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BANKING AND FINANCIAL SERVICES IN INDIAN ECONOMY - POST DEMONETIZATION

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Introduction

A month into India's demonetization initiative, long lines of people looking to Exchange notes still spew out of banks, some sectors of the economy continue struggling with the lack of readily available cash, grassroots businesses are still being revolutionized with electronic payment capabilities, and masses of people continue transitioning towards new ways of paying for basic goods and services.

On Nov. 8, 86% of India's currency was nullified in a great demonetization effort that aimed to clean out the black market's cash supply and counterfeit notes which completely disrupted the social, political, and economic spheres of the world's second largest emerging market. All 500 and 1,000 rupee notes were instantaneously voided, and a 50 day period ensued where the population could (ideally) redeem their canceled cash

for newly designed 500 and 2,000 rupee notes or deposit them into bank accounts.

"In certain parts of the country there used to be always an official amount and an unofficial amount for property," Nangia explained. "Now with this so-called black money going out of the window people are expecting that the price of real estate is going to fall, which is going to make it more affordable for honest, taxpaying people. It was previously estimated that 250 out of every million Indian bank notes were fakes. This recent culling of the bulk of the country's currency instantly rendered counterfeits as valuable as the paper they're printed on. It has also been reported that the new 500 and 2,000 rupee notes are less vulnerable to counterfeiting, having advanced security features — with one report claiming that it will be "impossible" for Pakistan (India's counterfeiting bogeyman) to fake them.

If a large amount of people and businesses are brought into the

bosom of the formal economy via the demonetization program, then India could be in for a boost in liquidity and an apparent increase in its recorded economic growth rate. Forbes contributor Naazneen Karmali stated that India's banks could "get turbocharged," as \$75 billion in old currency pours into the system in the form of new deposits.

If you are moving the informal economy into the formal economy and if the transactions which for years were never reported as part of GDP are now transacted through banking channels, it will only add to the GDP. However, this doesn't make anyone better off--we are after all already insisting that the economic activity was already taking place, and also insisting that we're just changing whether we count it or not. A digital economy is an economy which is tracked in real time. Each transaction is mapped. Every taxman likes numbers. It will certainly help expand the tax net. This potentially broad swath of people being push onto the economic grid also theoretically means more revenue for the government coffers.

India has done this before. In 1946, all 1,000 and 10,000 rupee notes were recalled. In

1978, 1,000, 5,000, and 10,000 rupee notes were demonetized. Indians queue up outside a bank to withdraw cash in Ahmadabad, India, Thursday, Dec. 1, 2016. Indian Prime Minister Narendra Modi, in his Nov. 8 televised address, announced demonetization of India's 500 and 1,000-rupee notes, which made up 86% of the country's currency. The government's sudden decision to withdraw large-denomination currency from circulation has caused enormous hardship to millions of people in the country's predominantly cash-based economy.

Financial exclusion imposes a very high cost on people. In India, 98 percent of people use non-banking channels such as hawala, and pay exorbitant costs to remit or receive money from their family members living in other regions. A survey of Indian migrant workers showed an average commission of 4.6 percent when transferring money through informal routes, whereas money transfers in a formal banking system come with little or no cost. Similarly, a meager 10 percent of Indian avail themselves of loans from banks. A person who is economically poor and does not have a bank account must access micro-finance – many times at

usuriously high rates of 50 percent or more – and store money in the form of cash, livestock, or jewelry. The value of cash withers with inflation, jewelry runs the risk of theft, and livestock is perishable.

All these factors adversely affect the flow of income, and hence impact consumption. A study involving households in Kenya found people using the MPESA service (a mobile banking service provided by Vodafone) are better equipped to absorb negative income shocks arising from poor health, crop failures, and job loss. Statistically comparable households not using the M-PESA service are likely to experience a six to ten percent reduction in consumption in response to similar income-related shocks.

This recent bout of demonetization was planned in secret by a small, tight-knit group led by Prime Minister Modi, and it overtook the country like a flash flood. This surprise was by design, as it was feared that if the black market caught wind of what the government was planning they would find ways to rapidly unload their illicit cash, and the initiative would flop on one of its initially-stated goals. Of course, this meant that the rest of Indian society was also

caught in the demonetization crossfire. Not even the banks — that would be required to do the heavy lifting on the ground — were in the loop. In the days following Modi's announcement, the banks didn't have enough of the newly designed banknotes on-hand to distribute in exchange for the canceled notes, and there simply wasn't an adequate supply of smaller denominations in circulation to run the cash economy. Far from being a 50 day transition, it is estimated that even if India's printing presses were to run 24/7 it would take upwards of four months to a year before the currency supply was adequately restored.

