ANTYA
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VITARKA

Markets, Investing, Economy & More

Modi's Gamble:
Brand India to Shell-Shocked India

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Emphasising Value
Empowering You

VITARKA[1] is a monthly publication of ANTYA Investments Inc.

[1] Reasoning, Argument, Opinion or Deliberation – From Sanskrit

Introduction

On November 08, 2016, at 8:00 PM in India, the Prime Minister of India Narendra Modi ("PM" or "PM Modi"), announced demonetisation of approximately 86% of India's currency. My initial reaction, in the wee hours of November 09, 2016, was that it was a hoax; like so much other fake news in cyberspace. Given that November 09, 2016, was also the much-anticipated U.S. election, I promptly forgot all about it. Later that night while following the U.S. election, I saw a New York Times story on the unfolding chaos in India. Then it dawned on me, that India, Zimbabwe, and the erstwhile U.S.S.R. had become comrades.

Nonetheless, I decided to prioritise the President-Elect, given that ANTYA's investors are likely to be impacted first and foremost by what happens south of the border. India comprises a small part of our investors' portfolios, via exposure to emerging market high-yield debt ETFs, or through emerging market equity ETFs.

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PM Modi, cabinet colleagues, policy makers and the Reserve Bank of India ("RBI") say that demonetisation of 86% of India's currency in circulation by value will:

1. Confront and marginalise the existing shadow economy of India; and
2. Eliminate fake currency from India.

There is no dependable figure for India's shadow economy. An IMF working paper titled, Shadow Economies Around the World: Size, Causes, and Consequences published in 2000, estimated the size of India's shadow economy at 22.4% of GDP. More recently Bloomberg estimated the shadow economy at US$780 billion, or

40% of the GDP[1]. "Black economy now accounts to 75% of GDP", reads another headline dated August 4, 2014, from the reputed national newspaper, The Hindu. Clearly depending on your source and methodology, estimates of India's shadow economy vary between 20%-75% of GDP. Nonetheless, there is no doubt that a shadow economy does exist, and that it is substantial.

Like many other countries of the world, there is also some fake currency in India. Canada faced a similar problem with its older $100 bills, that were ultimately replaced without much ado. However, unless the figures reported by the Reserve Bank of India in its 2015 Annual Report are understated, fake currency in India is not the menace that would cause the people of India to question the legitimacy of the physical stock in circulation. Figure 1 presents data from RBI.

Figure 1: Currency in India – Real vs. Fake

	(In Billions)	(In Billions USD)		
Currency Denomination	Notes in circulation	Value in circulation	% of Total	Fake currency (Bn. USD)
Less than 500	**68.24**	**33**	**14%**	**N.M.**
500	**15.70**	**117**	**48%**	**0.000204**
1,000	**6.32**	**94**	**39%**	**0.001958**
Total	**90.26**	**245**	**100%**	**0.002162**

Source: ANTYA Investments Inc., RBI Annual Report 2015-2016, 1USD = INR 67

Clearly based on column 5, demonetising 86% of the country's monetary base, to get rid of an insignificant proportion of fake currency in circulation is a miscalculation of staggering proportions. Now, the RBI does say that data provided in the annual report exclude fake currency seizures undertaken by India's law-enforcement agencies. However, it seems unrealistic to

[1] Jaitley Hails India's Tax-Free, Job-Rich Informal Economy – Bloomberg.com, November 03. 2015

argue that those seizures would make much of a difference to column 5 in Figure 1.

Therefore, it must be the shadow economy that the PM Modi intends to target.

What are the reasons behind the existence of a massive shadow economy?

Since 1947, successive Indian parliaments and supporting bureaucrats, have weakened Indian institutional and governance infrastructure to benefit those in power and their cronies. One doesn't need to write a treatise on this subject since it is an accepted truth within the country and outside. Every year countless scams involving businessmen, bureaucrats and politicians are uncovered, make headlines, and then fade from public discourse.

