INDIA: DEMONETISATION & THE ECONOMY

APRIL 2017

National Australia Bank

Prime Minister Turnbull visits India after important economic reforms

- With the Australian Prime Minister visiting India, the world's third largest economy, we review recent trends there – especially its de-monetisation experiment. The demonetisation program came as a surprise and imposed a shock on the economy as 86% of high value notes were quickly removed from circulation. One of the main aims was to shrink the black economy in India.
- Despite the shock, end 2016 GDP proved resilient, although it might have underestimated the negative impact on less officially organised parts of the economy. What has clearly changed is the increasing adoption of digital payments, as well as improved liquidity in the banking sector, leading to lower lending rates.
- The impact of demonetisation should gradually fade away, with the circulation of new currency notes and removal of restrictions on bank withdrawals. PM Narendra Modi continues to be popular, with his BJP party notching up a significant victory in the important state of Uttar Pradesh.
- The RBI held the policy Repo rate at 6.25%, but raised the Reverse Repo rate to 6% (from 5.75%), and lowered the Marginal Standing Facility rate by 25bp to 6.5%. The aim was to create a tighter corridor for more effective monetary transmission. The RBI also reiterated its focus on draining demonetisation-induced excess liquidity from the financial system.
- NAB Economics has maintained its forecast for a 25bp cut to the Repo rate to 6%, the last of the current rate cutting cycle. However, the risks are clearly toward no more rate cuts.

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KEY OBJECTIVES

Bring activity into the formal sector… And limit 'black money'.

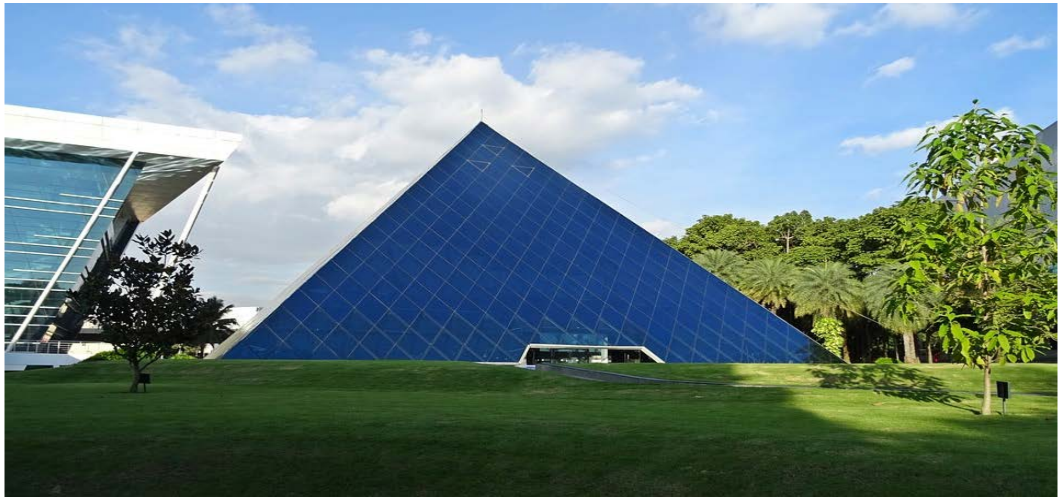
- On the 8th November, 2016, PM Narendra Modi banned the use of INR500 and INR1,000 notes. This move came as a surprise and caught the country unprepared. The notes were the largest in circulation at that time, and accounted for 86% of cash-based transactions. The reasons for the demonetisation program included:

1. Curbing corruption
2. Reduce the usage of counterfeit currency
3. Limiting the effectiveness of 'terrorist finance', given the prevalence of high-denomination notes among captured terrorists
4. Rein in the accumulation of 'black money', that is income that has not been declared with the taxation authorities.

- The demonetisation exercise should also be seen in the context of earlier measures to restrict black money, and other illicit activities. Some earlier measures included: *the Black Money and Imposition of Tax Act*, 2015; *Benami Transactions Act*, 2016; information exchange agreements with Switzerland; changes in the tax treaties with Mauritius, Cyprus and Singapore; and finally, the *Voluntary Income Disclosure Scheme*.

RS10 NOTE – NO CHANGE IN STATUS

HEAD QUARTERS OF IT GIANT, INFOSYS



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PLENTY COULD GO WRONG ON THE PATH TO LOWER DEBT

Several countries vulnerable to shocks leading to even higher debt burdens

BANNED RS1,000 NOTE

NEWLY INTRODUCED RS2,000 NOTE

- The note ban led to a sharp drop in cash in circulation, as newly printed Rs2,000 and Rs500 notes were insufficient to replaced banned Rs500 and Rs1,000 notes.
- Currency holdings fell from about INR14.5 trillion to INR7.81 trillion just after demonetisation, a drop of nearly 50%.
- The move resulted in restrictions on cash withdrawals, long queues outside ATMs and economic disruption.
- A daily withdrawal limit of Rs2,500 was initiated with a weekly limit of Rs24,000.
- The textile hub of Tirupur – which supplies goods to Wal-Mart, Marks & Spencer etc – had to substantially scale back operations and lay off many workers. Indore's Sarafa Bazaar (known for its jewellery and night food market) and Surat's diamond and textile businesses were badly impacted.
- India's wholesale markets , which are largely cash-dependent, were negatively impacted.
- Firms in the automobile and cement sectors experienced revenue declines. Modest revenue declines were also encountered by firms in the consumer durables sector.

- The RBI lifted all withdrawal limits from ATMs as of the 13th March, 2017.
- The remonetisation program is well underway. According to RBI data, as of 17th March there was INR12.135 trillion in cash with the public.
- There are plans to introduce a new Rs200 denomination note, possibly after June.