For a populous country like India, any future strategy for financial inclusion will call for technology to reach the bottom of the pyramid. To facilitate use of Internet and digital transactions, the government can consider forming a Digital Sevak Dal – a network of young people to educate and support the Indian public in cities and rural areas to transition to a cashless economy. The Student Police Cadet scheme in Kerala is an example where schoolchildren visit the homes of poor and the elderly and help with e-literacy and digital transactions.

Given the large number of unemployed, and that it requires minimal investment in education, the initiative can create major positive spin-offs.

Modi's demonetization initiative caused a sudden breakdown in India's commercial ecosystem. Trade across all facets of the economy was disrupted, and cash-centric sectors like agriculture, fishing, and the voluminous informal market were virtually shut down, with many businesses and livelihoods going under completely -- not to mention the economic impact of millions of people standing in line for hours to exchange or deposit canceled banknotes rather than working or doing business. The unbanked and informal economy is hard hit, The poor do not have the access to structural and cultural resources to adapt to shock doctrine economics. The poor were taken totally off guard and the banking infrastructure in the hinterland is rather limited. The tech class has poor exposure to critical social theory in order to understand the impact on the ground. There is an empathy deficit.

While, like in other sectors, this virtual shutdown of the black market is more than likely only temporary; there may be some

longer-lasting impacts. Cashless transaction systems have been encouraged across the board, which will not rid India of its massive shadow economy but may make it a little tougher to conduct business. India is a country that has over a billion people, and such a drastic event as the government suddenly telling people that their money no longer has any value could have sent the place into mass hysteria. Also, this initiative indicates that such wide-ranging, deep-striking governmental actions to combat what it sees as corruption could happen again.

Government reports from 47 cities in India indicate an overall 268% year-on-year increase in tax collection for November 2016, the month the demonetization campaign began. However, a good portion of this increase could be attributed to special schemes that were created for people to pay their past due taxes with canceled banknotes rather than a more integral improvement in tax collecting efficiency. Although there have been many incidents of protest, demonstrations, and occasional bouts of panic, relatively speaking, the bulk of Indians seem to have taken to this transition remarkably dutifully. Millions of people

have stood in long lines peacefully, enduring a rather irritating bureaucratic process that has disrupted their lives because many believe that it could be better for the country in the end.

The positive macro benefits of this move by the government:

This move by the government is likely to have long term benefits for the economy. The extinguishing of the major proportion of unaccounted currency would reduce from the liabilities of the government and would add to its finances. This can have very strong implication as the government would get money to spend without borrowing from the market. This would mean that while interest rates can be low, the government spending on large infrastructure (we assume that the government would use large proportion for infra spending) projects would kick start capex cycle and push economic growth higher in the medium term. The move is also likely to have a habit changing impact in the Indian populous and there could be increased belief of keeping cash in the banks rather than stashed at home and use formal banking channels for their spending needs.

With a large part of the cash moving through the banking channels, the banking sector is likely to be flush with funds in the near term and this would help them reduce cost of funds for such period. Also with more money being kept in the banking channel, some of these low cost deposits may be sticky and improve the medium to long term Current Account and Savings Account (CASA) ratio of the banks. Another element of the demonetization would be reduction in cash transactions in real estate. This is likely to reduce to real estate prices and make it affordable to some extent. This may be visible more in the rural belt, where many non-farming entities purchase fertile farmland, not for farming but for money parking purpose. The demonetization and consequent reduction in shadow economy would bring the demand for such farm lands down. This move is likely to lead to better tax compliance, raise the Tax to GDP ratio and improved tax collection. This could lead to lower borrowing and better fiscal management. Also with lower cash transactions in the near term, inflation may see downtrend in the near term. Also 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 and can improve consumption demand in the medium to long term.

However there could be near term challenges:

In the immediate term, the reduced ability of the unorganized sector to deal in cash would impact the demand. Consumption items which had large element of cash dealing involved may see lower demand. Real estate and allied sectors may see near term to medium term negative impact. This HDFC Bank Investment Advisory Group may also lead to corporate earnings getting impacted in Q3FY17, as a large part of the old currency gets extinguished and takes time for fresh money to come into circulation.

