Impact of Demonetisation

The Indian economy is growing at the rate of 7.5% with a stable control in all its vital economic parameters. The inflation rate is stable at 5% since past one and half year and has projected good health in the economy. Historical data displays introduction of demonetization in highly distressed economies where in vital economic parameters had gone for a toss. Hence in case of the Indian economy it is very clear that demonetization is introduced not as a tool for dealing with economic distress as in case of economies which did so in the past on account of economic depression . It is true that India has 70% circulation and in this circulation there is a rampant presence of counterfeit notes which is eating up value creation. Demonetization will surely curb this issue of counterfeit notes but only if India becomes more digital in its payments and the currency issued is of smaller denomination which is upto Rs500. Introduction of Rs2000 rupee note has put the economy in a perplexed state as demonetization in real sense means decreasing the value on paper currency in circulation . The Rs1000 note has been deleted from the circulation and a Rs2000 note has been introduced which has questions to the underlying principle of demonetization. However, the Indian government is being vocal about using this tool to cleanse black money from the system and is being supported by legends both in economic and business. It is very noteworthy to learn from statistical data that there are two very peculiar issues in India which are acting as stunning counterparts to each other and they are , India has a rich poor divide of 41% and India has 20% share of world's billionaires . This observation indicates that if black money does exist in India it does not do so among the 60% of the population which comprises of the middle income group and the population residing in the rural India which is more or less living below the poverty line. It is very true that the present banking system is holding about 60% NPAs on its balance sheet and a sudden cash deposit drive such as this would prove instrumental in wiping out these NPAs to a certain extent. It is very much true that only 11% of the Indian Population contributes to tax revenue and remaining 30% still evades tax . However better strategies than demonetization would have worked wonders instead of putting to task already economically stressed population.

India desperately lacks digital infrastructure and has number of bottlenecks in promotion of use of cashless payments. A bank debit card does not come free on an account and there is a transaction tax on credit card amounting to 2% on master and visa credit cards. China UnionPay also known as UnionPay or by its abbreviation, CUP, is a Chinese financial services corporation headquartered in Shanghai, China. It provides bank card services and a major card scheme in mainland China. Founded on March 26, 2002, China UnionPay is an association for China's banking card industry, operating under the approval of the People's Bank of China (PBOC, central bank of China). It is also the only interbank network in China that links all the ATMs of all banks throughout the country. It is also an EFTPOS (Electronic Funds Transfer at Point of Sale) network. This service also has been instrumental in saving billion dollar revenue exit from China which happens in case of master and visa cards. India introduced the Rupay card on the lines of Union pay but it still has yet to take grip of the situation.

86% of money is held in cash in India in Rs 500 and Rs 1000 currency showing the dominance of cash in Indian economy. This 86% currency cannot be termed as black because nearly 90% transactions are cash based due to inadequate information and infrastructure for cashless transactions to happen. The rural banking connect is at present only 20% of the total bank branch network in urban and semi urban areas. Infact even today 60% of the MNREGA deliveries are made in cash due to inadequate rural banking infrastructure.

It has been observed that cash is distributed among electorate at time of elections by political parties which is nothing but black money as the source of income is unknown and untraceable , an exercise such as this coupled with the introduction of Rs 2000 currency note is nothing but a whip on the politicians rather than any economic distress signal which has been triggered to have this event in first place. The other reason given for having this event was the issue of counterfeit notes, however, one can ascertain the efficacy of this exercise only upon learning the exact amount of counterfeit notes recovered from this exercise.

Introduction of infrastructure such as provision of internet to the last penetrable rural division, enough supply of printed Rs500 notes , incentivisation on digital payments, withdrawal of charges on electronic cards, facilitation of AADHAR enabled pos and normal pos machines at a subsidized rate to retail traders would have curtailed the negative impact on the common man who was affected by this kind of surprise attack. Though these measures are seeping through their pace is too slow for aggressive consumption based economy. The Indian economy that had recovered to 7.5% from a 3 year lull of 5.55 with a larger rate of inflation after a lot of hard work was subjected to such a steep fall of 1-1.5% and in a place like India where recovery of economic parameters need long time.

Some of the effects of demonetization are, North/East/central India were more impacted than South/South-western parts of the country post the demonetisation move – also, rural regions were more affected than urban areas.

Similarly, the unorganised space was hit more than the organized segment and the discretionary sector suffered more than staples. Also, traders, retailers and wholesalers were affected more than the manufacturers. Nevertheless, despite hardships, we observed massive acceptance of the move from the 'bottom of the pyramid' population – Many felt that this move would help check corruption and black money. Moreover, we also observed wide acceptability/movement of transactions to formal banking channels – if properly directed, this may boost the Indian economy both structurally and on the fiscal front in the long term. While the sudden liquidity crunch did lead to disarray, the situation is expected to mend as currency gets replenished. However, undoubtedly, a few days into demonetisation, business activity has been hit significantly. Pre-dated sales (in the first week of Nov), acceptance of old currency notes by some traders and credit extension might initially offset the demonetisation impact somewhat, but it would be reflected Dec-16 onwards. Below are the key gleanings from our on-the-ground interactions.

2.The great regional divide: The regional divide was very clear – North India is witnessing the maximum impact on business activity, given that the region's economy is more cash based. On the other hand, the demonetization impact was relatively lower in South.

3.Urban-rural divide: Urban areas have seen quicker demand recovery versus rural regions. This has been led by better cash availability, increased acceptance of plastic money and formal banking channels for transactions. Recovery has been slower in tier 2/3 cities versus metros/tier 1 cities.