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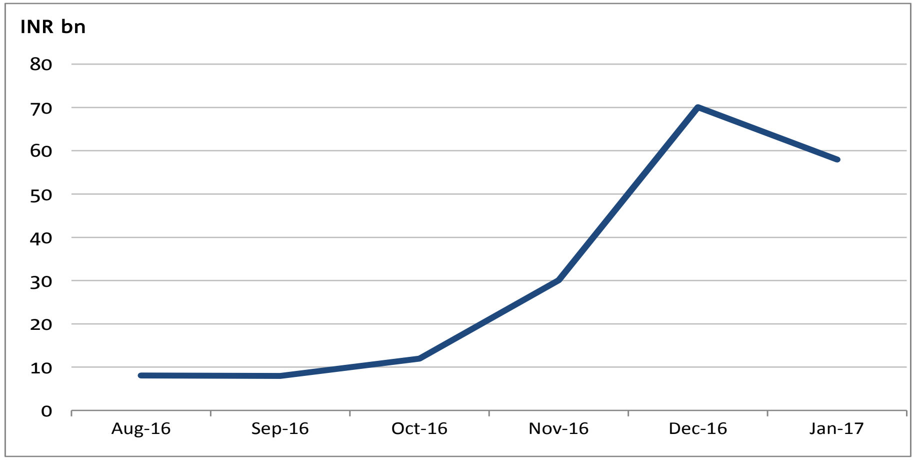
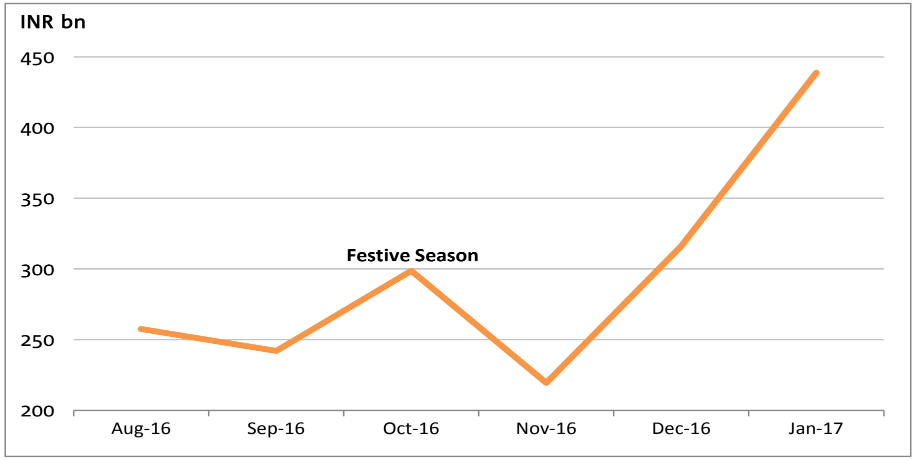
HIGHER USAGE OF DIGITAL CURRENCY

Demonetisation has spurred the off-take in electronic transactions

INCREASE IN RUPAY POS TRANSACTIONS



HIGHER CREDIT CARD USAGE



Source: NPCI

- India is a highly cash-dependent economy. The *Watal Committee* report on digital payments, released in December 2016, found that 78% of all consumer payments were made in cash.
- There has still been an increase in electronic transactions following demonetisation, evident across affluent and less affluent cohorts.
- Lower middle-income sections of society often have access to RuPay cards. According to data from the *National Payments Corporation of India* (NPCI), the payments data revealed a surge in POS transactions post-demonetisation. In October (during the Diwali festive season), total POS transactions using RuPay amounted to INDR12bn. In December 2016, during the peak of demonetisation, it escalated to INR 70bn, an almost six-fold increase.
- The increase in digital payments was also recorded in credit card usage statistics. Credit cards are more prevalent across higher income groups. Here too, card usage accelerated from INR298bn in October (festive season) to INR439bn in January, 2017, almost a 50% rise.
- It will be interesting to observe how this progresses with additional cash being injected in the financial system.

- The adoption of electronic payments is constrained by factors such as cybersecurity concerns, having the requisite infrastructure and the relatively modest average mobile phone bill of Rs 120-180, which basically indicates only modest amounts can be deposited in electronic wallets.

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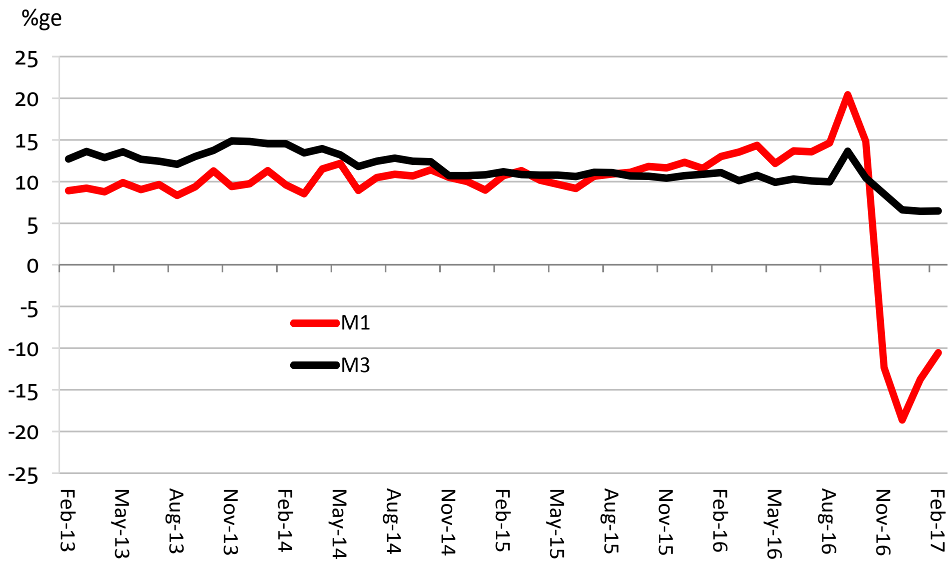
CASH CRUNCH HITS NARROW MONEY

