Significant structural benefits on the cards for India

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The government's stunning move late on Tuesday to demonetise Rs 500 and Rs 1,000 currency notes by replacing the former and discontinuing the latter – and announcing a new Rs 2,000 note -- will have a transitory impact on GDP growth in the short term, but will spell significant structural benefits over the long term.

The quantification of the transitory impact on GDP is difficult given there are only guesstimates on the size of the cash economy. But millions of small enterprises in the unorganised sector that use cash to transact will be inconvenienced for a while. Cash-dependent, consumption-led sectors will also feel the pinch, while investment demand will be tempered in the short term.

Over the long term, however, Tuesday's move could change the face of the Indian economy, improve the government's fiscal position and tax compliance. The size of the cash economy will shrink, as will black money generation avenues, because of better cash-flow trails.

Inflation would tread down as demand slows in the short term, but the impact over the long-term would be neutral.

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 $479 billion unaccounted for. Much of that money should get mainstreamed because of the demonetisation move.

The Macro Picture

Government revenues should see buoyancy in the medium-to-long term

The direct positive impact will be felt on government's tax revenue collections, its ability to spend on infrastructure investments and the resultant impact on growth. Inflation, we believe, will see some downward pressure in the short term because cash transactions will reduce. In the long run though, as government spending rises pushing up employment and incomes, demand will revive. Therefore, we expect the impact on inflation to be neutral in the medium-to-long term.

Tax to GDP ratio can improve materially

Income tax collections are expected to see a kick-up as funds earlier unaccounted for enter the banking system and eventually get taxed. The one-time impact on tax collections could be high. However, in the longer run, better tax compliance and some initial disincentive to hoard cash could push up direct tax collections in the medium term.

The government has already said declaration of unaccounted income because of demonetisation is liable to be taxed / penalised at a rate of 30 to 120% depending on the source. Already, the Income Declaration Scheme of the government which ended in September is expected to add close to Rs 300 billion to direct tax collections over fiscals 2017 and 2018.

Currently direct tax collections are just about 5.5% of GDP and about 50% of total tax collections, and this contribution is expected to rise going further. This will also help the government stick to its fiscal restraint path.

Public investments to rise and drive jobs and income

Over the last two years, fiscal savings on account of lower oil subsidies gave the government room for infrastructure spending. Higher direct tax collections will now allow the government to further increase such spending. This is critical given that private infrastructure investments remain weak. It will also have positive spillover effects on employment and income.

As investments drive up the supply capacity of the economy, overall GDP growth is expected to benefit in the long term. In the short-term, GDP growth may get impacted negatively as the cash based economy feels a crunch and consumption and investment moderates.

According to a 2013 report[1], value of cash transactions in India, as a percentage of total consumer payments was approximately 86% in 2012. This number might have come down in last few years led by some pick-up in electronic transactions, but at that level still is quite high.

Tax rates could edge lower

Higher income tax collections arising from better compliance would also offer scope to reduce income tax rates over the long term, which would increase disposable incomes. This can have a positive impact on consumption demand in the long term.

Downward pressure on inflation:

We expect lower demand to exert downward pressure on inflation in the coming few months. Categories such as housing, transport and food that tend to have a higher cash component could see downward price pressures in the coming months as demand is negatively affected. Also, rural areas which have a higher share of cash transactions could see a sharper dip in inflation compared with urban for most categories. That said, in the long run, as government spending rises pushing up employment and incomes, demand will revive. Therefore, we expect the impact on inflation to be neutral in the medium-to-long term.

Variables	Immediate impact	Medium-to-long term impact	Overall long-term impact
GDP	**Negative** Consumption and investment demand to see some dent as the cash based economy feels a crunch. Also, not all the black money may get declared and therefore the overall money available with people for cash based consumption demand would be lower.	**Net positive** Increased direct tax collections to create room for investment spending. Also, disposable income may go up in the long term, if government chooses to bring down income tax rates given that the tax base will widen. Higher disposable income to bode well for consumption. On the other hand some sectors of the economy (mainly those in construction) can get negatively impacted. It is also a worry because these sectors generate huge employment.	↑
Inflation	Downward pressure on prices due to lower demand, especially in rural areas and for sectors such as housing, transport and food where share of cash transactions is high. Sharper fall in rural inflation Vs urban is possible.	**Neutral** To have minimal impact in the long run, as demand will bounce back up with increased government spending and positive impact on employment and incomes.	↔
Liquidity	**Positive** Increased liquidity in the banking system led by higher deposits. Will help mitigate any short term liquidity concerns on account of FCNR redemption.	**Neutral** RBI's stance is to maintain neutral liquidity in the banking system. RBI will suck out any excess liquidity through open market operations.	↔
Currency in circulation	**Negative** As on 31 March, 2016, 500 and 1000 rupee notes constituted around 86% (Rs 14.8 trillion) of the total currency in circulation Short-term reduction in usage of these notes, along with	**Neutral** As new currency notes are introduced, currency in circulation is expected to revert to normal levels. However, if people are averse to holding cash and if there is a greater move towards accepted electronic	↔

[1] N Joseph, R Korenke, B D Mazzotta and B Chakravorti, 'Cash Outlook: India', IBGC Working Paper 13-01, The Institute For Business in the Global Context, The Fletcher School, Tufts University

