Latin Manharlal
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Demonetization – Significant Benefits in Long-Term

Prime Minister Narendra Modi announced the demonetization of Rs. 500 and Rs. 1,000 notes presently in circulation. Demonetization move is aimed to combat against black money, corruption and fake currencies that also allegedly fund terrorism. In 2007, the World Bank estimated the size of India's shadow economy at 23.2% of GDP. Assuming this ratio still holds, that's about UDS 479 billion unaccounted for. Much of that money is expected to get mainstreamed because of demonetization move. In Long term; this move can have a number of positive impacts such as improvement in fiscal deficit, tax GDP ratio, tax compliance, transparency, reduction of black money (on a large level) from the economy which can change the face of Indian economy but in short term it has number of negative impacts which poses number of challenges to the world's fastest growing economy.

Macro view

Shrink in Parallel economy

The removal of these Rs. 500 and Rs. 1000 notes and replacement of the same with new Rs. 500 and Rs. 2000 Notes is expected to remove the black money from the economy which will reduce the black money from economy.

Government revenue is expected to see significant improvement

The Government's tax revenue is expected to increase on account of demonetization resulting in higher spending on infrastructure and lower fiscal deficit of the government. Higher investment on infrastructure is likely to generate income and jobs in the economy which will help to improve GDP growth in longer term.

Effect on GDP

GDP growth is expected to have a negative impact for next two to three quarters due to liquidity crunch also Indian economy can pay cost with losing tag of the world's fastest growing economy however in longer term liquidity situation is expected to be normalized on account of infrastructure spending, better liquidity, improvement in tax collection, higher rate of job creation, improvement in income etc. These supportive factors will help GDP to come on track in longer term.

Public investment will drive higher income and jobs

Over the past two years, fiscal savings on account of lower oil subsidies gave the government room for infrastructure spending. Higher tax collection will now allow the government to further increase spending which will lead job creation and improvement in GDP.

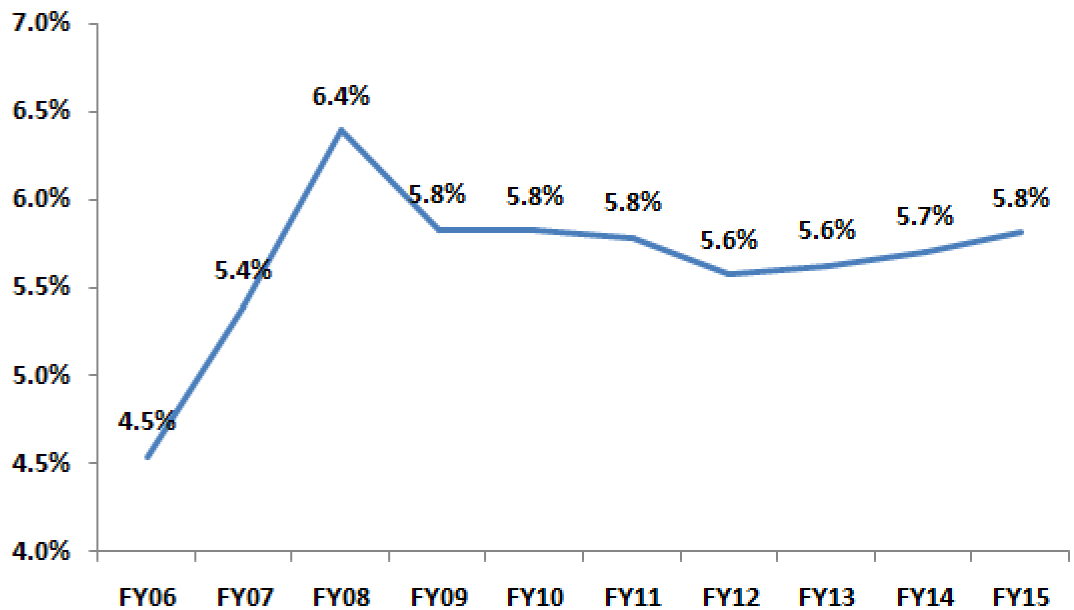
Liquidity; short-term – tight situation, long term – normalized situation

With the older 500 and 1000 Rupees notes being demonetized, until the new Rs. 500 and Rs. 2000 notes get widely circulated in the market, money supply is expected to be reduced in the short-term. To the extent that black money does not re-enter the system which will create short term liquidity situation which is expected to have impact on sectors and companies which have higher ratio of cash transactions like real estate, jewelry, consumer goods etc. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up hence we can expect normalization of consumer goods sector in long-term.