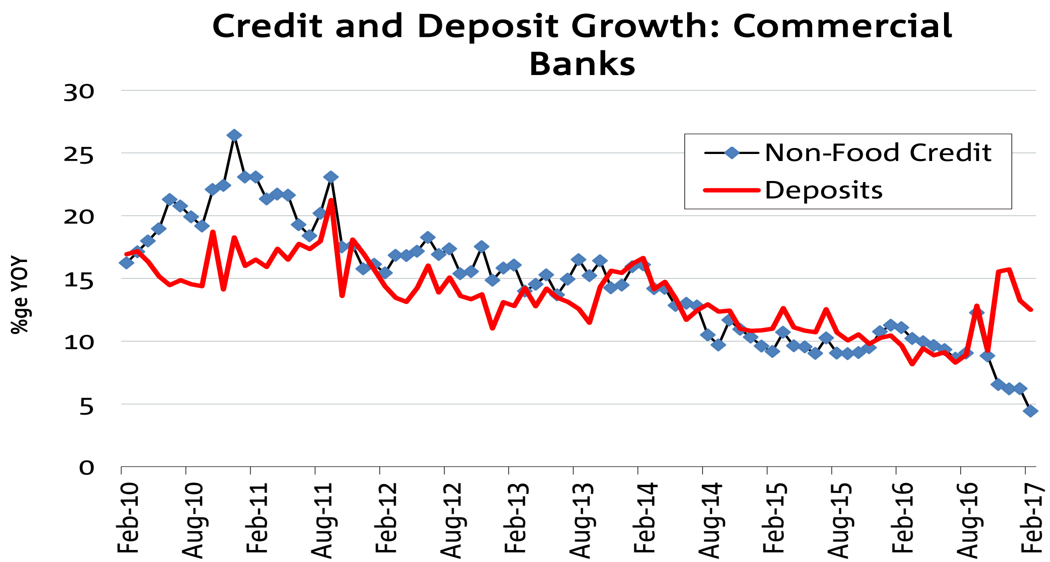
Surge in deposit growth; credit growth still weak

NARROW MONEY PLUNGES; BROAD MONEY HOLDS UP



- Clear divergence between the growth rate of the M1 measure and the broader, M3 measure.
- Currency with the public is almost half of M1. The cash crunch post-demonetisation explains the steep contraction in M1.
- Time deposits account for approximately 80% of M3, explaining still solid growth in this broader measure of money holdings.

CREDIT WEAK, BUT DEPOSIT GROWTH STRONG

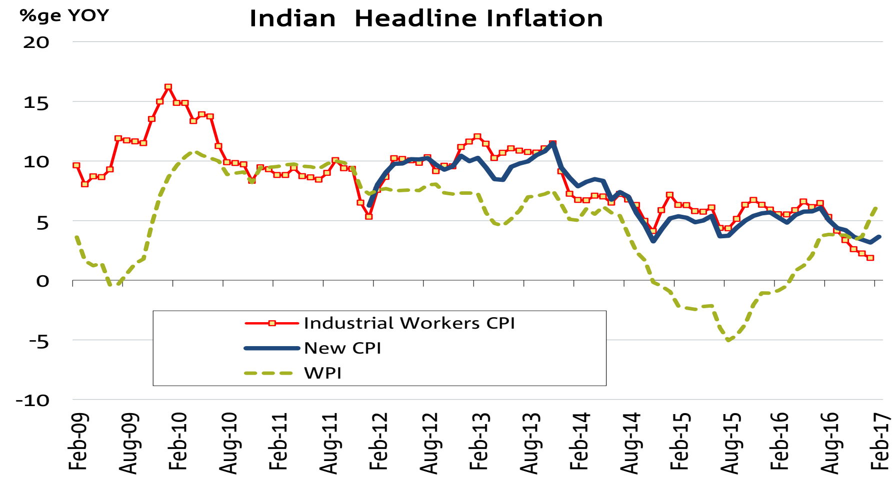


- Another way of looking at the financial data is the relative performance of credit and deposits.
- After demonetisation, there was a sharp rise in deposits, as customers rushed to deposit their old notes to meet the deadlines for depositing their currency.
- Credit growth was weak prior to demonetisation and it seems to have got even weaker since then.
- Favourable liquidity conditions induced by demonetisation facilitated improved monetary transmission of lower interest rates. According to the RBI, lending rates have fallen by about 70bps since November, 2016.

PARTIAL INDICATORS-1

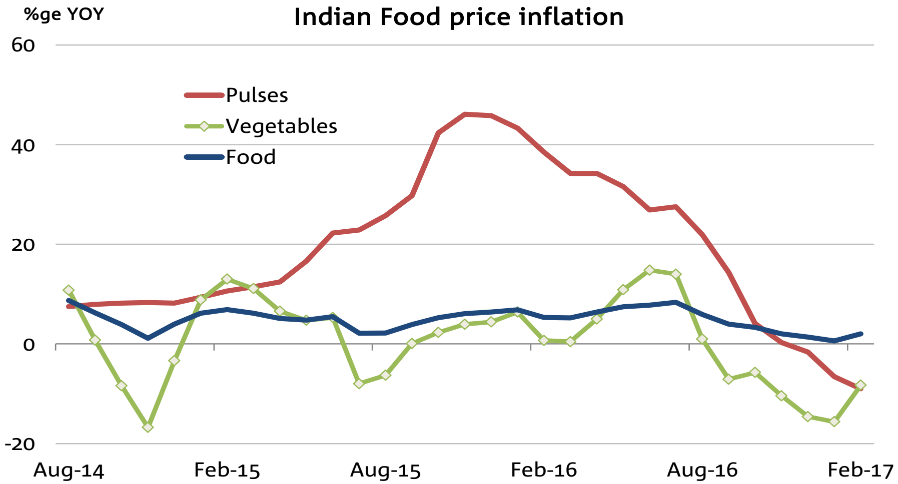
Inflation remains contained due to demonetisation-induced demand weakness

