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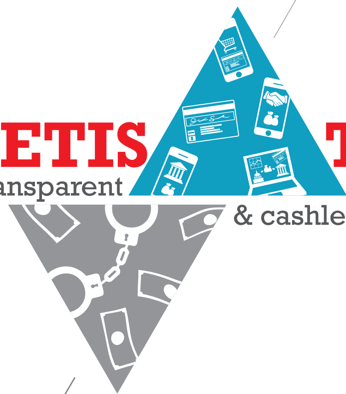
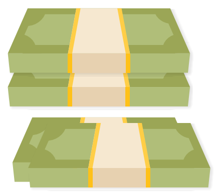
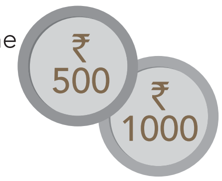
DEMONETISATION



A move towards a transparent & cashless economy



The value of notes in circulation as a percentage of GDP in India stood at more than 12% in FY16 - **significantly higher** than other developing economies such as Brazil and China



The ₹ 500 ₹ 1000 rupee notes comprised of around 86% of the notes in circulation as on March 2016

Total number of counterfeit notes (₹ 500 & ₹ 1000) detected in the banking system increased from 1.2 lakhs in FY06 to 6.3 lakhs in FY16

Over the past two and a half years, more than

₹ 1.25 tn of black money has been brought into the open

Demonetisation

A move towards a transparent & cashless economy

Some of the steps taken to move towards a cashless economy

Digital India
Power To Empower

Digital India

To transform India into a digitally empowered society

Payment Banks

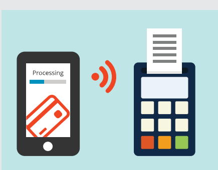
In-principle approval to 11 applicants

Jan Dhan Yojana

255.1 mn accounts opened and 194.4 mn RuPay cards issued as on 9 Nov 16

Electronic Toll Collection

FASTag, cashless payment mechanism, operational on more than 340 toll plazas on National Highways



Unified Payment Interface (UPI)

Introduction

On the evening of Tuesday Nov 8, 2016, the Government of India announced that the 500 and 1000 rupee notes will no longer be legal tender from midnight, Nov 8, 2016.

The Government also announced that it has accepted the recommendations of the RBI to issue 2000 rupee notes and new notes of 500 rupees will also be placed in circulation.

The Prime Minister also announced a series of steps that will help overcome the potential problems arising out of the demonetisation.

The Prime Minister in his address to the nation stated that the steps taken by the Government would strengthen the hands of the common citizens in the fight against corruption, black money and counterfeit notes. He also shared the insight into how the magnitude of cash in circulation is linked to inflation and how the inflation situation has worsened due to the cash deployed through corrupt means. The Prime Minister added that it adversely affects the poor and the neo-middle class people.

The efforts taken by the Government to eradicate black money over the past two and a half years, which include formation of a Special Investigation Team (SIT) on black money, law passed in 2015 on disclosure of foreign bank accounts, levy of strict rules to curtail benami transactions in 2016, and scheme to declare black money in 2016, have resulted in more than ₹ 1.25 tn of black money being unearthed.

This big-bang initiative supplements the earlier steps taken by the current Government to move towards a cashless economy like the Jan Dhan Yojana, payment banks, Digital India, Unified Payment Interface (UPI) amongst many such moves.

Need for demonetisation

Why the measure to ban high denomination notes?

This was necessitated to tackle the issue of counterfeit Indian banknotes, to effectively nullify black money hoarded in cash and curb funding of terrorism with fake notes.

India remains a cash-based economy, hence the circulation of **Fake Indian Currency Notes (FICN)** continues to be a menace. Counterfeit/FICNs are used for various subversive activities such as espionage, smuggling of arms, drugs and other contraband in India. Notes in circulation as a percentage to total money supply in India is around 14%. Out of this, 86% comprises of ₹ 500 and ₹ 1000 denominated notes. The value of notes in circulation as a percentage of GDP in India stood at more than 12% in FY16, which is significantly higher than other developing economies such as Brazil and China.

As per the RBI, the number of **counterfeit notes** detected in the banking system has increased from 1.24 lakh notes in FY06 to 6.33 lakh notes in FY16 with the share of high denomination notes (₹ 500 notes and ₹ 1000 notes) increasing from 10.4% to around 64.0% during the same period.

Measuring the size of the shadow economy in India

As per the IMF report 'The Revenue Administration: Managing the Shadow Economy', the estimated size of India's **shadow economy grew from 23.6% of GDP in 2002 to 25.6% of GDP** in 2007.