A weak governance structure, ethically compromised elected officials, a disgraceful nexus between law-enforcement, immoral corporations and individuals in positions of power that silences critics via antiquated imperialistic laws, form a backdrop to this quagmire. PM Modi said as much on his visit to Canada when he said: "India was known as scam India" and he wanted it to be known as "skilled India[2]" [Paraphrased]. Finally, an uneducated electorate misled by rhetoric, and unable to come to terms with facts, completes an unflattering portrayal of a country in denial[3].

Thus, some believe that a "shock and awe" approach will solve India's problems. PM Modi has taken the first of what is likely to be many steps in that direction because there can be no going back now. Demonetisation might destroy ill-gotten hoards of the stock of existing currency to a certain extent.

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[2] Crowd who packed arena to see Indian PM Modi were not disappointed – The Globe and Mail, April 15,2015

[3] 1.25 billion people call India home. Approximately 825 million are expected to benefit from the National Food Safety Act which provides targeted food distribution to prevent hunger and malnourishment.

Demonetisation does not, and will not, solve the root cause of India's malaise – a lack of responsibility, accountability and ethical character in the elector and the elected. No diktat can change that.

A nation founded on the principles of Satayameva Jayate (Truth alone triumphs), is bedeviled with chicanery at every turn. That makes PM Modi's decision even more perplexing, and the ensuing chaos easily predictable. The question is will it be manageable or will it turn ugly?

Where does the shadow economy exist and find sanctuary?

The shadow economy of India exists everywhere. From the bazaars of India's vast heartland to the executive offices of Cuffe Parade in Mumbai. The seat of the government in New Delhi has also come under its grip in the past (The 2G spectrum scam involving telecommunication spectrum allocation is a well-known incident from previous Prime Minister Manmohan Singh's government). It finds sanctuary in real estate, in gold, in luxury cars, in foreign vacations, and in a vast network of educational institutions run by members of the bureaucratic, political and industrial elite.

To use allegory, India's shadow economy is a hydra-headed monster that shares traits with Ravana , and the Indian population is hoping that PM Modi will slay this demon.

Sectoral Impact of Demonetisation

Gold

India is among the largest importers and consumers of gold in the world. The current liquidity crunch is likely to do two things. It could create forced selling of gold in the marketplace, as individuals try to meet current obligations because any cash hoard is now worth a lot less, given tax consequences and/or exchange costs and delays. Therefore, in our view, gold prices will decline worldwide as gold demand in India drops significantly in 2017. Bullish gold investors must deal with not only rising rates but also with falling global demand. Indian jewellery and investment demand will decline.

We believe, global gold investors should stay on the sidelines. Due to these sudden developments in India, gold could decline to below US$ 1,100 or thereabouts. Indian jewellery demand has averaged 600 tonnes of gold per year since 2010.

Real Estate & Hospitality

Indian real estate sector is up against it in 2017. Most developers are dependent on public sector banks for survival. With demand in luxury real-estate expected to decline, project delays and/or failures are likely to take place across India. Public sector banks, which depend on land as collateral for loans, will find the value of that security decline precipitously. Thus, non-performing loans in the construction sector will rise, eroding the benefits of the liquidity bonanza the that banks are dealing with currently.

India's hospitality sector (5-star hotels, restaurants) is a favoured hunting ground for gains that accrue from the shadow economy. The prospects for that sector don't look too bright in 2017. As per the RBI, construction, trade, hotels, transport and communications accounted for 27% of gross value added in India's economy in FY16.

Banks

Indian banks are likely to see rising non-performing assets across the entire spectrum of the loan book because liquidity that enabled commercial transactions in the shadow economy has been wiped out overnight. Therefore, many small and medium size business could default, or find it difficult to service debts. Moreover, the banking sector will experience a decline in net interest margins since interest costs associated with an overnight increase in existing deposit base are being accrued, but avenues to deploy these funds right away do not exist.