DEMONITISATION HAS LED TO LOWER PRICE GROWTH

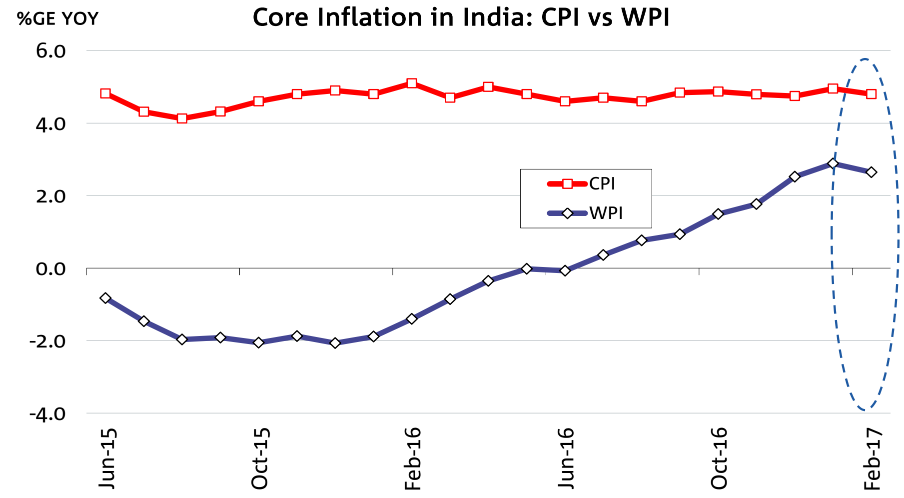


Source:CEIC

STRONG SUPPLY AND FALLING DEMAND LOWERS FOOD PRICES

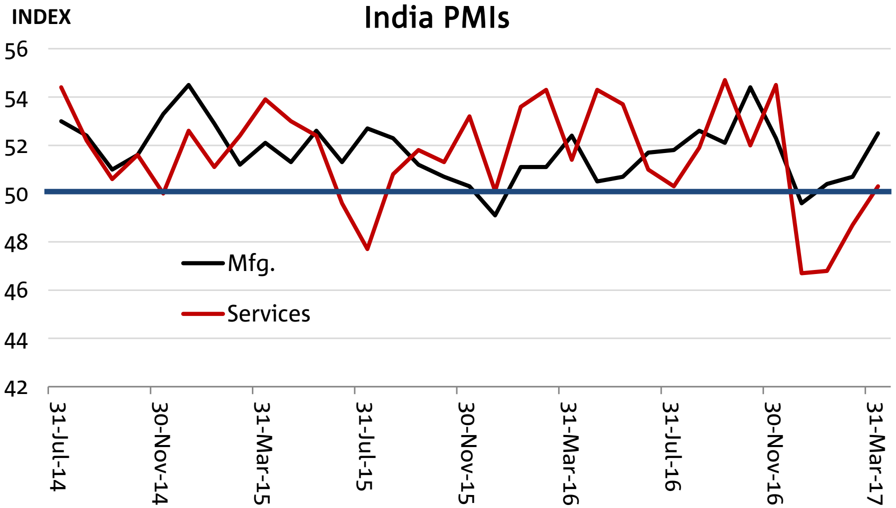


CORE INFLATION - STICKY



Source: NAB Economics

BUSINESS SURVEYS – RECOVERING FROM THE INITIAL SLUMP



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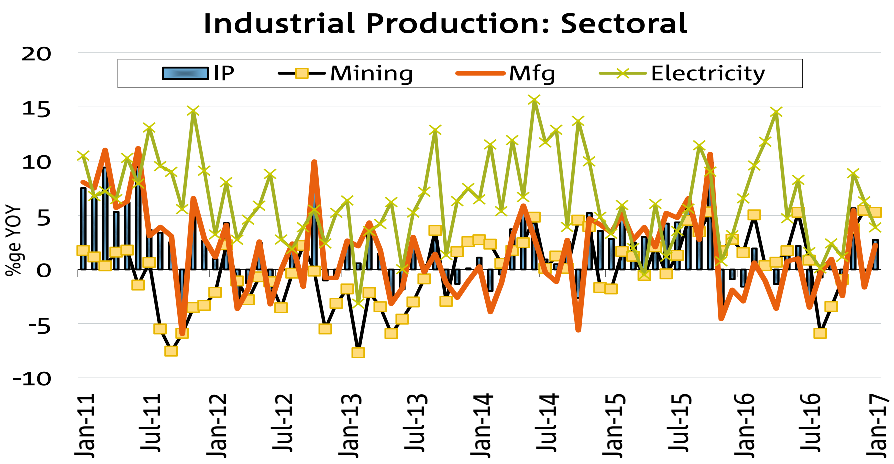
PARTIAL INDICATORS- 2

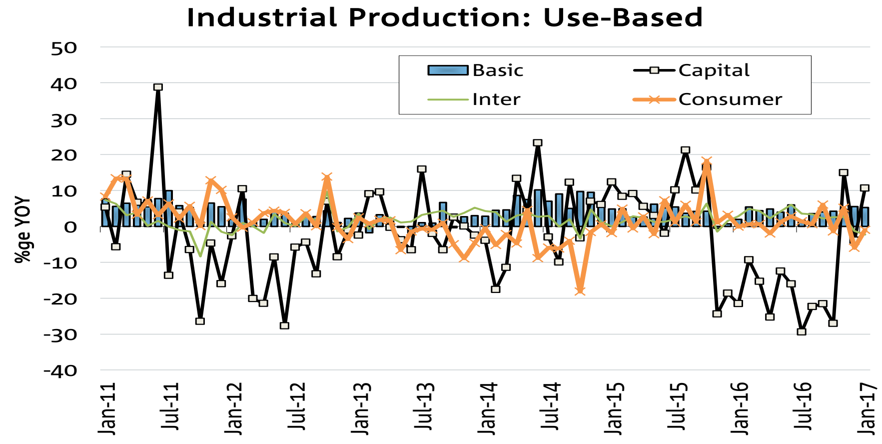
Industrial production holding up; weakness in 2-wheeler vehicles (more rural) sales

