



## Matthews Asia Perspective

### India's massive demonetization: Is bitter always better?

India is introducing new 500 and 2,000 rupee bills with the aim of curbing so called “black money” (or cash not accounted for), counterfeit currency and corruption—all of which distort the real economy and fund certain illegitimate activities. While the move was surprising, the country's recent demonetization effort, which also renders its existing 500 and 1,000 rupee bills (worth about US\$7.50 and US\$15) illegal tender, may be helpful in bringing the parallel economy into the mainstream—at least for the time being. *Matthews Asia Portfolio Manager Sunil Asnani offers his views on the scheme.*

#### How chaotic has the environment in India been since this demonetization announcement?

Since the announcement, millions of Indians nationwide have lined up in front of banks and ATMs to try to exchange their old, and now worthless, currency for the newly issued banknotes. However, the banks have struggled to cope with these crowds, resulting in long queues and hours of waiting. Weekly limits have been in place as to the amount of money a person can exchange and withdraw, which is why the banks have distributed only a small fraction of the money collected. The currency operation also requires a recalibration of ATMs across the vast nation to allow them to disburse the new notes, which are said to be of a different size now. There is also an acute demand for lower denomination bills to enable effective exchange, since 2,000 rupee bills cannot be used for most small-ticket items or services. So, it has been fairly chaotic, and unless management of this transition becomes more efficient, it could be political suicide for Modi's government, and his agenda for clean governance might get cut short prematurely.

#### The demonetization of higher denomination bills itself is not unprecedented in India, but what's the difference this time?

Correct, the country did this in 1946 and in 1978, but this time, the level of demonetization is over 85% of the money in circulation, compared to less than 2% in those previous occasions.

#### What could be the short- and medium-term consequences of this move on India's economy?

In the short term, high-ticket consumer discretionary items—along with things like paying for wedding ceremonies and buying real estate (areas where black money is used extensively)—could see some reversal. At the same time, counterfeit currency could also be curbed, which is estimated to be about 250 rupees for every 1 million rupees in circulation. This move could also boost cashless transactions and allow for more efficient measurement of economic data. Some critics, however, do believe that the scheme might only change the currency of corruption from the existing banknotes to the new ones, and the big fish of corruption stash their illegitimate wealth in non-cash forms such as property, gold, and overseas bank accounts. The long-term consequences of this act really are not yet clear, especially because it's easier to store more black money in bills of higher denomination.

#### Can the pain of such an undertaking lead to some gains, such as a cashless economy?

On the surface, this might appear to be the case. As a precursor to this move, more than 250 million bank accounts were opened under a new scheme called Jandhan Yojna with no minimum balance requirements, along with Aadhar-linked (universal identification based on biometrics) debit cards, which should enable the poorest citizens to make transactions without cash. But if we dig deeper, one would realize that this is not a good enough enabler. For example, only 1 million or so merchants have point of sale (POS) machines that can accept cards, out of nearly 40 million merchants registered nationwide. Mobile banking and mobile payment solutions might partially make up for this deficiency. But in order for this to work, India would also need to overcome the limited literacy levels for almost half its population. A few mobile wallet vendors are seizing on this opportunity to sign up thousands of merchants daily, but that may not be enough to deal with this problem over the next couple of months. At 25,000 sign ups per day—a rate at which one

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leading vendor is signing up merchants—it would take many years to sign up all merchants. It is unlikely that India can seamlessly move to a cashless system any time soon, even if demonetization is a concrete step in that direction.

Only time will tell whether the current demonetization results in intended outcomes, but as of now, it has been more pain than gain, even without counting the loss of productivity to the system. It is quite possible that the country may face deflation in the short term unless a significant replacement of old notes happens soon, especially with bills of lower denomination.

**Given the circumstances, how long do you think it will be before things normalize?**

The short answer is a minimum of a few months. Currently, there are about 200,000 ATMs, of which only 120,000 are operational. The existing ATMs are only useful for withdrawing 100 rupee bills or other lower denomination bills (until they are recalibrated to accommodate the newly issued bills that are larger in size. This may take a few weeks). These existing ATMs are estimated to carry

cash of only 200,000 to 400,000 rupees per machine when fully loaded with lower denomination bills. Assuming a withdrawal limit of 2,000 rupees per person, one machine can serve about 100 to 200 people each time it is replenished, which happens once in two days for most machines. So, 50 to 100 people could be served per day per machine, totaling 6 to 12 million people served daily, compared with hundreds of millions of people that are lining up every day at these ATMs.

Using a similar analysis one can estimate that if the country has to add an equal number of 100 rupee bills to the circulation as it is today, it could take many months to do so. If the country had enough lower denomination bills, perhaps it wouldn't have been necessary for India's central bank to instruct banks to recirculate soiled 100 rupee bills. Given the printing capacity of India, it is estimated to take about four months to print the new 500 rupee bills, by which time the current chaos could become a serious public order situation.

The biggest question is whether we can assume there will be a safe and seamless supply of new notes, given the country's track record of execution and security.

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