Significant improvement in Tax to GDP ratio

Income tax collection is expected to increase due to unaccounted money which will be channelized through banking system hence onetime tax collection could be high. The government has already said declaration of unaccounted income because of demonetization is liable to be taxed/penalized at rate of 30% to 200% depending on the source. The Income declaration scheme has closed in September is expected to add nearly Rs. 300 billion to direct tax collection over fiscal 2017 and 2018. currently direct tax collection are only 5.5% of GDP and about 50% of total tax collections but this contribution is expected to rise significantly in coming years. This will help to decrease the fiscal deficit to the government.

Chart 1: Tax to GDP Ratio



Downward pressure on inflation in short term

Liquidity crunch is expected to lead lower demand which will put downward pressure on inflation in the short-term, sectors which have high usage of cash such as housing, transport and food will have lower demand in the market whereas rural area also have high impact due to high usage of cash however long term situation will be normalized on account of better liquidity management by RBI and the government.

Tax rate could be lower

Demonetization will generate higher income tax collection arising from better compliance by wider area, if so; the government can reduce tax rate which will help for higher production and lower cost which will also lead higher demand in the economy.

Effect on online transactions and alternative modes of payment:

Cash will be gradually out from system in short-term hence people will use alternative forms of payment like digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. Rise in alternate mode will increase demand in the market and also increase the awareness of usage hence we can see better digital infrastructure in the coming years.

Currency market

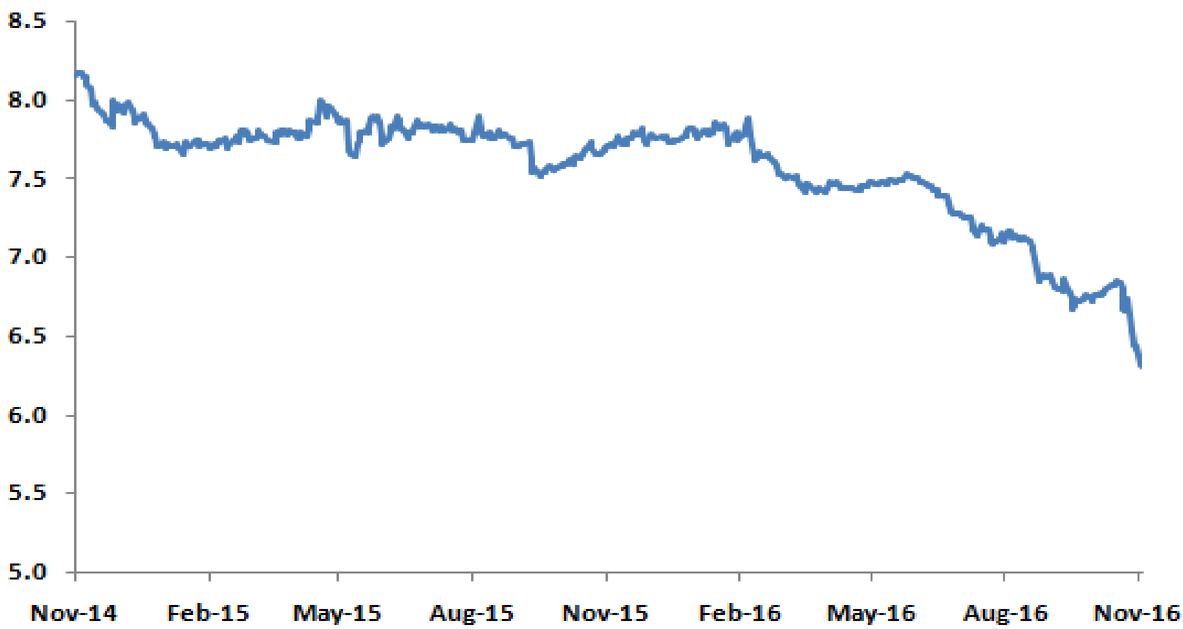
Indian currency was expected to be appreciated on account of lower inflation and lower circulation of currency in short term but it has been offset by USD appreciation against emerging markets currencies.

Chart 2: INR Vs. USD

Bond Market

Banking system has been witnessing oversupply of liquidity which will increase the demand of bonds in short term resulting lower yield on bonds. The Government's fiscal deficit will improve in long term while banking system will have significant liquidity which will increase the demand of bonds resulting in pressure on bond yield.

Chart 3: 10 Years Bond Yield



Hamper on counterfeit notes

Demonetization is expected to curb on counterfeit notes which help to reduce terrorism, smuggling, espionage, other non-social activities etc.

