Prime Minister Modi’s politically risky push to tamp down India’s outsized underground economy by pulling the largest rupee bills out of circulation is causing real disruption among consumers and businesses. Consumer spending is sure to take a near-term hit that will undercut economic growth in the months ahead. But the short-term pain could bring significant long-term gain if the plan’s so far shaky execution is ultimately successful.

Major structural reforms rarely go off without a hitch. Prime Minister Narendra Modi’s surprise November 8 move to bring India’s “black money” economy onto the books by replacing the largest currency bills in circulation is clearly no exception. The stakes are huge, politically for Modi and economically for India.

The estimates on the size of India’s underground economy range anywhere from 20% to 45% of formal gross domestic product, and comprise the vast majority of the country’s labor force. The reason,
of course, is that not all India’s shadow transactions are illicit. Much legitimate business takes place on a cash basis due in no small measure to India’s regulatory swamp and onerous tax regime. Hence, Modi’s motive in forcing Indians to exchange big bills for new, more secure legal tender, along with greater use of electronic payments and checks, doesn’t just involve whipping the rug out from under corrupt businessmen and politicians, not to mention crime syndicates running counterfeiting rings. It also aims to improve paltry tax collection in a country that has run chronic fiscal deficits, which the government is pegging at 3.5% in the current financial year, and public debt amounting to around 67% of GDP, which is rather high by emerging market standards.

“India remains very much a cash-driven economy, which allows large portions of the population to operate with cash, and consequently to underreport income,” notes Thornburg’s Pablo Echavarria. “I think it is unequivocally positive for India’s long-term development, and I really admire Modi for carrying through with this reform.”

Short-term, though, Echavarria notes few positives. The plan’s critics, including sundry politicians from various parties that have traditionally engaged in patronage otherwise known as vote buying, have some legitimate points. Execution of the demonetization of 1,000 and 500 rupee bills, forcing their exchange for new 500 and 2,000 rupee bills with improved security features, has been marred by poor preparation: insufficient availability of the new bills; too little supply of smaller-denominated bills; and ATMs that weren’t calibrated to handle the new notes. India’s media have been full of images, video and stories of people waiting hours to exchange old bills, some unsuccessfully, as well as of services denied, including medical, due to either rejection of the old bills or the lack of small bills needed to transact.

The scale of the illiquidity and near-term dislocation is hard to measure. But it’s clearly significant: According to CLSA, the old notes represent nearly 87% of total banknotes by value, and 24% by volume. Cash in circulation is roughly equivalent to 12% of GDP. So near-term consumer spending has been badly hit, and CLSA expects the related drag on fiscal year GDP to amount to 0.5% to 1%. “This temporary hit could have been avoided,” CLSA’s Rajeev Malik wrote in a note. “This is essentially the cost of poor execution…rather than an outcome of demonetization, as is being misconstrued by many.”

Since the November 8 announcement through Monday, November 21, the country’s benchmark Sensex stock index lost more than 6%, bringing the year-to-date return to a negative 1.3%. Many investors had been banking on corporate profit growth thanks to a strong monsoon season after two years of drought. But the cash crunch and hit to demand have changed the near-term outlook. To cushion its impact on the financial system, the Reserve Bank of India on Monday announced that banks can give borrowers an additional 60 days to make housing, car, farm and other loan repayments, and so don’t have to recognize the delayed payments as non-performing for the two-month period, providing asset quality relief, especially to the non-bank financial companies.

Economists generally expect the disruptions to get ironed out over the next few quarters, though the impact on real estate-related businesses and gold and jewelry dealers will last longer, as they have been prime conduits by which to launder money, Echavarria warns.
In the meantime, the Modi administration will look forward to netting a higher proportion of undocumented wealth, and the cash that isn’t exchanged can ultimately be shipped by the central bank via an accounting maneuver to the central government. The windfall—which could amount to tens of billions of dollars—might be used as a welfare stipend or to help recapitalize public sector banks. The PSUs, as they’re known, are laden with non-performing assets, which have held down loan growth and retarded financing for a long-awaited upturn in the corporate investment cycle.

In any event, India’s public and private sector banks are now enjoying a huge increase in their deposit base, reducing their cost of funding, which should translate into lower lending rates. It has also contributed to a near collapse in Indian government bond yields as banks deploy the deposits. The fall in the Indian government 10-year yield comes amid the spike in the U.S. 10-year Treasury yield since the November 8 election of Donald Trump to the White House, and the heavy pressure that the steepening U.S. yield curve is exerting on nearly all emerging market bonds outside of India. (Figure 1)

**FIGURE 1: U.S., INDIA 10-YEAR GOVERNMENT BOND YIELDS**

Source: FactSet

The political risk for Modi will come if the cash illiquidity doesn’t disappear soon. That could hurt his Bharatiya Janata party’s (BJP) prospects in Uttar Pradesh, India’s most populous state, which is holding elections next spring and is crucial to his 2019 reelection prospects. If the cash problems are resolved in short order and bank lending picks up steam, the BJP’s electoral odds will improve, in Uttar Pradesh and other state elections slated for 2017. Pradeep Mathur, a senior official of the opposition Congress Party in Uttar Pradesh, complained that the demonetization is forcing his party “to hold smaller rallies” and give out “fewer ‘freebies’ for voters,” New Delhi Television reported.

The economic opportunity that demonetization represents can be compounded if the expected increase
in tax revenues is coupled with a tax reform that includes lower rates and less complexity. Modi has already demonstrated a willingness to pursue hard reforms with the demonetization and a pending goods and services tax overhaul that should greatly facilitate inter-state commerce once implementation comes toward the middle of 2017. Continued deregulation could also ensure that India’s economy, already the fastest growing among the world’s largest, continues to expand at both a robust and sustainable rate.

Lower and simplified corporate taxes, a decline in compliance costs and greater flexibility in the country’s product, services and labor markets would certainly boost corporate operating margins, supporting faster earnings growth. That would leave the latest compression in stock multiples an attractive entry point for long-term investors.

Once the dust from demonetization settles, Modi should keep up the good work.

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