Assuming that the pace of growth (2002-2007) of the shadow economy had remained the same since 2007; in 2016, the size of India's shadow economy would be approximately 30% of GDP i.e. around ₹ 41 tn (calculated at current prices). Rerouting this into the formal economy would immensely boost the tax collection and increase the share of the organised sector.

Under **The Income Declaration Scheme (IDS), 2016,** only 64,275 declarations were filed upto the midnight of Sep 30, 2016 with an aggregate of ₹ 652.50 bn worth of hitherto undeclared incomes in the form of cash and other assets being declared. Under the **Voluntary Disclosure of Income Scheme (VDIS),** introduced in 1997, income disclosed amounted to ₹ 330 bn.

Data shows that while India's shadow economy grew 7.4 times over the period of 14 years (2002–2016), the disclosed income in 2016 under IDS were only twice the income declared in 1997 under VDIS.

India ranked 3rd in **illicit financial outflows** after China and Russia in 2013, when US$ 83 bn of illicit money was siphoned out of India, according to the report' 'Illicit Financial Flows from Developing Countries' released by Global Financial Integrity, a non-profit, Washington DC-based research and advisory organisation. The report defines the illicit financial flows to be generally the product of **tax evasion, corruption, bribery and criminal activities.**

- **Trade misinvoicing** has been the only source of outflow for illicit money in India while **Hot Money Outflows** has been nil unlike China and Russia. In India, average trade misinvoicing outflows as a percentage to total trade for the period 2004-2013 was 10.3%, the cumulative amount of which was US$ 505.6 bn during the period.
- The report also points out that out of the US$ 1 tn in illicit flows leaving poor nations annually, over 83% is due to trade misinvoicing. Each year over US$ 800 bn in illicit trade exits developing countries.

Impact of demonetisation

The immediate impact would be on the general cash market transactions until the current value denominations have been replaced with new ones.

While the impact of the measures would bring about a disruption and ambiguity in the short term, there will be positive implications in the long run. Even if it does not completely eliminate the cash flow of black money, it would certainly raise the costs and risks of such activities significantly in future.

Curbing the illicit economy

High denomination notes are the preferred payment mechanism of those pursuing illicit activities, given the anonymity and lack of transaction trail they offer, and the comparative ease with which they can be transported and moved.

The announcement to remove the current high denomination notes out of the system was sudden without any prior intimidation and the window for declaring them invalid was very short. This has provided with little or no opportunity for entities to convert their black money to white. This overnight move has halted illegal activities in betting, gambling and matka trade.

Informal sector in the economy

In the short term, a large part of the informal sector that engages only in cash transactions will face disruption. Sectors to be impacted would be retail, transportation, metal scrap and dealings in agriculture land.

In the long term, this initiative along with Goods and Services Tax (GST), will push the informal sector to become more organised and transparent. This changeover will occur over a period of time and this segment of the economy is likely to take the longest time to recover from the current impact.

Banking operation

This would place a temporary burden on the formal banking system and will also create a disruption in the supply chain.

Change in operation module: The additional pressure on the banking operation to facilitate the acceptance of old notes and disbursement of new notes in such a short notice would force banks to change their operation module in the short-term. Banks have been mandated to deploy additional resources to manage the increasing footfall for currency conversion.

ATM machines would have to be recalibrated to accommodate dispensing of the new currency notes: The difference in the size of the new notes (New ₹ 2000 note: 66 x 166 mm: Old ₹ 1000 note 73 x 177 mm) would entail cost for the banks. As on Nov 23, 2016, nearly 43% of the 2.31 lakh ATM machines have been recalibrated.

Impetus to Financial technology: While cash-based transactions will be impacted in the immediate term, online transactions are set to grow. Fintech firms saw an exponential rise in the volume and value of their transactions. As per National Payments Corporation of India (NCPI), cards and mobile phones have emerged as the most widely available money transfer systems. The mobile payments segment has witnessed a surge in the number of transactions in Immediate Payment Service (IMPS) as well as in UPI.

This move is also expected to be beneficial for the B2B online lending players in medium to long term. There has been a surge in the use of cards on the point of sales devices as well as in e-commerce. Companies that are in the online SME lending space, in particular, are expecting an increase in number of enquiries since the daily cash spend for businesses has been impacted and working capital needs have become the call of the hour.