IP – SIMILAR TO PRE-DEMONETISATION PERIOD



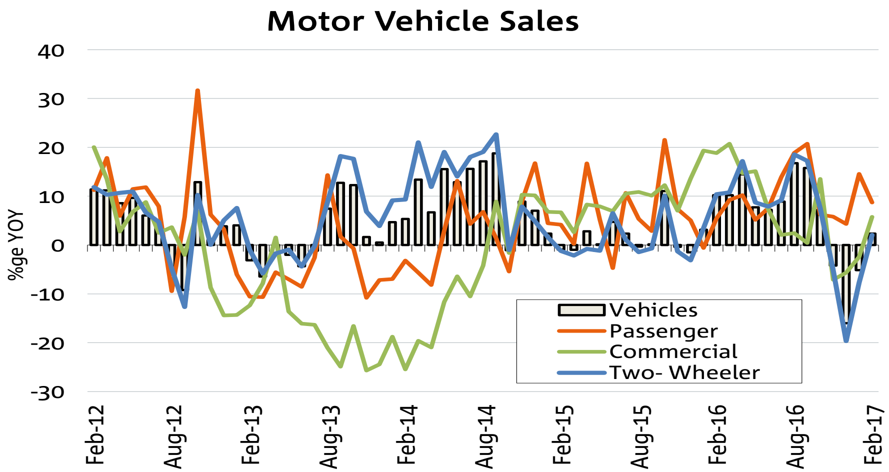
Source: CEIC

IP BY USE – VISIBLE WEAKNESS IN CONSUMER SEGMENT

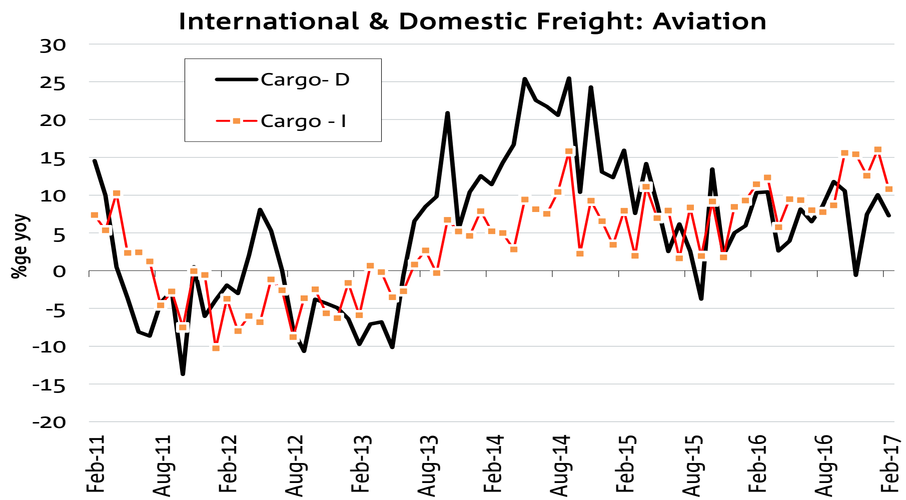


Source: CEIC

SALES OF 2-WHEELERS (MORE RURAL) BADLY HIT



DOMESTIC AIR FREIGHT TEMPORARILY HIT; INTERNATIONAL OKAY



GDP SURPRISINGLY STRONG

Impact of unorganised sector maybe underestimated; demonetisation will be less relevant in the future.

- Indian real GDP expanded by 7% yoy in the December quarter 2016, a surprisingly strong outcome. Real GVA (Gross value added) grew by 6.4%, probably a more realistic growth rate.
- Consumption was the biggest contributor to growth, followed by investment and inventories. Net exports and the statistical discrepancy detracted from growth. The strong contribution from consumption and investment looks odd, given the demonetisation and weakness in consumer durables output.
- By sector, there was broad-based convergence across the major categories of agriculture, services and manufacturing around the 6-6.5% growth rate. However, if we exclude agriculture and public administration, GVA growth came in at 5.8%, indicating less momentum in the economy than in either the June (7.4%) or September quarters (6.4%).
- A lack of adequate statistics on the big “informal” sector of the Indian economy could explain why GDP held up better than expected post-demonetisation. Companies may have also shown their cash in hand as sales, boosting published GDP estimates.
- March quarter should show further weakness in sectors such as cement production. Against that, the infusion of cash into the economy could see an improvement in activity towards the latter part of the March quarter, as highlighted by the RBI.

- **While there remains doubt about the accuracy of the GDP numbers, what is not in doubt is the substantial progress in remonetisation. As a result, the impact of demonetisation should weaken during the year ahead, and other factors – including the proposed GST implementation – will assume greater significance.**