Impacts on macros

Factors	Short-term impact	Medium to Long term Impact	Overall Long – term Impact
GDP	**Negative:** Consumption and investment will be lower in short term due to liquidity crunch which will lead lower GDP growth for next two to three quarters.	**Positive:** Demonetization will help the government for higher tax collection; hence the government will start to invest in infra projects which will boost the economy in log term. If the government reduces income tax rate which may boost production resulting in higher income and job creation.	Positive
Inflation	**Negative:** Inflation is expected to have downward pressure on prices due to lower demand from housing, transport and food where share of cash transaction is high.	**Neutral:** Inflation is expected to have neutral impact due to pick up in demand on account of infrastructure spending which will generate income and jobs for the economy.	Neutral
Liquidity	**Negative:** market liquidity is expected to be lower on account of higher deposits in banks.	**Neutral:** RBI and the Government will take appropriate action to maintain liquidity on account of substantially availability of funds.	Neutral
Fiscal Deficit	**Positive:** The government's fiscal deposit will improve on account of higher collections while onetime tax collection could be very high which will decrease the borrowing cost of the government.	**Positive:** The Government's tax collection is expected to increase on account of better tax compliance which will improve the tax GDP ratio hence the government's borrowing cost is expected decline substantially in coming years.	Positive
Digital Payments	**Positive:** High usage of digital sources due to liquidity crunch.	**Positive:** People will have more awareness of digital system and start to use it which will help to create better infrastructure.	Positive

Impact on stock Market

The liquidity crunch caused by the demonetization had negative impact across many sectors; with 86% of currency in circulation suddenly becoming non-usable for commercial transactions, there will be immediate impact on overall level of economic activities. Sectors with high proportion of cash transaction has witnessed sever disruption. We expect Real Estate, Jewelry, Retailing, Restaurant and Quick Service Restaurant, Logistics consumer durables, luxury brands cements and housing finance to face short term turbulence. Cement sector will have negative impact due to higher exposure to real estate sector (approximately 67% revenue comes from real estate - IBEF). We expect few sectors such as real estate, Jewelry and high end consumer goods to face medium term headwind in terms of slowdown in demand.

Real Estate and Property:

Prices in this sector are largely expected to fall, especially for sales of properties where major part of the transaction is cash based. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices. Lower interest can also help to the sector for regaining to some level over medium to long-term.

Effect on Banks

Demonetization has increased deposit ratio in the banks (especially in PSU banks). This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. Few of the banks have decreased interest rate on fixed deposit hence banks will get benefit in short term.

Impact on various sectors

Sector	Impact	Remarks
Real Estate	**Strongly Negative**	A. Residential projects will have a strong negative impact while commercial project will have lower impact as compared to residential projects. B. Builder will face liquidity problem in short to medium term. C. Land prices are expected to fall due to higher contribution of cash. D. Real estate bill will improve transparency in the sector. E. Sector will offer attractive valuation hence FDI can invest in the sector which will help the sector in long-term.
Jewelry Retail	**Strongly Negative**	A. Nearly 80% transactions are done on cash basis which will face lower demand in short term. B. Requirement of KYC will lead lower demand in unorganized market however it may offer some relief to the organized sectors.
Cement	**Negative**	A. Cement sector's ~67% revenue comes from housing sector (real estate) hence it will have indirect impact however demand from infrastructure (exposure 13%) is expected to offset marginally.
Consumer Durables	**Negative**	A. Demand is expected to be lowered in short term on account of high proportion of cash (~75%) in overall sales of consumer durables. B. Over the long term, its impact on the sector will be neutral as penetration for most durables items is still low in India and consumers would slowly move to other modes of payments.
Retail (Organized)	**Positive**	A. The organized sector is expected to have negative impact in short term whereas it will be benefitted in long term on account of better infrastructure and higher demand.
Retail (Unorgan.)	**Negative**	B. Unorganised retail sector is expected have negative impact in short term. Retail sector is expected to have neutralized impact as market will have substantial liquidity in long term.
Steel	**Negative**	A. High exposure (30% to 35%) to the real estate is expected impact in the short term while demand from infrastructure is expected to offset marginally in the long-term.
Banking and NBFC	**Neutral**	A. Deposit ratio of saving and casa account will improve resulting in lower cost for source of funds. B. Asset quality pressure from the real estate, cement, steel etc. C. Digital payment, nascent stage, will increase hence operating cost will be lower for the banks and NBFCs in long term. D. NBFCs (Housing loan, Agri loan, and rural loan) are expected to face asset quality pressure in short term due to high proportion of cash however it may improve in long term.
Auto	**Slightly Negative**	A. Lower demand from luxury cars B. Slightly impact on small value segment C. Slightly impact on two wheeler segment

Chart 4: Sensex

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