Impact on macroeconomy

Money supply

Basis the result of the demonetisation that took place in 1978; if 25-30% of the unaccounted/ undeclared money does not come back in the system i.e. ₹ 3.5 tn to ₹ 4.3 tn, it will impact growth in money supply by approximately 3%. Considering the average growth of money supply for the last three years i.e. around 12%, growth in money supply might moderate to ~ 9% in near term. If the RBI decides to print the entire 86% of the high denomination currency, money supply will pick up with the new notes being gradually circulated over a period of time.

Interest rates

With the cash deposit by the households and business units in the banking system and the restrictions on withdrawals placed by the Government, liquidity has increased and is expected to surge further in the near term. This has led to reduction in deposit rates. With fall in the cost of funds, the lending rates are also expected to come down, with some banks already having initiated this move. Banks have reported that deposits effected from Nov 10, 2016 upto Nov 27, 2016 amounted to ₹ 8.1 tn. The increase in funds in the banking system along with the fall in the Government borrowing owing to improved tax collection can herald a period of low interest rates in the near term.

Inflation

If growth in money supply as discussed above decreases, then it will exert a downward push to overall inflation. Cash constraint, moderation of consumer demand and lower speculation in the commodity markets including agriculture commodities owing to forced income declaration will also have a moderating impact on prices.

Fiscal balance

With the increase in declaration of income and income sources, the revenue collection of the Government will increase for the current fiscal year and help in further reducing the fiscal deficit.

For those who declare their unaccounted money, a significant proportion of the money will go to the Government in the form of taxes and penalties. With better tax compliance and improvement in tax collection, it would reduce the borrowing of the Government and also bring down its interest liabilities.

However, the Government anticipates that around ₹ 4 tn will not come back to the system i.e. citizens might choose not to declare such amount. In such a case, the liability of the RBI will decrease and hence there will be a gain to asset side and benefit to balance sheet. Eventually, this benefit will be transferred to the Government in the form of dividend over a period of time. If the entire benefit is transferred to the Government over a period of time, it could be used for various purposes like financing of fiscal deficit or cutting taxes which will be a short term initiative or investing in infrastructure activities which will be long term in nature.

This would also present an opportunity to the Government to increase the fund allocation for various socio economic activities and push for more infrastructure activity, both in the rural and urban centers. This would push economic growth higher in the medium term. With higher tax to GDP ratio, the Government may also get enough headroom to reduce the income tax rates, which can lead to higher disposable income with people. However, on a realistic front, it might not be a correct move from a political point of view in the short term.

Savings

The note exchange terms and condition, to a larger extent, would impact the mindset of the household sector. Thus, this move would bring about a change in the behavior of the Indian population who would now prefer to keep cash in the banking system instead of hoarding it. The channelisation of the cash savings in the formal banking system would be redeployed for physical and financial asset creation.

Economic growth

Given the large base of the informal sector and cash based transaction, in the **near term**, consumption demand is likely to get severely impacted as transaction in high value denomination gets restricted. Consumption decisions are likely to be postponed, which could affect growth in the immediate term, while households and private sector financial investment through banking channel are likely to get a push. The various segments under the infrastructure sector that largely involves the unorganised segment, contract workers and modes of personal finance will face disruption in the short term. Thus, the GDP growth is likely to be subdued in the next one –two quarters by upto 50 basis points.

In the **mid term**, however, GDP is likely to improve by around 100 basis points. The sudden spurt in deposits in the banking sector is likely to have a positive impact on GDP in the mid-term through credit multiplier effect. In the **long-run**, as the current cash constraint gets normalised, this initiative to curb flow of black money would boost growth. The circulation of money in the formal economy would help in efficient re-allocation of resources and enable flow of resources into the productive segments of the economy. Hoarding of black money tends to create asset bubbles in segments in which it can be easily accumulated, for example gold and real estate, and distorts the optimal price determination.

With the revival of the consumption demand, increase in the savings rate and improvement in the revenue collection of the Government, the growth momentum is likely to get a boost through this initiative in the mid to long term.

Impact on Micro, Small and Medium Enterprises (MSMEs)

Short term impact

The MSME sector consists of approximately 51 mn units, and almost 93% of them are unregistered, which mainly thrive on cash transactions. Small traders and businesses, particularly in the rural and semi-urban parts of India will be hit, mainly where modern banking is yet to make inroads and cash is the principle mode of transaction. Small and medium sized businesses across the country are likely to be struggling to cope with lower consumer demand, fewer supplies and pending salaries in the short term. As informal fund flows from moneylenders, friends and family dry up, MSMEs will seek aid from Banks, NBFCs and Digital Lending platforms to meet their working capital finance needs.