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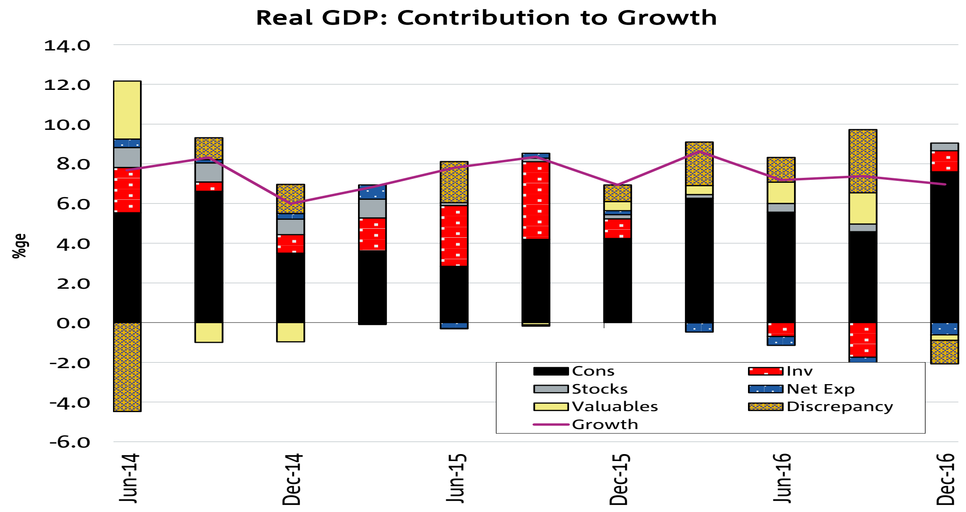
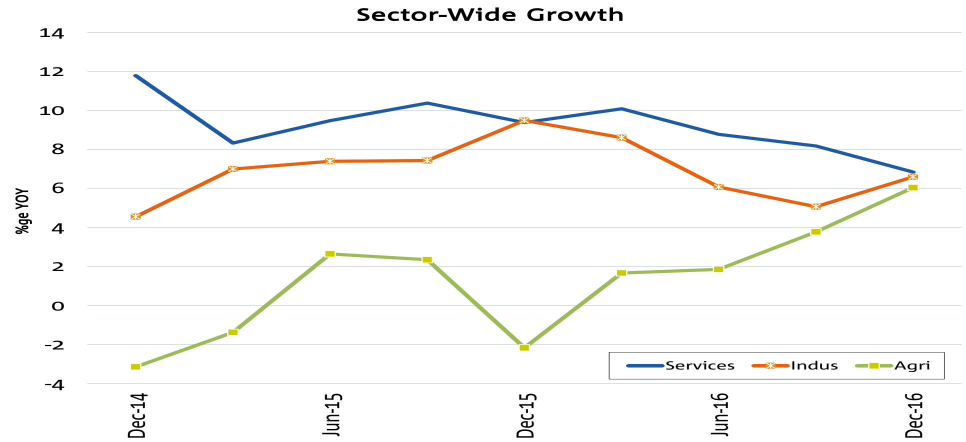
GDP GROWTH BY EXPENDITURE CATEGORY



Source: CEIC

GDP GROWTH BY SECTOR



Source: CEIC

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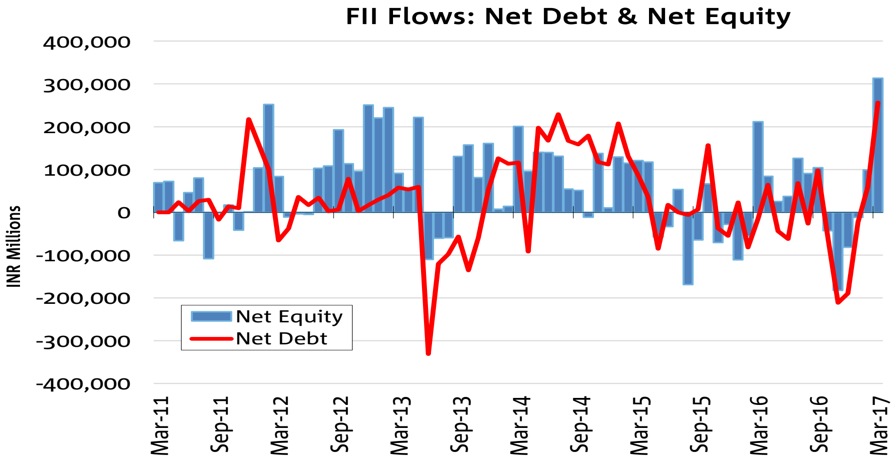
FINANCIAL & EXTERNAL METRICS

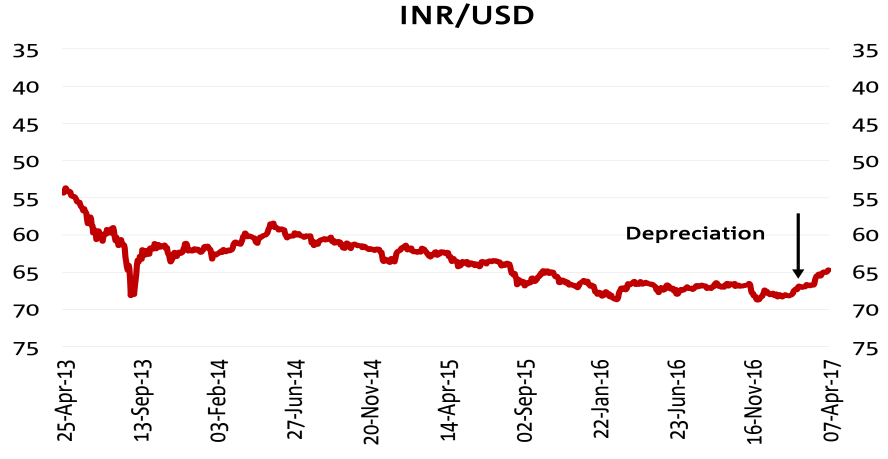
Stronger Rupee, Equity markets near record highs, High FX reserves & Foreign Portfolio Inflows: A positive picture