The impact of this move will be felt across sectors with differing intensities and across varied time zones:

Effect on parallel economy: Cash Economy to Witness Contraction

The currency of the aforementioned denominations constitutes around 86% of the total value of the currency in circulation. It is expected to remove black money from the economy as they will be blocked considering the holders will not be in a position to deposit the same in the banks, temporarily halt the circulation of large volumes of counterfeit currency and curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

Effect on GDP: Downward Bias to GDP Growth

The sudden decline in money supply and simultaneous increase in bank deposits is going to adversely impact consumption demand in the economy in the **short term**. This coupled with the adverse impact on real estate and informal sectors may lead to lowering of GDP growth.

The GDP formation could be impacted by this measure, with a reduction in the consumption demand. However, with the recent rise in festivals, demand is expected

to offset this fall in an overall impact. Moreover, this expected impact on GDP may not be significant as some of this demand will only be deferred and will re-enter the stream once the cash situation becomes normal.

Lower Money Supply has a Deflationary Effect:

With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to be reduced in the short run. Reduction in money supply can also have a deflationary effect in the economy. However, whether the impact of the reduced money supply will lead to deflation or contraction in demand or a mix of both will vary from sector to sector depending on the nature of goods & services. To the extent that black money (which is not counterfeit) does not re-enter the system, reserve money, and eventually, money supply will decrease permanently. However, gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up speed.

Impact on Bond Markets:

Surge in deposits will create more demand for government bonds and other high rated bonds in a situation of tepid demands for credit, leading to lower bond yields especially in the shorter end of the curve. At the same time, a reduction in leakages in systemic liquidity will reduce the scope for open market operation purchases in the coming days. We believe that the RBI will continue to sterilize excess liquidity from the banking system to keep the short term rates aligned with the policy rate.

Credit Impact across Sectors:

Impact of this policy measure will flow to the economy mainly through the Real Estate sector, which has strong linkages with sectors such as cement and steel and which will turn credit negative in the short-run. A significant impact in the short-run will be on the daily/weekly wage employment in the informal sector. The construction sector has one of the highest employment multipliers. The key segments of the economy where

cash transactions play a vital role are real estate, gold and the informal sectors, which may face near term contraction. With more money coming into the banking ambit, deposit growth is likely to improve and positively impact the savings rate. The medium- to long-term gains are likely to outweigh the short-term pains.

Effect on Banks:

As directed by the Government, the 500 and 1000 Rupee notes, which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Accounts of commercial banks. This, in turn, will enhance the liquidity position of the banks, which will be later utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there are expected to be withdrawals at the second stage.

Effect on Online Transactions and alternative modes of payment:

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increases in demand. This should eventually lead to strengthening of such systems and the infrastructures required.

Bank Deposit Rates to Soften:

We can expect a large amount of cash in circulation to be brought within the purview of the formal banking system by way of deposits. This is structurally positive for banks, as part of this cash gets deposited as current account and savings account (CASA) deposits, reducing banks dependence on higher cost borrowing. Deposit deployment remains a challenge in the short to medium term due to the current tepid demand for credit, subsequently pushing deposit rates lower.

NBFC's Asset Quality Faces Pressure:

We believe in the asset quality of Retail Asset Lenders, especially NBFC's which have developed expertise in the credit assessment of the informal segment and have built models around it to stay under pressure in the short term. Within NBFC's, asset quality of lenders with a large dependence on cash collection remain vulnerable in the short term. In the longer term the implications could be a risk profile shift for the NBFCs, as the stronger borrower profile could potentially migrate to banks. Across the medium term, the demand for real estate, especially in the secondary market i.e. Resale Transaction and Tier-II cities where the cash component, as a proportion of transaction is significant could face a slowdown. This trickle-down effect could encompass the entire real estate sector putting pressure on the demand itself.

This could adversely impact NBFC's & housing financiers with a large proportion of exposure Mortgage built with a self-employed customer profile.

We believe that Micro Finance Institutions and Small Finance Banks (SFB's) may not be significantly impacted in the long term, considering that the cash flows of the borrower segment are usually in the smaller denomination. However, there could be near

term disruptions in the collection cycles along with a spike in over dues, which could put their liquidity strengths and the disbursal cycles under pressure.

