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INDIA ABOLISHES LARGE BANKNOTES TO CURB CORRUPTION

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SUMMARY

Measures to curb corruption by abolishing large currency banknotes will have a far-reaching effect on India's economy. On Tuesday, November 8, Prime Minister Narendra Modi announced that at the stroke of midnight, currency notes of Rs. 500 and Rs. 1,000 denominations would cease to be legal tender.

- The move aims to bring billions of dollars of wealth out of the shadow economy and into the formal part of the country's economy.
- It is also expected to put an end to terrorist financing, as militant groups have been known to use counterfeit Rs. 500 notes to fund their operations.
- Small and medium-sized businesses, and real estate transactions that use hard cash are expected be particularly negatively impacted in the short-term.
- Banks began to reopen on November 10 and the Reserve Bank of India (RBI) is issuing Rs. 500 and Rs. 2,000 notes.
- The measure may increase compliance of SMEs ahead of Goods and Services Tax (GST) implementation, leveraging GST to create an economic bump.
- It is expected to build on Jan Dhan Yojna / Financial Inclusion programs to bring informal sectors into the formal sector quickly and may have implications on labor costs in certain segments.
- Potential impact on campaign finance may be felt for upcoming elections, reducing the availability of undocumented contributions.
- The measure is expected to bolster increased adoption of online payments services and presents a growth opportunity for the country's electronic payments sector – mobile payments companies are seeing increases of over 500 percent in their mobile wallet balances.

A MAJOR STEP IN LINE WITH MODI'S REFORM AGENDA

When he came to power in 2014, Prime Minister Modi and his ruling Bharatiya Janata Party (BJP) made it very clear that it would curb the growth of the country's shadow economy. This was part of a whole host of policy measures that sought to create a vibrant common market and facilitate economic growth in India. The recently announced measure is in line with previous policy pronouncements and is a signal that the government will continue its economic reforms agenda in the coming months.

- **Declare and deposit cash into the banking system.** People will have until December 30 to deposit their Rs. 500 and Rs. 1,000 notes into bank and post office accounts. Depositors will also have to file a declaration disclosing their assets. The government has also said that deposits above Rs. 250,000 that do not match with income tax disclosures would attract taxes and a 200 percent penalty under Section 270(A) of the Income Tax Act. The value of these notes in circulation is approximately Rs. 14 lakh crores (US$ 210 billion).
- **Convert old currency notes into new denominations.** The RBI has started issuing new tender starting November 10 for Rs. 500 and Rs. 2,000 denomination notes. There will also be withdrawal limits on bank accounts that will restrict withdrawals to Rs. 10,000 per day and Rs. 20,000 per week. It is expected that the limits will be raised once the RBI gets more currency notes to bank branches. ATM withdrawals will also be restricted – starting at Rs. 2,000 per card and increased to Rs. 4,000 per card in the coming days.

This effort has been widely lauded by representatives from the RBI, banking institutions, and watchdogs seeking to curb corruption in the country. The Managing Director & CEO of ICICI Bank, Chanda Kochhar said that "this move will definitely bring about a whole amount of transition to no cash or low cash kind of transactions."

The decision to circulate new Rs. 2,000 notes, however, has attracted criticism as it undermines the government's efforts to increase the opportunity cost of conducting large cash-based transactions. The quick timeline of the conversion has also led to a petition in the country's Supreme Court. The petition termed the government's decision as "dictatorial" and argues that the government should provide a reasonable timeframe to avoid "large scale mayhem, life threating difficulties."

Long lines at banks, reduced economic activity for small and medium-sized businesses, and a decline in transactions in the gold, real estate, and consumer durable sectors are expected in the immediate term. This is due to two major reasons: Firstly, people must rush to get new notes and find a way to bring their unaccounted wealth into the formal economy. Secondly, a substantial part of the unaccounted wealth will be erased due to this measure. This is because the undeclared cash hoards must now be declared and accounted for, and every deposit over Rs. 250,000 is liable for tax payments and penalties if the depositor's income returns do not match the wealth being declared. As a result, large transactions in the above mentioned sectors will slow down in the coming weeks and months.

In the long-term, however, this measure is expected to bolster economic growth. This has potential to bring much of the country's shadow economy, which is estimated to be worth US$ 450 billion, into the formal sector and promote increased economic growth. The measures are also expected to provide an impetus to adopt digital and online payments. The government is seeking to achieve this goal by not restricting the size of payments made through checks, debit or credit cards, and electronic/online payments.

Digital and electronic payments sector to emerge as the winner

India's nascent digital payments sector, estimated to reach US$ 500 billion in annual transactions by 2020, will emerge as the clear winner. India's e-commerce sector currently relies on cash-on-delivery (COD) for over 60 percent of all transactions. As this reform reaches completion, COD payments are expected to shrink and consumers are expected to increasingly adopt digital payments services on their mobile phones.

Digital payments companies will see a rapid uptick in transactions volumes in the coming months.

With smartphone subscriptions set to cross the 700 million mark and e-commerce expected to reach US$ 80 billion by 2020, India's digital payments industry will form the backbone of the country's financial sector. As the GST is rolled out across the country, India should witness the formation of a modern digital economy. This has been a key vision of Mr. Modi's government and successive reform efforts have showcased his commitment to achieving this goal.

Early data suggests that the transformation is already taking hold. Paytm, one of the largest digital payments companies in India, saw its overall traffic increase by over 400 percent after the government's announcement. Transaction volumes increased by over 250 percent on the platform, and there was a 1,000 percent increase in the amount of money added to mobile wallets by users of the application. Snapdeal, one of the largest e-commerce companies in India, also saw a 1,200 percent increase in the average wallet balance on its Freecharge mobile payments platform. Mobikwik, another digital payments company, say its average wallet balances increase by over 700 percent.

Mobile payments companies were expecting transactions to total US$ 1 billion in 2017. Mobikwik's co-founder Upasana Taku said that following the government's announcement, transaction values could cross the US$ 10 billion in 2017.

As India's cash-based economy transitions to a formal banking system, payment companies will have to quickly build up capacity to handle the increased amount of transactions. Failure to provide a reliable and secure customer experience will risk in companies losing out on what could potentially be the largest transition to digital payments in the world.

Traditional banking services, including credit and debit card transactions, should also see a rise in transaction volume in the coming months. After coming to power, Mr. Modi announced the Jan Dhan Yojana program during his first independence day speech on August 15, 2014. The aim of the program was to ensure access to financial services at an affordable cost to the average citizen. The program has been successful across India and over 250 million new bank accounts have been opened under this program.

This program has seen increased adoption of banking services in India, particularly among rural communities. A major criticism of the plan was that a majority of the bank accounts opened were dormant – a World Bank-Gallup Global Findex Survey showed that about 43 percent of the total bank accounts in India are dormant. The ongoing effort will result in increased usage of these services as the opportunity cost of cash-based transactions rises. As the volume and value of transactions conducted through the formal banking system rises, banking institutions will see an improvement in their liquidity positions. The increased activity will also promote infrastructure investment in the banking system and accelerate the modernization and strengthening of India's banking industry.

While a net positive for financial services and digital payments, this measure does not mean that cash will become obsolete in India. Hundreds of millions of low-income consumers will continue to rely on cash-based transactions on a daily basis. Companies that provide goods and services will need a strategy to engage with and provide cash-based services to this demographic. In the long-run, however, the government's efforts will bear fruit and see the widespread use of modern financial services in India.

ASG's India and South Asia Practice has extensive experience helping clients navigate markets across the region. For questions or to arrange a follow-up conversation please contact Uzair Younus.