FII INFLOWS – REBOUND SINCE FEBRUARY



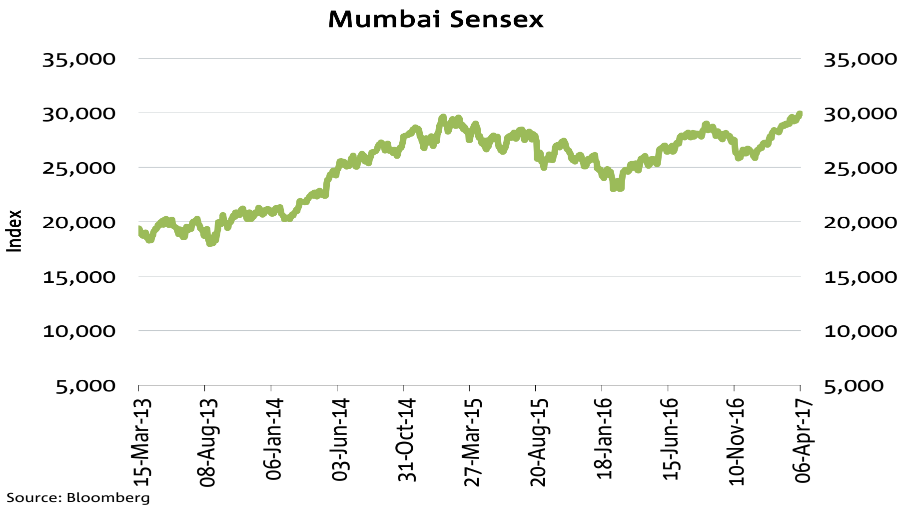
Source: DX

INDIAN RUPEE: BENEFITING FROM STRONG INFLOWS



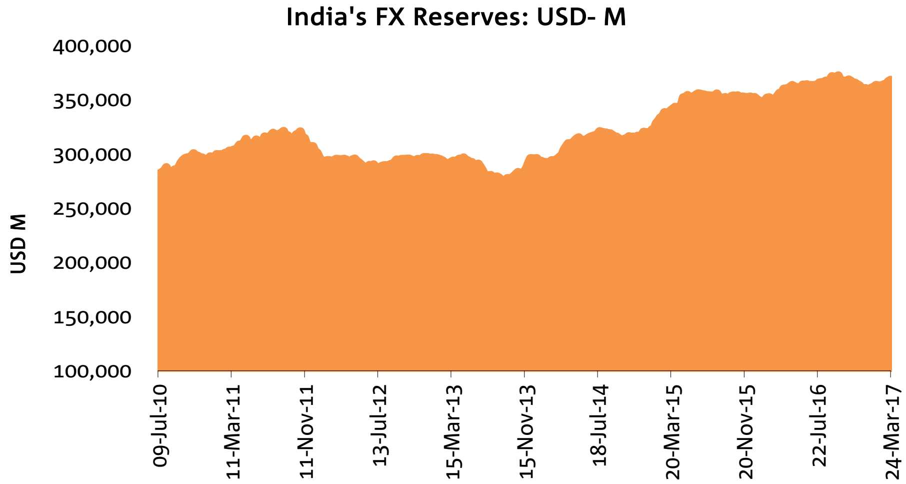
Source: Bloomberg

SENSEX NEAR RECORD OF 30,000 POINTS



Source: Bloomberg

FX RESERVES – HIGH AT USD367.9BN



Source: Bloomberg

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SECTOR WIDE SUMMARY

Post-Demonetisation stance by authorities crucial; interesting to see if the Government targets the real estate sector

Sector	Short-term impact	Long-term impact
Interest Rates	Declined on deposits and loans.	Further falls are possible if the increase in deposits proves durable.
Financial Savings	Increased.	Increase further, if there is a permanent decline in the cash-deposit ratio.
Corruption		Could reduce, if compliance incentives improve.
Digitalisation	Sharp increase.	Some return to cash expected, but continued growth in digital payment streams likely.
Broad Economy	Some job losses, disruption in cash-intensive sectors.	Should broadly stabilise as the economy is remonetised with newly injected cash.
Unaccounted Income	Stock of black money fell, as some holders came into the tax net.	The *flow* of unaccounted wealth should ease.
Private sector wealth	Private sector wealth declined, as some high denomination notes were not returned.	Wealth could be negatively impacted if the Government targets the real-estate sector.
Tax collection	Income taxes rose because of higher disclosure.	Over the long run, taxes should rise due to improved compliance and a rise in the formalised sector.
Uncertainty/Credibility	Uncertainty increased among firms and households. Investment decisions and durable goods purchases were postponed.	With remonetisation, uncertainty should ease. Aggressive action form the tax authorities might prove counterproductive for revenue raising. Demonetisation should be followed by incentive-based including better use of smart data, streamlining taxes, etc.
Real Estate	Sales activity is likely to have fallen sharply. However, RBI data indicates that actual house prices have held up.	Could come under pressure if the Government targets this sector as part of its anti-corruption drive.

Source: Economic Survey – Finance Ministry, Government of India; NAB Economics

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POLITICAL SITUATION POST DE-MONETISATION

PM Modi remains popular with the electorate.

- PM Narendra Modi's popularity remains high, despite the demonetisation program. He has managed to successfully sell the message of short-term pain for long-term gain, and that the demonetisation program was in the national interest. The message seems to have been accepted by the electorate.

- The most visible impact has been in the crucial state of Uttar Pradesh, where the BJP won 312 out of the 403 contested seats, and took power. The BJP also benefitted from measures to help the less well-off sections of society, in addition to consolidating its support among its traditional mercantile voter base. Measures to support rural, unorganised workers have helped the BJP reap electoral dividends.

- Since the elections, the newly elected UP state BJP government has begun to implement its electoral promises. RBI Governor Urjit Patel expressed his disapproval at this platform, as it could erode credit discipline. Further, the ratings agencies have expressed concern at aspects of the UP government's platform.

- Besides the win in Uttar Pradesh, the BJP notched up an electoral victory in Uttarakhand, held on to leadership in Goa and managed to form a coalition administration in the North Eastern state of Manipur. The only setback was in the northern state of Punjab, where Amarinder Singh of the Congress party defeated the BJP.

