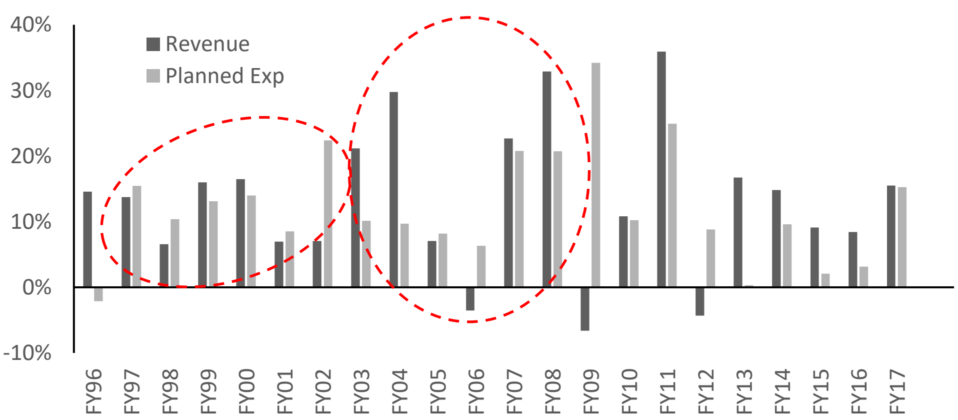
Rome Was Not Built In A Day **November 2016**

Demonetisation has created a huge stir in a country that was already polarized between ideologies rather than economic agenda. Opinions have been divided, based more on one's ideology supporting the Prime Minister or against him, rather than on the merits or demerits of economic policies that he has been implementing over the last two and a half years. A lot has been said about the recent ban on currency notes – from the timing of the announcement to the effectiveness of its execution – with little attention being paid to the medium-to-long-term implications of these actions. When faced with a lot of noise, investors would be better-off in taking a step back and assessing the situation from a bird's eye perspective - akin to finding a high ground when lost in the woods. Let us, therefore, delve into history to understand the relevance of this action and then, the short term and medium to long term implications of these actions.

During the last decade or so, the Indian Government ran a fiscal policy which was not only expansionary in nature but also allocated a large amount of monies to non-planned expenditure. These allocations went towards salaries (6th pay commission), subsidies (higher Minimum Support Prices, Food Stock Build up, MGNREGA) and other non-developmental schemes. This led to huge amounts of monies being syphoned off and led to very high inflation. Large amounts of projects related to the infrastructure were bid out with natural resources being given at huge discounts to private companies which led to a credit binge and over leveraging of corporate balance sheets. Crony capitalism also led to unviable projects being funded in this period.

Even during the boom years of FY2004-FY2008 the then GOI did not take advantage of revenue buoyancy to invest monies into planned expenditure but rather frittered it away on populist and vote bank policies.

Figure 1: Growth in Revenue and Planned Expenditure of the Government (FY96-FY17)

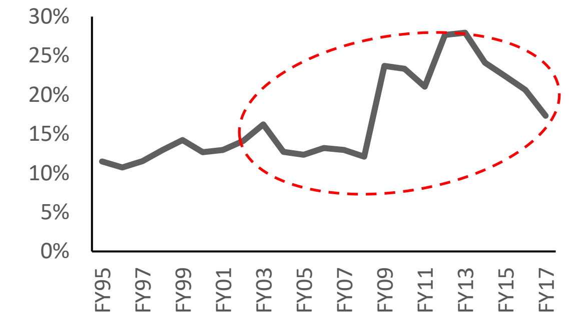


While the growth in planned expenditure was close to the growth in the revenue in the initial years, the gap between the two widened significantly after 2002.

Source: GoI, Tamohara

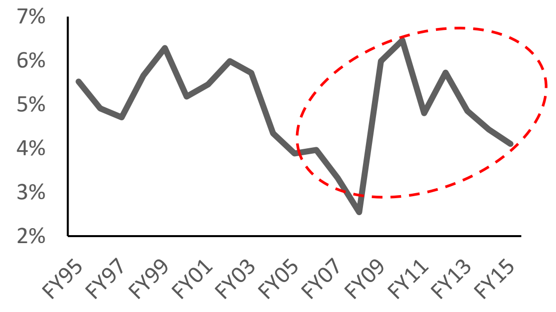
This was further accentuated between 2009-2014 with total policy paralysis resulting in a period of high fiscal deficit, almost zero employment generation, and last but not the least, a huge consumption demand destruction as both inflation and currency depreciation reduced the purchasing power of the average individual drastically.

Figure 2: Subsidies as a percentage of revenue (FY95-FY15)



Source: GoI, Tamohara

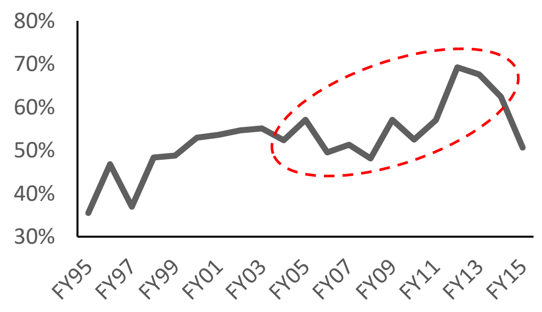
Figure 3: Fiscal Deficit as a percentage of GDP (FY95-FY15)



