FRANKLIN TEMPLETON INVESTMENTS

Demonetization – No Pain No Gain

November 2016

Summary

- **Our perspective**
- **Sector-wise impact**
- **Impact on key macroeconomic variables**
- **Striking black money – Impact**

Our perspective

- On November 8th, in a historic move, the Indian Prime Minister announced demonetization of high-denomination currency notes by withdrawing the legal tender of the existing notes of INR 500 and INR 1,000. This move is intended to tackle counterfeiting Indian banknotes, to effectively nullify black money hoarded in cash and curb funding of terrorism with fake notes.

- Overall, we believe that the demonetization exercise should help to ***accelerate financialisation of the Indian economy*** over medium to long term.

- This measure needs to be seen in context of other far reaching measures effected by the current Government, including Goods and Services Tax (GST) act, Aadhar, Jan Dhan Yojana, and Unified Payment Interface (UPI). All these measures put together should help in ***shifting significant portions of the informal economy (estimated at 40% of GDP by NIPFP) into the formal economy.***

- This could in turn improve productivity by reducing frictional inefficiencies and improve the Government's tax revenues led by significantly better financial trails over medium to long term. These measures would give ***more flexibility for the Government to manage fiscal deficit***, as also potentially enable a shift to lower interest rates in India.

- However, the demonetization measure is likely to be negative for growth in the very near term until the level of cash in circulation reverts to normalcy. A sudden withdrawal of INR 14 trillion of cash (9% of GDP) represents substantial monetary tightening, which could result in ***deflationary forces due to lower aggregate demand***.

- We believe that there exists a scope for a 50 bps policy rate cut (by the RBI) from current levels over next 1 year, which may be undertaken in order to offset the deflationary impact.

- Meanwhile, the flow of substantial cash holdings into bank deposits will mean that ***banking system will be flush with liquidity and CASA balances are expected to improve***. As credit demand is likely to be muted for next couple of quarters, there would be very limited opportunities for banks to lend these deposits. The possibility of this money ***being channelized towards government securities may lead to a bond rally***.

- We expect aggressive rate cuts by banks, thus helping RBI in achieving better monetary transmission. The ***lower interest rates, along with a return to normalcy for cash in circulation should set the stage for a stronger recovery in aggregate demand in FY18***.

Sector-wise impact

Sector	NEAR term impact	LONG term impact
Real Estate	Volumes could take a step down as black money leaves the system and this could have a second order impact on revenues across various companies. There can be near term pain given the dependence on cash and temporary block to cash flow.	The real estate regulatory bill coupled with demonetization is likely to reduce the gap in primary and secondary market transactions. As the sector reorganizes itself, it is likely to transform into corporatized and transparent asset class which could offer a sustainable growth path.
	Negative in Near Term, but Positive in Long Term	
Cement	Urban housing (15-20% of cement demand) and Rural housing (40-50% of cement demand) will bear the brunt of slowdown in real estate sector.	Government spending (15-20% of demand) has been the key driver in last 12 months and is likely to sustain. Government may choose to further accelerate the spend through special packages in order to offset near term weakness in the economy.
	Negative in Near Term, but Positive in Long Term	
Auto	Volume growth across segments could be affected in the next few months. Sales of motorcycles could slow down (since they are largely bought with cash). Sales of luxury cars and premium SUVs, along with the unorganized used car market could also decrease.	Organized players are likely to gain traction. Further, both the stakeholders -- consumers (buyer and seller) will see transparency in transactions.
	Negative in Near Term, but Positive in Long Term	
Consumption	Cash transactions account for a significant proportion of purchases in several categories. It is possibly highest in jewellery (60-70% for organized players and 90-100% for unorganized players), but fairly high in other segments as well (~70% in paints)	There could be a shift to organized players, a benefit expected from GST implementation as well. Organized players in FMCG categories with many regional and unbranded players like soaps, laundry, oils etc. are expected to benefit the most.
	Negative in Near Term, but Positive in Long Term	
Banks	With share of savings moving into banking channel, a rise in deposit base i.e. higher CASA (current accounts, savings accounts) should help to replace the high cost of borrowing and lower overall cost of funds	Banks with strong underwriting and/or strong retail franchise may see a positive impact from an improvement on the liability side and revival in loan growth.
	Positive in the Near Term as well as Long Term	
NBFCs	As collections in these asset classes are primarily through cash, they would be negatively impacted.	Local money lenders will see a serious challenge to the business. These businesses could see an accelerated shift to Small Finance Banks and MFIs.
	Negative in Near Term, but Positive in Long Term for select sub sectors	
Technology, Telecom, Energy and Healthcare	There might be some marginal impact on data growth (the discretionary component) but the case for this does not appear to be compelling.	
Industrials	They may not experience any material impact as payments in the sector are conducted through banking channels.	