- The financial markets have responded positively to these election results, as they suggest a continuation of the Modi Government's reform agenda, including the upcoming Goods and Services Tax (GST) legislation.

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MONETARY POLICY: 6TH APRIL

Increasing focus on mopping up liquidity; inflationary concerns linger

- As expected, the central bank kept the policy Repo rate on hold at 6.25%. However, it raised the Reverse repo rate (at which banks lend to the RBI) by 25bp to 6%, and cut the Marginal Standing Facility (rate for excess borrowing from the RBI) by 25bp to 6.75%. It has thus narrowed the interest rate corridor.
- A focus of the RBI currently is to drain the financial system of excess liquidity that has stemmed from demonetisation. The RBI has committed to removing this excess liquidity with a combination of measures, aiming to remove surplus funds moving around in the financial system from triggering inflationary pressures.
- The RBI is also looking into other ways to remove excess liquidity, for instance the *Standing Deposit Facility*. This would provide the RBI with the means to fine tune liquidity and involves banks lending to the RBI without the RBI providing collateral in exchange.

- The RBI expects economic growth to strengthen, with real GVA (gross value added) expected to accelerate from 6.7% in 2016-17 to 7.4% in 2017-18. Inflation is expected to average around 4.5% over the April-September 2017 period, rising to 5% during the October 2017-March 2018. There are upside risks to these projections from any potential shortfall in the upcoming monsoon season, the inflationary effects of the 7th Pay Commission and the one-off effects in the implementation of the GST.
- As a result of these upside risks, the RBI considers achieving its 4% medium-term inflationary target to be a challenge.

- NAB Economics expects a final rate cut (possibly in August) to 6% to boost business investment and employment growth. However, the risks to our forecasts are clearly to the upside, i.e. less chance of a cut, given uncertainties about the inflation outlook.

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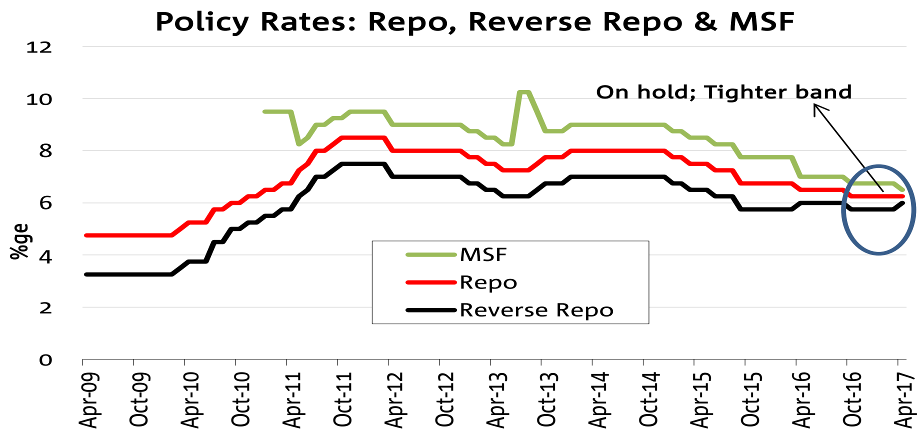
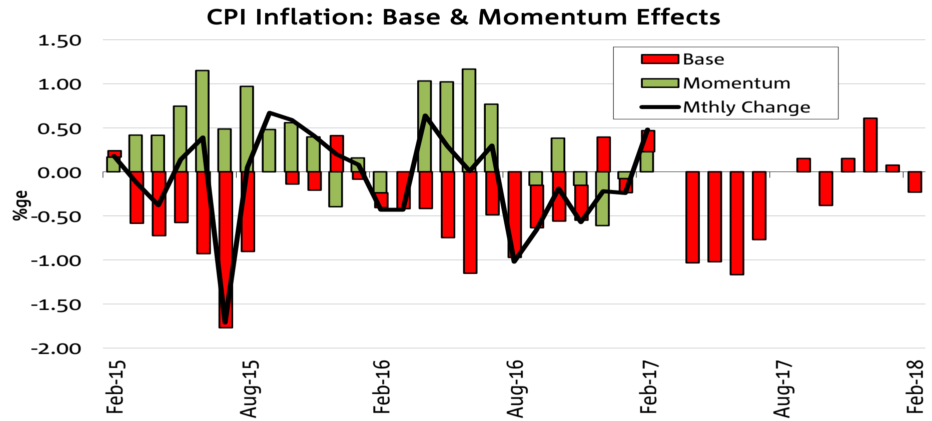
POLICY ON HOLD; TIGHTER CORRIDOR



Source: DX/RBI

INFLATION: FAVOURABLE BASE EFFECTS TO WANE



Source:NAB Economics

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CONCLUSIONS

Economy still growing solidly but plenty of reform still needed to lift performance .

- There remains some uncertainty as to the overall impact of demonetisation, with suggestions that the December quarter GDP print was overstated. However, there were unambiguous gains in 2 areas: the increased popularity of digital payments and a move to lower lending rates.

- The direct impact of demonetisation is expected to fade as substantial progress has been made – and continues to be made – in supplying new currency notes.

- Further, the program has proved to be particularly beneficial to PM Narendra Modi, with the win in Uttar Pradesh a clear example that he has been adept at selling his political message to the electorate.

- At this stage it is too early to suggest if the de-monetisation has been a success or failure. Results will surface over the medium to longer term and will be assessed on a number of measures. These include: improvements in the business climate; a greater tax haul; increased adoption of digital payments; greater transparency.

- If the Indian economy shows a durable improvement in growth prospects, then the demonetisation program will have been worthwhile, although it has caused some short term pain to the general populace.

- **While reforms are essential for India's future, the manner in which they are implemented is important. Subjecting the economy to unanticipated, 'shock therapy' can be destabilising to an Indian economy that already faces considerable challenges, particularly the modest pace of business investment and the high proportion of non performing loans in the banking system.**

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