In other words, costs have risen while there is no clear line of sight to revenue growth. After the U.S. financial crisis, the recapitalised U.S. banking system hoarded cash and used the Federal

Reserve to build equity, through various means. Indian banks could similarly use the RBI to rebuild capital after years of non-performing loans, defeating PM Modi's agenda to kick-start growth after demonetisation. It is a catch-22 situation in Indian banking.

In our view, demonetisation may have helped the Indian banking system from going bankrupt. FY16 suspension of dividends by 16 public sector banks is another indicator of financial duress at Indian public sector banks. Expect Indian banks to muddle through over the next two or three years.

Domestic Consumption

India is a domestic consumption powerhouse (a plutonomy of the shadow economy participants), with private consumption expenditures comprising 55.4% of GDP for FY16 ended March 31, 2016. With domestic demand crimped due to a lack of liquidity, compounded by a sudden loss of wealth, inventories will balloon throughout the Indian economy affecting global supply chains for electronic goods, autos, computers, peripherals, luxury watches, jewellery and wine.

Moreover, if consumption demand falls 10%-20% from current levels, it will contribute to a 5.5% - 11% decline in GDP[4]. In FY16, as per the RBI, capital investment and inventory restocking comprised 33% of GDP. Falling consumer demand will dampen investment growth as well, causing additional strain on GDP growth.

Inflation Picture Becomes Murky

With economic activity, especially in the transport sector coming to a standstill, food shortages could occur in some parts of the economy causing food price inflation. Thus, in the short term, essential commodities are likely to witness price increases, especially in urban areas, because most rural areas are self-sufficient. Therefore, India will likely witness dichotomous inflationary trends between rural and urban India, and between

[4] Assuming 30% of private final consumption demand is discretionary and 80% of its comes from the shadow economy it would imply a fall of 13.2% in GDP (55%*30%*80% = 13.2%).

the industrial economy and primary consumption economy related to food and necessities. It will take some time for inflation data to normalise.

In the medium term, i.e. within six months, we expect deflation to take hold.

Growth Trajectory Has Changed Overnight

In ANTYA's view, India's economic trajectory changed overnight at a time when President-Elect Trump has already roiled global bond markets. With deflation/low inflation expected in India, RBI will likely lower rates to induce growth. With India's sovereign bond yield spreads expected to compress over U.S. treasuries, the inflow of foreign portfolio capital into India's domestic bond market will also suffer.

While declining gold and other consumer imports will lower India's current account deficit from a manageable 1.1% of GDP for FY16, to perhaps even a surplus in FY18, a slowing and/or contracting economy could raise India's gross fiscal deficit for the central government beyond the budgeted 3.9% for FY17 and FY18.

A contracting economy accompanied with or without a current account surplus will pressure the Indian rupee, which is likely to depreciate up to 10% towards the end of 2017.

It's a big Gambit

To sum up, India is now at crossroads. Demonetisation is expected to deliver multiple unforeseen benefits in the future, accompanied by unmanageable complications today. A contracting economy will clash headlong with a growing workforce. On the other side of the current hardship, the citizenry will expect better governance, more foresight and a plethora of opportunities. Overnight India has become a high-stakes gamble for the world economy.

With many Canadian pension funds making a beeline for India and investing significant capital for higher prospective returns, the risks have risen manifold. It will be interesting to hear the views of, Fairfax India Holdings, one of the few pure-play India companies on the S&P/TSX when they report.

In 2017, ANTYA expects the Indian economy to contract, corporate profits to decline, and BSE Sensex to correct upwards of 20% over the next twelve months. Combine that with a depreciating currency, a global risk-off environment, rising global bond yields, and it swiftly forms the perfect backdrop for global portfolio capital to exit India.

The Indian electorate, the elected, and the policy makers, find themselves in a quandary. Unless India follows-up rapidly with more institutional reform and manages the fallout of this decision judiciously, PM Modi's gambit will be remembered more for its impudence than its prescience.

A concerned global audience is earnestly watching.

For India's sake, it is our sincere wish that PM Modi succeeds.

Our Vision

Investing That Empowers You

Our Mission

Simplicity and Transparency

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