Long term impact

The MSME sector will take some time to recover, because of the extent of cash involved in doing business in this segment. Traditional as well as Digital lenders can expect a surge in demand as MSMEs move from the informal credit economy to the formal credit economy.

Impact on select sectors

The liquidity crunch and crackdown on black money on account of demonetisation move is expected to have varying degrees of impact on sectors across the spectrum. Sectors with a high proportion of cash-based transactions would witness the most disruption. These would include real estate, retail, jewellery, hotels & restaurants and consumer durables, among others.

From a short term perspective, demand slowdown is expected to be seen in certain sectors such as real estate, high-ticket consumer durables, jewellery, luxury brands, etc. However, over a period of time, with the introduction of new high value currency notes, the current short term liquidity concerns would be resolved. From a long term perspective, demonetisation would be a big positive for sectors such as infrastructure, real estate, hospitality, gold & jewellery, e-commerce and fintech.

Fintech

Short term impact

In the short term, cash alternatives like plastic money, payment gateways and e-wallet segments will continue to witness a rise in transactions. Cash dependent MSMEs will seek alternative sources of credit and means to accept digital payments from customers. As the small business ecosystem embraces the cashless revolution, fintech services like digital lending will witness a rise in demand.

Long term impact

Demonetisation augurs well for companies in the fintech and alternate lending space. With a reduction in cash transactions, there will be a greater shift towards the digital channel for payments. As the government roots for a digital, cashless economy, we anticipate a rise in the number of fintech startups. Use of digital currency and payment systems driven by digital wallets, plastic money and Unified Payment Interface will lead to evolution of more fintech companies especially in transactions and online lending space. Smartphone-based digital finance services will gain traction. With the promotion of net banking, use of plastic money, e-wallets etc, digital lending platforms will be able to service the personal and commercial financing needs of the country with ease. Overall, the current fintech startups may have to grow exponentially to cater to rising demand.

Banking

Short to medium term impact

Liquidity in the banking system will go up in the near term as households and businesses deposit cash in the banking system, along with the restrictions imposed on daily and weekly withdrawal limit. The increased liquidity, in turn, would reduce the cost of funds. With some of these low cost deposits turning out to be sticky, it will improve the medium to long term Current Account and Savings Account (CASA) ratio of the banks.

While households are expected to withdraw in the second stage, the larger contributions expected from the commercial sector would inflate the liquidity in the banking system on an immediate basis. This will have an impact on deposit rate. Several banks have already reduced deposit rates and others are expected to follow suit.

Infrastructure

Short term impact

From a short term perspective, there would be operational problems in infrastructure and the related ancillary sectors, such as delay in payment of salaries and wages to labour.

Long term impact

Demonetisation is expected to have a long term positive impact on the infrastructure sector. The dividend realised by the government through benefit to the RBI's balance sheet, can be used for need based funding. The direct positive impact on tax revenue collection will improve the government's ability to spend on infrastructure. This will have a multiplier effect as it will also drive employment and income in the related sectors. The government spending on the large infrastructure projects would kickstart capex cycle and push economic growth higher in the mid to long term.

Real Estate

Short term impact

The real estate sector, which contributes significantly to India's GDP, is already reeling under pressure due to high interest rates and slow economic growth. The demonetisation move and consequent reduction in shadow economy will cause a further blow to the real estate sector in the short to mid-term, given the extent of cash transactions. In the short term, builders will be faced with a liquidity crunch. Real estate prices are expected to correct, making housing more affordable.

Long term impact

From a long term perspective, demonetisation will bring in greater transparency in this sector and empower property buyers with buying decisions based on more realistic prices. This along with the Real Estate (Regulation and Development) Act will benefit the established and reputed developers by bringing in transparency in transactions. Construction activities are expected to be affected temporarily, due to which demand for cement, steel and other metals is expected to weaken in the short term.

Retail

Short term impact

The retail sector, especially businesses through physical stores, could see marginal impact in the short to mid-term as their dependence on cash transactions is quite significant. The luxury segment might also see some impact due to the short term disruption and wealth erosion. This includes segments such as luxury cars & SUVs, gems & jewellery, and high value consumer durables and luxury brands. While increased usage of credit/debit cards & e-wallets will help the sector to some extent, overall business is expected to be impacted in the short term.

Long term impact

The unorganised segment of the retail sector, which carries out business operations largely in cash and is not equipped with debit or credit card machines, will see a slow but gradual transition to becoming more organised.