Variables	Immediate impact	Medium-to-long term impact	Overall long-term impact
	imposition of withdrawal limits will lead to decrease in currency in circulation in the next few months.	payments in future, that can bring down the currency in circulation.	
10 year G-sec yields	**Positive** Improved liquidity in banking system to drive up demand for bonds and cause downward pressure on yields	**Positive** Improved fiscal position to reduce borrowing requirement and exert downward pressure on yields	↑
Fiscal deficit	**Neutral** To take time for tax officials to claim tax on the deposits made by people. The one-time impact on tax collections could be high. However, in the longer run, better tax compliance and some initial disincentive to hoard cash could push up direct tax collections in the medium term.	**Positive** Income tax collections expected to see a kick-up as funds earlier unaccounted for enter the banking system and eventually get taxed. About 23% of the economy estimated to be unaccounted for. Plus this involuntary declaration of income to invite 30 to 120% rate, depending on the source of income. Additional collections to help create room for infrastructure spending	↑
Current account deficit (CAD)	**Positive** Gold demand already dented due to policy restrictions. This step will additionally bring down gold import because demand is mostly driven by cash (about 80%).	**Negative** Pent up demand for gold may lead to higher imports. Also people might chose to hoard gold instead of cash. This can widen CAD.	↓
Digital payments	**Positive** Individuals substitute towards digital payments	**Positive** Because the unified payments interface (UPI) gains greater acceptance and a larger proportion of the population gets incorporated into the digital financial ecosystem	↑

Key: ↑= improvement, ↔ = Neutral, ↓ = Worsening

The Sectoral Picture

The liquidity squeeze caused by the demonetisation will be negative 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 activity.

Sectors with high proportion of cash transactions will see most severe disruption. We expect real estate, jewellery, retailing, restaurants/quick service restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space to face short-term turbulence.

For the cement sector in particular, the impact will be largely indirect with ~60% of it going into real estate.
While short-term liquidity issues will get sorted out over a period time, we expect a few sectors such as real estate, jewellery and high-end consumer goods to face medium-term headwinds in terms of slowdown in demand.

This move, along with introduction of GST will have a negative impact on small businesses across sectors and drive consolidation/market share gains for organised players.

Here's how we see the sectoral impact:

Sector	Impact	Remarks
Real estate	**Highly negative**	• Cities/ micro markets such as NCR with high investor demand to be severely impacted
		• Residential real estate demand to decline- more severely in micro markets with high share of unorganised developers (where practices of cash transactions were prevalent)
		• Developers will face serious fund crunch in the short to medium term, which will further delay ongoing projects.
		• Cities/ micro markets with high unsold inventories to witness fall in capital values

Sector	Impact	Remarks
		• Land prices to fall -- the magnitude will depend on multiple factors including investor concentration and share of unorganised players in the micro market
		• The demonetisation, along with the move to implement the Real Estate Regulatory Bill will improve transparency in the sector materially
		• While demand and capital values are likely to be under pressure in the medium term, the move will support industry's growth and end-users' confidence in the long term
		• Going ahead, developers are likely to consolidate. Internal practices within sector to become relatively transparent; this in turn will help attract more FDI funding in future
		• Combined impact of this announcements, Real Estate Regulatory Bill and continuous monitoring of circle rates/ ready reckoner rates by states will reduce the gap in prices in the primary and secondary market transactions
Jewellery retail	**Highly negative**	• Demand for gold is likely to pick up in the long term, but the industry is bound to feel the pinch in the near-term as around 80% of the gems & jewellery purchases in India are done on cash basis.
		• The move may sound the death knell for unorganised small jewellery retailers as they deal mostly in cash. These players will have to reorient their business models and infrastructure to accept more non-cash payments, but all players may not be able to do so.
		• Therefore, in the long-term, we foresee organised jewellery retailers benefitting from this structural change in the market.
Cement	**Negative**	• 60-65% of consumption is by the real estate sector, so near-term demand will be affected.
		• There will be pressure on already low prices.
Consumer durables	**Neutral**	• Demand growth for appliances would slow down in the short term as cash transactions account for ~70-75% of the overall sales of consumer durables.
		• Over the long term, its impact on the sector will be neutral as penetration for most durable items is still low in India and consumers would slowly adjust and move to other modes of payment.
Retailing	**Positive mostly**	• In the short-term, retailers may feel the pinch as consumers, particularly those who prefer to pay by cash, would face a squeeze of liquidity.
		• In the long-term though, the movement towards a cashless economy would be positive for organised retailers (both brick & mortar and e-tailers), as demand would gravitate towards them. Most small retailers do not currently have the infrastructure to deal with non-cash payments.
		• However, organised retailers dealing in luxury high-value goods may see a squeeze in demand in the long-term as well.
Steel	**Marginally negative**	• Since 30-35% of consumption emanates from real estate sector, near-term demand will be affected
		• There could be marginal pressure on long steel prices
Banks and NBFCs	**Neutral**	• From a liability perspective, banks would benefit as increased share of savings are likely to move into the banking channel. However, there will be asset quality pressures in the short term.
		• Digital wallet service providers (including wallet services provided by banks) and payment banks would be huge beneficiaries of this move, as more payments move through these channels. M-wallet transactions, in value terms, have increased 20-fold in the last 3 years ending fiscal 2016, and this move would give a further fillip to this nascent channel.
		• NBFCs, particularly those offering microfinance, gold loans, and used vehicle loans, would be negatively impacted in the short-term, as collections in these asset classes largely happen

Sector	Impact	Remarks
		through cash. However, these players are likely to reorient their business to deal with the new realities, and therefore the long-term impact may not be pronounced. Collections in retail NBFC sector are largely in cash, and may see some temporary difficulty due to limited availability of currency
		• Another asset class likely to witness pressure is loan against property (LAP). Delinquencies in this segment were already on the rise, and the likely fall in resale prices of property and elongation of time to liquidate a property would add to the woes of financiers' in this segment.
		• Consumer durables financiers could benefit as more consumers are likely to opt for it
Auto	**Marginally Negative**	• Demand for cars in the luxury, sedans and SUV segments is likely to be impacted the most.
		• Two-wheeler demand will be marginally impacted in the short term

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