SQUIRE PATTON BOGGS

The Impact of Demonetization in India

On 8 November 2016, India's Prime Minister Narendra Modi announced the Government of India's decision to cancel the legal tender character of ₹500 and ₹1,000 banknotes with effect from 9 November 2016. He also announced the issuance of new ₹500 and ₹2,000 banknotes in exchange for the old banknotes.

While the announcement essentially rendered the ₹500 and ₹1,000 banknotes invalid from 9 November 2016, the Ministry of Finance has been monitoring the implementation of these measures in a number of ways:

- Exchange of old currency notes for new ₹500 and ₹2,000 currency notes has been permitted until 31 December 2016 (i.e. 50 days from the date of the announcement)
- Such currency exchanges have been limited to certain specified amounts announced from time to time and excess amounts are required to be deposited with banks subject to applicable KYC requirements
- Cash withdrawals have been limited to ensure adequate supply of new currency notes
- Usage of old currency notes has been permitted for certain specified periods and purposes, such as at hospitals and pharmacies, gas stations and foreign currency exchange for tourists

The demonetization of the highest denomination currency notes is part of several measures undertaken by the government to address tax evasion, counterfeit currency and funding of illegal activities. The requirement to deposit currency notes in excess of specified limits directly into bank accounts has resulted in the declaration of hitherto unaccounted income, subject to higher tax and other penalties.

General Impact

These demonetization measures have had significant and immediate impact on the state of the Indian economy. These measures are also expected to result in long-term impact on certain industries and sectors.

These measures have resulted in a significant decrease in liquidity in the short term, which is expected to ease gradually with the introduction and circulation of the new currency notes. As a result of these measures and increased deposits with banks, the bank deposit base has increased significantly, and financial savings are expected to increase as a result of the shift from unproductive physical asset based savings to interest-bearing financial assets. This, in turn, is expected to enhance the liquidity position of banks, which can be leveraged for lending purposes.

An increase in the deposit base may also enable banks to lower the blended cost of funds as higher CASA (current accounts, savings accounts) deposits enable replacement of higher borrowing costs and decrease overall cost of funds.

With cash transactions impacted by a decrease in liquidity, alternative payment methods, such as e-wallets, online transactions using e-banking, debit and credit card usage have increased significantly. This will increase usage of such payment systems, and enable a shift towards an efficient cashless infrastructure.

Reduced liquidity has also caused a sharp decline in the availability of disposable income, affecting spending patterns and consumption trends in the economy in the short term. These trends, together with certain industry-specific issues discussed below, are expected to affect India's GDP growth rates adversely in the fiscal year ending March 31, 2017. While rating agency Fitch has projected a decrease in India's GDP growth by approximately 50 basis points, other projections peg India's GDP growth rate for fiscal years ending March 31, 2018 and 2019 lower by approximately 30 basis points. These forecasts indicate that an upgrade of India's credit ratings for the next two years remains unlikely, although India's current sovereign credit rating of 'BBB-' is expected to remain steady in the long term.

Impact on Key Sectors

Real Estate and Construction

The real estate sector in India has traditionally involved a significant level of informal funding in the form of cash transactions. As the demonetization measures are expected to result in decreased informal funding sources, the real estate sector is expected to be adversely affected. Cash transactions are most common in secondary sales, and resale transactions are expected to decline. While these measures are expected to in the long term promote transparent pricing in the real estate sector, decreased liquidity resulting from lower informal funding sources is expected to significantly weaken the demand for resale properties.

Luxury and high-end real estate transactions have also typically involved large cash transactions, with a significant proportion funded from informal sources, and not from banks and other financial institutions. Luxury property rates are therefore expected to decrease as a result of fewer purchasers with significant liquidity. These measures are expected to adversely affect investors in projects with insufficient audit and KYC funding procedures.

A decline in resale property rates is also expected to adversely affect real estate investors that intend to leverage existing real estate investments for investment in new projects. In turn, this is expected to affect the primary market as funding new projects become more challenging, and is also expected to affect industries related to the real estate, infrastructure and construction sectors, such as the steel and cement industries. The real estate market is however expected to stabilize with the increase in bank deposits, gradual stabilization in banking operations and resultant lower cost of funds.

Large institutionalized real estate developers are however not expected to be directly affected by such demonetization measures. Since infrastructure development projects are typically part funded by the government, these measures are not expected to impact such projects directly. However, the unorganized and middle tier real estate developers that in the past were predominantly dependent on cash funding are expected to increasingly rely on institutional investors for funding projects. These institutional investors may also be more inclined to invest in the real estate sector now compared to that in the past, with a more transparent pricing structure and anticipated stability in the medium and long term.

The long term impact of these demonetization measures on the real estate sector is expected to be positive, and complement other measures undertaken by the Government of India, including the introduction of the Real Estate (Regulation and Development) Act, 2016 (**RERDA**) and the implementation of the Benami Transactions (Prohibition) Act, 1988 (**BTPA**). The RERDA contemplates the establishment of the Real Estate Regulatory Authority (**RERA**) to regulate residential and commercial real estate transactions. It requires all real estate projects involving land exceeding a specified area to be registered with the RERA. In order to ensure appropriate application of earmarked project funds, it also requires developers to maintain a significant percentage of the project funds in a dedicated account. The BTPA prohibits property transactions, including transactions undertaken for and on account of a third party beneficiary funding such transaction, irrespective of complicity of the named owner; such transactions are now subject to criminal penalties as well, and the relevant property may be subject to confiscation.

Automobiles and Auto Ancillary

These demonetization measures are expected to impact cash transactions in the automobile industry in India, particularly for two-wheelers, used vehicles and other secondary automobile and auto ancillary industries. These measures may indirectly affect OEMs as well as potential automobile customers may find sale of older vehicles more challenging as a result of the reduced liquidity. In particular, these measures are expected to significantly affect rural and semi-urban regions, as well as tier 2 and tier 3 cities and towns that cater largely to the two-wheeler and used vehicle markets primarily driven by cash transactions.

While OEMs and auto component suppliers continue to monitor inventories, automobile dealers have focused on funding initiatives with banks and other financial institutions in order to offer schemes for cashless purchases and zero down payments. The short term impact of these initiatives on the automobile, auto ancillary and related industries, including banks and vehicle financial institutions focused on these markets, has been significant.

Although the comprehensive long term impact of these demonetization measures cannot be fully ascertained at this stage, the overall economy is expected to benefit from a decrease in unaccounted cash transactions and an elimination of counterfeit currency notes, leading to more effective tax collection and increased transparency in ascertaining transaction costs. An increase in transparency is also likely to improve attractiveness for foreign investors, while higher bank deposits and formalizing large hitherto unaccounted for income streams is expected to improve the fiscal deficit of India.

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