Hospitality

Short term impact

In the short term, smaller hotels and restaurants which accept mostly cash payments are expected to be hit. The travel & tourism sector will also receive the brunt of this move to a small extent, especially inconvenience to NRIs who might be carrying Indian currency for the upcoming wedding season. Footfalls in the restaurant industry have fallen, impacting businesses of hotels and restaurants which transact mainly in cash; however this is only a short term phenomenon.

Long term impact

Demonetisation is a big positive for the hotels & restaurants sector, as the shadow economy is expected to collapse, thereby bringing about a level playing field for the companies. Thus, demonetisation is expected to resolve the problems related to shadow funding, unaccounted cash transactions and tax evasions in this sector.

E-commerce

Short term impact

Demonetisation has had an impact on cash-on-delivery payment business of e-commerce firms, although this dip is only marginal and temporary.

Long term impact

Demonetisation is positive for e-commerce firms as many people would now shift to online transactions from cash-based transactions. With the rise in cashless transactions, consumers will prefer to route their demand through e-commerce companies instead of brick and mortar shops.

Education

Long term impact

Generation and circulation of unaccounted cash is widespread in the education sector in India, particularly in the private sector, by way of donations or capitation fees. The recent move is a step in the right direction in making education more affordable and bringing more transparency in the sector.

Jewellery

Short term impact

The demonetisation of high value currency notes will hit cash purchases of gold and jewellery in the short term.

Long term impact

On account of the ban on high denomination currency notes, gold is expected to emerge as a preferred alternative. Consequently, demand for gold will increase, thereby firming up prices in the mid to long term.

Consumer Durables

Short term impact

From a short to mid-term perspective, demand for high-ticket white goods such as television sets, refrigerators, washing machines etc is expected to be affected, given the curbs on cash withdrawals. More than tier I and tier II markets, sales of consumer durables are expected to be more severely impacted in the smaller cities and towns, since a significant proportion of sales in these markets takes places in cash.

Automobiles

Short term impact

While there will be no long term impact on demand for automobiles, in the short term, purchase decisions are likely to be postponed, particularly in the case of passenger cars and two wheelers, as consumers will face shortage of cash to make the down payment before purchasing the vehicle.

Besides, unorganised trade and services, transportation, financial markets, international transactions involving tax havens, and the informal services sector will witness significant pain in the near term.

Conclusion

While these measures would cause short term pain across the board, it is largely anticipated to have far reaching impact on the Indian economy in the mid to long term. In sync with the Digital India initiative, these measures would accelerate the move towards a cashless economy. Along with GST, this measure would improve tax compliance and fiscal balance of the Government. This will also help in bringing down inflation and corruption, eliminate fake currency and most importantly, send out a strong signal to the global investors. India could climb the rank of various indices published by international agencies i.e. Corruption Perceptions Index etc.

Dear All,

Only time can tell the actual impact Demonetisation will have on the economy and society, but I can confidently say that we are witnessing history in the making.

There is no denying the pain our fellow countrymen have faced bravely in this temporary upheaval. Until the new notes get widely circulated again, cash transactions will reduce drastically, creating a liquidity crunch in the distribution value chain. This might also lead to certain sections of the economy facing disruptions in facilitation of their transactions.

Conversely, from a credit providers perspective, as cash-based money-lenders shut shop, lack of adequate “cash” in market will lead to increase in the credit demand from formal sources. Digital lending platforms like ours will be the frontrunners in reaping the benefits but will have more responsibility as well due to this sudden disruption with informal sectors coming to almost nil. The inherent limitation of traditional financing sources like banks in assessing the creditworthiness of borrowers without adequate credit history and credit score will further strengthen our stand. Also, as more transactions go online, we will get richer data from our borrowers, and this will strengthen our credit systems.

Digital lending platforms would be the perfect avenue for the entire distribution and procurement value chain in India, offering speed, convenience and flexible terms. The composite cost of a Digital lending product is more competitive due to its pay-per-use interest rates, no disproportionately high collateral, flexibility and no undue harassment. Digital platform like ours will continue to set new standards in transparency and consumer friendliness.

I like the word re-monetisation instead of demonetisation. We are replacing our ways of dealing in currency notes with digital money transfers. Today for any corporate, the market size is limited by a very small section of population dealing in digital money. But now as digital money is adopted across sections of population, we will have a much larger addressable market.

I am confident that this report from Dun & Bradstreet will enhance your understanding of potential impact of demonetisation on the economy in general and your business sector in particular.

I wish all the readers a great future ahead.

Harshvardhan Lunia | Director at Lendingkart Finance Limited

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