



Investment note: Revisiting India's demonetization

On 8 November 2016, Prime Minister Narendra Modi banned Rupees 500 and Rupees 1,000 notes, sweeping away nearly 85 percent of the total currency in circulation. In this note, Manulife Asset Management's India Equities Specialist Rana Gupta provides an update on how he views the impact of the demonetization policy:

1. Demonetization as a positive long-term policy promoting economic inclusion, favourable to consumer staples companies
2. Expects interest rate cut by 25 to 50 basis points by April 2017, benefitting certain banks, consumer durables and autos

Update on India's demonetization policy



Photo: Prime Minister Narendra Modi banned Rupees 500 and Rupees 1,000 notes (shown in picture) on 8 November 2016.

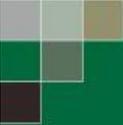
India Prime Minister Modi's surprise announcement to demonetize Rupees (Rs) 500 and Rs 1,000 currency notes caught the markets and Indian public off-guard. The policy, which was aimed at fighting corruption, introduced a new Rs. 2,000 note and Rs. 500 note to make it easier to track and difficult to forge¹.

After the policy's introduction and reaction of individuals and businesses, more information has been released that has led us to revisit some of the original analysis released in the earlier note.

For example, our latest estimate for the total amount of "cancelled" money² in the demonetization is roughly US\$ 20 billion instead of US\$60 billion to US\$90 billion. The government's revenue collection is likely to be supported by another policy (the second voluntary income disclosure scheme). Gupta expects the government will collect substantial revenues from this scheme, roughly amounting to US\$25 billion.

¹ Source: HDTV, hindustantimes, as of 12 November 2016.

² For this note, "cancelled" money is defined as: money which will not get deposited in to the banks as holders would not be able to explain source of funds.



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Efforts to put cash back into circulation have been slower-than-expected, negatively affecting the economy. The government can help boost the economy over the short-term through fiscal and monetary policies:

- Government direct transfers to poor families, using funds from the tax disclosure scheme, could help boost consumption; funds could also be used for infrastructure investment.
- We expect that the central bank will likely cut interest rates by 0.25% to 0.50% by April to provide additional support.

Overall, circulation of more currency and integration of informal businesses will help broaden the tax base and increase government revenue collection over the long-term.

Portfolio positioning

Financial inclusion and indirect tax reform leading to formalization of economy have been our key themes on the Indian market, and the recent demonetization in spite of short term negatives, has accelerated its pace.

Consumer staples to benefit from government's spending: Our key investment theme continues to be formalization of the informal business sector. If the informal sector fails to formalize, companies in the formal sector will gain market share and boost revenue growth. In either of these scenarios, we expect government revenue collection and spending to remain strong.

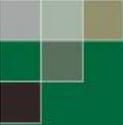
For sectors, we like consumer staples companies with products across price points and a wide distribution network to benefit from the government's spending on direct benefit transfers for families that belong to the bottom quartile (lowest 25%) of the income distribution.

Banks, consumer durables and autos would benefit from lower interest rate environment: We are also constructive on companies that will benefit from a lower interest rate environment. Rates are expected to head lower due to a number of factors: increased revenue from an expanded tax base, and increased savings as more informal sector businesses are integrated and inflation stays moderate.

Certain Banks should benefit from this dynamic, as their cost of funding is reduced. We also like consumer durables and autos as lower interest rates spur consumer demand for goods.

Conclusion

Overall, we see demonetization as a positive long-term policy to promote formalization in the Indian economy, including integrating the large informal commercial sector, which will have positive knock-on effects for government revenue and economic activity. Although there are risks with pursuing this policy, we believe the benefits outweigh the costs.



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