Payment Banks to Benefit:

Payment banks and others entities which are part of the transaction ecosystem are likely to be long term beneficiaries, as more and more cash finds its way into the formal banking channels. We believe the cumulative measures taken to reign in black money will improve banking habits, create financial and transactional history of the informal & cash dependent segments and could, over the long term, make them 'bankable'.

Investment in Financial Products:

Investors in the short term will now believe that Cash is not the safest asset and there is little point in hoarding it. This will shift them from physical asset to financial assets where returns are also higher

Impact on Consumption Sectors:**Agreement Cost of Real Estate May Rise:**

We expect that the real estate demand from end users is unlikely to be impacted, since a majority of them are backed by funding from bank loans. Demand from investors for real estate however may come down since in some cases, investors prefer cash transactions. If the proportion of earlier transactions in the real estate sector, which were allegedly done through partial cash payment, reduces, the registered prices for real estate will go up. We expect the supply of real estate in the secondary market, which is strongly rumored to have a large cash component involved, to suffer in the short term, which may in turn improve demand for residential real estate in the primary market.

In the medium term, the prices in this sector could regain on many fronts as developers rebalance their prices (probably charging more on cheque payment).

Demand for Gems and Jewellery to Decline:

We can expect the demand for gems and jewellery to decline in the next two to three quarters. This would result in a weakening in the credit profile of industry players due to the high working capital cycles and high operating leverage. The unorganized segment will be hit particularly hard, given the large proportion of unaccounted inventory and high proportion of cash sales. Over the medium-term the organized industry players will benefit at the cost of the unorganized players. Gold imports through the unofficial channels are likely to reduce. There will be no significant impact on jewellery exporters because it is mostly an organized market and sales are against invoices.

Liquidity crunch (short term effect):

Liquidity shock means people are not able to get sufficient volume of popular denomination especially Rs 500. This currency unit is the favorable denomination in daily life. It constituted to nearly 49% of the previous currency supply in terms of value. Higher the time required to resupply Rs 500 notes, higher will be the duration of

the liquidity crunch. Current reports indicate that all security printing presses can print only 2000 million units of RS 500 notes by the end of this year. Nearly 16000 mn Rs 500 notes were in circulation as on end March 2016. Some portion of this was filled by the new Rs 2000 notes. Towards end of March approximately 10000 mn units will be printed and replaced. All these indicate that currency crunch will be in our economy.

Impact on bank deposits and interest rate:

Deposit in the short term may rise, but in the long term, its effect will come down. The savings with the banks are actually liquid cash people stored. It is difficult to assume that such ready cash once stored in their hands will be put into savings for a long term. They saved this money into banks just to convert the old notes into new notes. These are not voluntary savings aimed to get interest. It will be converted into active liquidity by the savers when full-fledged new currency supply takes place. This means that new savings with banks is only transitory or short-term deposit. It may be encashed by the savers at the appropriate time. It is not necessary that demonetization

will produce big savings in the banking system in the medium term. Most of the savings are obtained by biggie public sector banks like the SBI. They may reduce interest rate in the short/medium term. But they can't follow it in the long term.

Impact on black money:

Only a small portion of black money is actually stored in the form of cash. Usually, black income is kept in the form of physical assets like gold, land, buildings etc. Hence the amount of black money countered by demonetization depends upon the amount of black money held in the form of cash and it will be smaller than expected. But more than anything else, demonetization has a big propaganda effect. People are now much convinced about the need to fight black income. Such a nationwide awareness and urge will encourage government to come out with even strong measures.

Impact on counterfeit currency:

The real impact will be on counterfeit/fake currency as its circulation will be checked after this exercise.

Demonetization as a cleaning exercise may produce several good things in the economy. At the same time, it creates unavoidable income and welfare losses to the poor sections of the society who gets income based on their daily work and those who doesn't have the digital transaction culture. Overall economic activities will be dampened in the short term. But the immeasurable benefits of having more transparency and reduced volume of black money activities can be pointed as long term benefits.

View:

From an equity market perspective, this move would be positive for sectors like Banking and Infrastructure in the medium to long term. This could be negative for sectors like Consumer Durables, Luxury items, Gems and Jewellery, Real Estate and allied sectors, in the near to medium term. This move can lead to improved tax compliance, better fiscal balance, lower inflation, lower corruption, complete elimination of fake currency and another stepping stone for sustained economic growth in the longer term.