Source: GoI, Tamohara

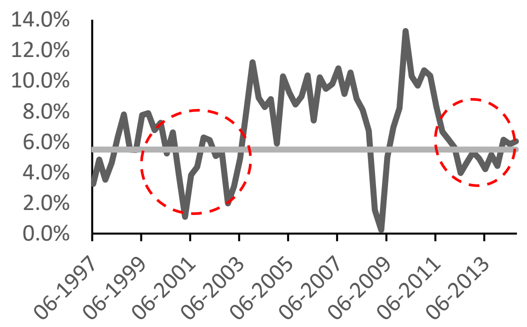
As a result of the above, over the last decade or so, the percentage of physical savings to financial savings moved up by ~10% of total savings (from approx. 55% to 65% of total savings), leading to huge shortfall in financial savings too. The average individual moved to physical savings to hedge against inflation. Further, all the black money generated (independent studies estimate that the social schemes of the government during this period had a leakage of 40%-75%) led to a huge informal and black economy, where the illegitimate income saw its way into tax havens of real estate and gold, driving their prices further up. Consequently, more money chased these assets, taking down both our financial savings and capital formation rates, eventually leading to anaemic GDP growth. Tellingly, during FY11-FY14, we had 8 consecutive quarters of sub 5.5% real GDP growth, which has not happened since 1991 - even during 1998-2003 when there were 4 bad monsoons.

Figure 4: Physical Savings as a percentage of total household (FY95-FY15)



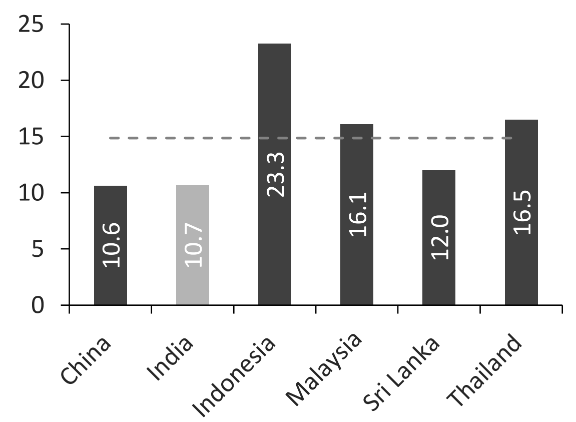
Source: GoI, Tamohara

Figure 5: Quarterly GDP growth (Jun 1996 – Sep 2014)



Source: GoI, Tamohara

Figure 6: Tax/GDP (%; Central) of various Asian Countries



Source: World Bank, Tamohara

India has continued to be plagued with low tax compliance at the central tax collection level of around 10.7% compared to over 15% for countries like Indonesia, Malaysia and Thailand. Even cumulative state and centre tax collections at 19.5% of GDP for India is lower compared to peers who are between 25%-40% of GDP, putting a break on the potential GDP growth that the economy can achieve. In the light of this background, the GOI has targeted to implement 4 long term reforms. 1)Increase Tax/GDP by increasing the size of the formal economy and getting more tax compliance which could be deployed for better hard and soft infrastructure in the country. 2) Reducing subsidies to GDP, by seeding the country with Aadhar Cards (now almost 1bn, most of the adults have a card) for KYC purposes, Jan Dhan Accounts, so that Direct Benefit transfers can be achieved. 3) Make in India: - as almost 30,000 people are joining the work force every day, creating a requirement of almost 10 mn jobs every year. 4) Skill development, education, and health infrastructure to drive productivity gains. The government has been implementing several policies and legislations to create a long term sustainable path for economic development in India.

Demonetisation may be a painful first step. There may be arguments that a fraction of the black money is hoarded in the form of cash. However, this does 2 things: (a) It makes people more compliant to tax laws as they fear that the government may enact many more policies to capture this black wealth; (b) more importantly it will also encourage many individuals and businesses to move to digital money as the cost of technology to do these transactions are very low and easy to implement. We expect the formal economy to grow leaps and bound in the medium to long term.

We also expect a lot of other initiatives to be announced along with the demonetisation move to reduce the problem of black money and at the same time reward the citizens who are tax complaint.

In a few words, what would be the demerits and merits of demonization? The short-term impact would be the hardships for people and business' who have been dependent on cash transactions and have nothing to do with black money, but will take time to adjust to a more formal and digital platform, and must wait for the circulation of the currency to return in the economy. This will impact incomes for individuals and profits for business' as there will be a deferment. We expect this to impact business profits by 12-18 months before they normalise. On the other hand, Savings that were outside the banking system, which were not being used productively, are coming back for investment or growth. Thus, in the medium term as inflation and interest rates fall, and in the longer term the direct benefits of a larger formal economy, higher tax compliance and targeted subsidies play out, we will see a large indirect benefit of higher financial savings, higher GDP growth, more spend on soft and hard infrastructure and last but not the least higher job creation which will drive higher and sustainable GDP growth. This will have a very positive impact on corporate profits and we believe that this will put India on a global map as a destination for investments - both direct (FDI) and portfolio (FPI).

We believe that demonetisation is a landmark reform and only time will tell when the benefits will play out. We are using the high noise, polarised opinions and the ensuing sell off in the Indian equity markets to participate into high quality businesses which are available today at reasonable valuations. Economic transitions can be a slow and painful process in the short term. Investors who have the capacity to endure short term pain will reap the gains in the long term. *Rome, after all, was not built in a day.*

Until next month,
On Behalf of Team Tamohara,
Sudhanshu Asthana

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