



India's Cash Crackdown

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The Indian people are reeling from a government-instigated curb on their cash economy, but what should investors make of the situation? Aninda Mitra, emerging market analyst at Standish Mellon Asset Management, discusses this topic.

AN INFORMAL ECONOMY

One factor that distinguishes India from other emerging market powers, such as China, is that a large portion of its economic activity takes place in cash and often under the table. India's currency in circulation represents 12% of the country's GDP, nearly twice the 7% average for all emerging market countries.¹ Despite the country's image abroad as a technology hub with a burgeoning middle class of consumers, much of India's population does not use banks and the "informal economy" generates around 45% of GDP and a whopping 80% of all jobs.²

A significant portion of this informal economy is untaxed activity conducted using cash. According to the World Bank, this illegal "black economy" accounts for roughly 23% of India's GDP and the campaign currently being waged by Prime

Minister Narendra Modi against this "black money" has attracted widespread attention from around the world.

The government's program to compel its citizens to exchange 86% of the cash in circulation for new bank notes and register themselves as potential taxpayers in the process is not just a huge political gamble for Modi, but, it also represents a profound monetary shock for what has been one of the brightest stars among emerging markets in recent years, and also shows the government's determination to make tough, market-friendly reforms.

Cash transactions ranging from shopping at mom-and-pop stores to purchases of luxury goods and real estate have dropped sharply amid the cash crackdown. India's long and creaky supply chains, including those connecting farmers to urban

¹*The Economic Times*: 'Going Cashless: Rising Currency-GDP Ratio Key Impediment,' November 27, 2016.

²*The Wire*: 'Modi's Demonetization Move May Have Permanently Damaged India's Informal Sector,' November 16, 2016.

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wholesalers, have also been hurt. As Mitra puts it, “It is clearly regressive in nature as it hurts the poor and smaller businesses who are more cash-dependent and has resulted in considerable hardship.”

SHOCK TACTICS

Mitra says India’s initiative to root out black money is certain to shock near-term growth and likely to bring about a patch of disinflation over the medium term. “We expect a sharp but short hit to activity in Q1 2017 and a fall in annual GDP growth in the fiscal year which ends March 31, 2017 to between 6% and 6.5% (down from around 7.5%). Over the medium term, around three-quarters out and beyond—alongside ongoing social and political stability—we are now becoming more constructive about the fiscal and growth implications from less “black money” and a significant increase in formal economic activity.”

A return to financial normality will take a few more weeks while old bank notes are exchanged for new ones, with the process likely to be completed by the end of January, says Mitra. Industrial production data is likely to remain weak through that time, but downside risks should also be somewhat offset by a jump in financial services activity, with all the

deposits and exchanges of old notes at bank branches.

THREAT OF DEFLATION

Of more immediate concern for investors, the bond market is pricing in disinflation for India, with 5-year and 10-year yields having dropped while most other sovereign emerging market (EM) yields have risen since the U.S. election. The swap market is pricing in nearly 50 basis points worth of rate cuts by the central bank in the year ahead even as markets elsewhere in Asia are pricing in monetary tightening, says Mitra. But the central bank belied these expectations by keeping its policy rate on hold at its December 7 meeting. In its press release, the bank highlighted India’s “sticky” core inflation and emphasized that the downturn in activity was only temporary.

The stock market has also come off noticeably, but it is not signaling a collapse. This underscores some of the medium-term optimism that this downturn is temporary.

Says Mitra, “The fiscal situation seems likely to improve with more individuals and businesses registered as taxpayers and a new goods and services tax due to kick in by mid-2017. But a sharply disinflationary environment, and near-term drop

in activity, will also lower near-term tax buoyancy. A broadening tax net encompassing more businesses could, however, have mixed consequences. In certain parts of the economy, with strong underlying demand, firms will simply pass on the higher tax burden by charging higher prices. In other areas, businesses could be forced to shed workers or find other ways of remaining cost-competitive. That makes it less clear how long some of these shocks will take to pass.”

Modi has run a huge political gamble with his campaign against cash. By adversely impacting smaller businesses, he has hurt a key constituency of his party, the Bharatiya Janata Party. But Modi wants to be seen as decisively moving against corruption, sharply contrasting his coalition with the Congress Party, which has endured a slew of corruption scandals involving government officials and coalition allies. For global investors, the benefit may lie in the reassurance provided by an essential emerging market nation demonstrating it can undertake difficult reforms to lower corruption, reduce rent-seeking and increase tax collection. That should amount to a cultural revolution, if not a great leap forward.

Main risks: Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. **Equities** are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees.

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