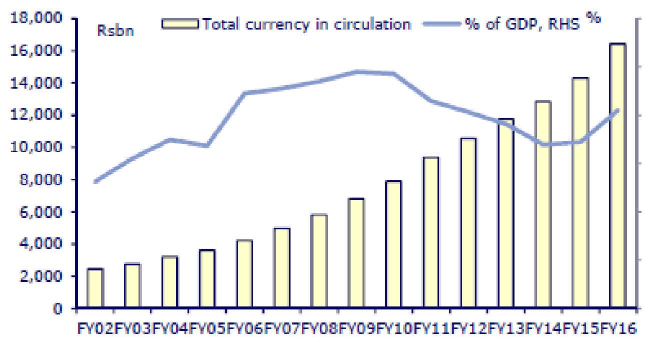
Impact on key macroeconomic variables

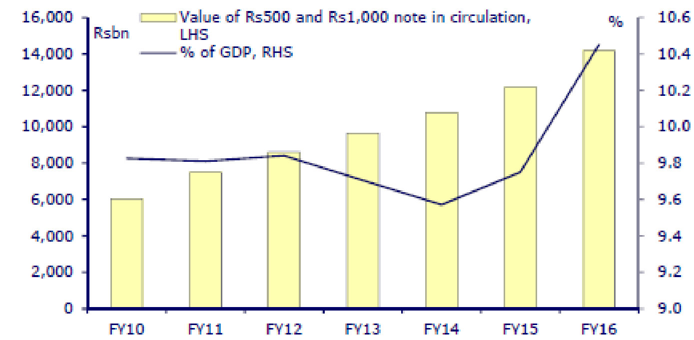
Variable	NEAR Term Impact	LONG Term Impact
Currency in circulation	INR 500 & INR 1000 notes constituted ~86% (INR 14.8 tn) of the total currency in circulation. A cap on withdrawal along with decrease in the usage of these notes will bring down currency in circulation.	Once new notes are amply available, the currency in circulation is likely to improve substantially.
	Negative in Near Term, but Neutral in Long Term	
Inflation	Given, the high share of cash transactions in rural India, the demand is likely to decrease. Lower demand could weigh negatively on prices. There could be a drop in the rural inflation.	Demand is likely to recuperate post government spending, which should have positive impact on employment and disposable income
	Positive in the Near Term, but Neutral in Long Term	
GDP	Consumption demand likely to decrease, with decline of currency in circulation. Moreover, there would be an adverse impact on informal sectors. As a result, there could be dip in 3QFY17 GDP.	There could be an increase in direct tax collections, which could pave way for increase in investment by the government.
	Negative in the Near Term, but Positive in Long Term	
Government finances	As a share of the unaccounted money makes its way into formal channel, the government could benefit from higher income tax collections. This should help government's FY17 fiscal deficit target, *especially post the shortfall in anticipated spectrum revenues.*	This could infuse a transition from unorganized to organized sector, which could thereby enhance the government's ability to tax commercial transactions. As a result, there is a likely structural improvement in tax to GDP ratio in Indian economy.
	Positive in the Near Term as well as Long Term	
Bond yields	Improvement in bank deposits is likely to lead to higher SLR (Statutory Liquid Ratio) demand. This could augur well for a fall in the government bond yields.	With expected improvement in tax buoyancy, supply of g-secs is likely to get more rationalized, putting downward pressure on yields.
	Positive in the Near Term as well as Long Term	

Striking black money - Impact

India has large number of currency notes in circulation

Trend in INR 500 and INR 1000 notes in circulation



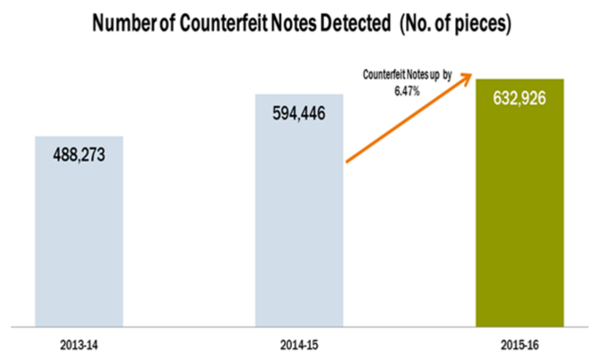


Source: CMIE, RBI, CLSA Strategy Outlook – November 2016

Currency leakage going up

- Net fresh issuance of currency notes have increased by 34% in FY15 and 46% in FY16. This raises a possibility of large currency leakages – money going out of the system (e.g. hoarding of black money or outside India, both are illegal).

Fake currency counterfeit notes have moved up



Source: Annual Report RBI.

- **Large currency demand unnatural, indicative of black money**
  - ✓ Alongside a sharp rise in electronic transactions, the currency demand has also increased substantially.
  - ✓ It appears that with increasing KYC norms, tax scrutiny, international and national surveillance of financial transactions, a substantial part of illegal/tax evaded money is being held as cash.
- **Impact on the RBI balance sheet**
  - ✓ The RBI's currency liability remains unchanged if all these notes are exchanged for legally valid currencies issued by the RBI.
  - ✓ In case some of these notes are not exchanged, then the RBI's currency liability goes down to that extent.
  - ✓ As the RBI has assets (mostly government bonds, forex assets and gold) against all currency liabilities, hence, when RBI's currency liability goes down without commensurate fall in assets, the excess would get added to the reserve in order to balance the asset and liability.
  - ✓ The RBI may eventually transfer the excess reserves to profit and loss account as income.