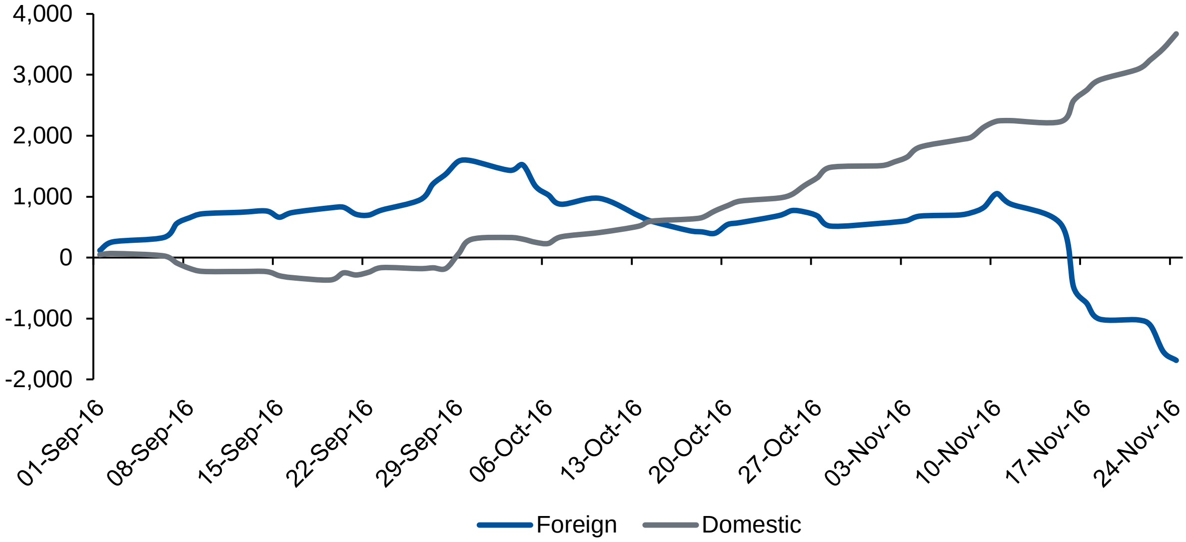
Chart 1: India's 1 Year Government Bond Yield (%)



Source: Bloomberg

The political implications of Modi's actions cannot be ignored, whether these are considered to be a fortunate by-product of events or the primary driver. Since local, regional and national political parties have historically funded the majority of their election commitments using cash, it would seem that Modi has stolen a significant march on his political competition. And if the PM can maintain the political goodwill he has generated through his actions so far and the economy shows signs of a recovery within the 50 day time frame outlined, then this ought to influence the BJP's prospects in Uttar Pradesh in 2017? What might facilitate this process somewhat further is the prospect of a windfall dividend from the RBI (forecast to be between US$25bn and US$40bn) gained out of cash that is never returned to the banks. Speculation is rife that this money could be spent in a number of ways, the most politically expedient being a direct cash payment to the bank accounts of every Indian registered as below the poverty line, through the direct benefit transfer system already established and the 300m bank accounts opened since May 2014.

Chart 2: Foreign and Domestic Incremental Fund Flows (US$m)



Source: Bloomberg

So much for Modi not being a big bang reformer! Whatever you may say this is as bold as any policy implementation undertaken in either developing or emerging markets and for that the PM should be rightly feted, in spite of the near-term uncertainty that has been created. Since this has been announced in the midst of a broader EM currency and equity market sell-off, it is hard to decipher which event is impacting India sentiment more. Though caution in the near term should abound, any further temporary rotation out of EM, should be seen as an opportunity to gain exposure to India at a defining point in its economic development.

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