4.Essentials consumption – Recovering swiftly: We observed that essentials consumption has been the quickest category to pick up (down only 10-15% so far). Discretionary consumption (especially big-ticket items) is expected to take 3-6 months to recover. We believe the recovery order would be trade, manufacturing and construction in terms of economic activity. Consequently, sector-wise recovery order could be Essential Staples, Impulse Category Staples, Telecom, Petroleum Products, Consumer Durables, Autos, Cement, Home-improvement and Realty.

5.Organised players to gain market share: Given increased acceptability of plastic money, government's focus on digital cash and GST push, organised players should gain market share. This was visible post demonetisation as super markets and organised electrical product stores saw a mild rise in sales, while unorganised trade dried up.

6.Keenness to accept digital payments: We observed that acceptance of digital payment modes by traders was wide-spread. It varied from usage of Pay-TM by micro retailers, multi-fold increase in application for POS terminals by shops and increased activity on the UPI front.

Impact on key economic activities:

Agriculture: Vegetable prices have been hit the most given the perishable nature of produce and a bumper crop due to the early onset of winter. Wholesale vegetable prices were down 70-80% across India, while retail prices were down only 20-30%. Grain prices have been stable so far. o APMC activity in the North has been hit more given the higher cash component in trading. Wider acceptance of cheques/RTGS has lent support to western/southern APMC markets.
Rural areas are still facing cash crunch along with lower number of banks (at times one bank servicing five villages) – this has led to some productivity loss in farms.

Construction: Retail construction activity has been halted, while institutional construction is going on, albeit at a slower pace. Construction activity also has been impacted by sand/steel availability (majorly traded in cash; hence, a bottleneck).
Trading:
Dealers/stockists have seen an inventory build-up of 1.5-1.8x across sectors. A few companies have extended credit (HUL, GCPL etc.) and some have not (Asian Paints, ITC etc.). New orders have been muted.

Wholesalers, especially in North India, have seen an impact on trade, given higher cash component of transactions.

Cash retail sales have been impacted the most. Part of this demand has been postponed or destroyed and part has been fulfilled through the organised retail channel.

Manufacturing: We visited various manufacturing hubs across India and observed a sharp decline in activity in the unorganised sector. The unorganised sector is dependent more on cash (daily wage payments and supply chain transaction are cash based).

Sectoral impact:

Autos: Two-wheelers, tractors and CVs have seen the most pronounced impact (~40-50% dip) compared with passenger vehicles (20-30% decline). More delivery postponements have happened in rural/semi-urban areas given the high amount of cash used. We observed that Maruti's and Eicher's deliveries were the least impacted.
Cement: While retail cement demand has completely dried up, institutional demand is keeping it going. Overall demand is down ~20-25%, with a pronounced regional effect.
Consumption

o Staples – Staples have seen a quick recovery, with sales down only 10-15% of the original level. Essentials demand has recovered completely, while impulse purchase category is still seeing the impact.

o Discretionary – Durables sales in smaller towns/rural areas have been hit significantly. In metros, wedding season and financing options have lent some support to durables demand.

Home improvement: This segment has seen a sharp decline in sales ranging from 50-60% to 70-80% decline across categories (paints, tiles, window panes, sanitary-ware etc.).
Realty: Price correction is expected widely, especially in regions with lower ready reckoner rates. We
also observed a spike in pre-dated sales in Nov (which happened in old currency).

Telecom: Usage of old currency notes has lent some support to pre-paid recharges, thus negating some of the lost sales in mid-Nov. New activations are down 15-20%. Pre-paid recharges in rural areas have suffered more given the cash crunch.
Fleet traffic/Oil & Gas: Fleet movement has been impacted more in North/West/East/central India compared with the South given their cash dependence. Though acceptance of old notes helped boost sales in early-Nov, sales in petrol pumps are down in general and the impact would be clear only in Dec.
Impact on GDP: Overall, we have reduced our GDP growth estimate for H2FY17 to 6.4% from 7.8% earlier. The maximum impact will be seen in Q3FY17. The sectors that are likely to be hit the most are Construction, Trade, Electricity and Manufacturing. GDP growth for FY17 is expected to be lower by 60bps at 7% (7.6% earlier) and for FY18 to be lower by 20bps at 7.6% (7.8% earlier).

o Transactions approach, an alternative way to assess the impact on economy: We have attempted to analyse the impact of cash transactions on overall transactions growth to arrive at an impact on the economy. As per the analysis, we expect that transactions growth (22% till Oct-16) might fall to 16.1-19.4% for FY17.

India Strategy

The impact of such an enormous demonetisation exercise is difficult to determine (specifically, determining the duration of the 'near' term impact is difficult). We had recently increased weights for B2B, utilities, Oil & Gas and sectors that have businesses outside India. We had reduced our weightage on Financials and sectors facing the retail consumer (Autos, Consumer discretionary etc.). Our 'on-the ground study' reiterates the sectoral recommendation shift. We would like to emphasise that over the next six months, we will have more of a 'bottom up' approach to stock selection as the impact of demonetisation could vary. Meanwhile, we maintain our sector calls –

Our top picks are HDFC Bank, SBI, Tata Motors, HPCL, Adani Ports, Sun Pharma, Godrej Consumer, Aurobindo Pharma, Motherson Sumi, Infosys, Tech Mahindra, Power Grid, Adani Transmissions, UPL, EIL, Nava Bharat Ventures, TeamLease, PI Industries, Sintex, Kaveri Seeds and Suzlon. Our top sells are Nestle, Bajaj Auto, HMCL, Titan, BHEL, CCI, DLF and Gujarat Gas.