At a time when those living in the UK are desperately searching for one of a handful of Jane Austen commemorative £5 notes worth more than £50,000, the Indian population are desperately trying to deposit notes of an equivalent value with banks before they become worthless.

On November 8th Narendra Modi, the Indian Prime Minister, gave just four hours' notice that his government were withdrawing all 500 rupee and 1000 rupee notes (worth around £6 and £12) from circulation and that anyone in possession of one of the redundant notes had until the end of this year to deposit them into their bank account or exchange them for a newly issued 2000 rupee note. This had a much greater impact than the ECB withdrawing the €500 note earlier this year because these two banknote denominations account for circa 86% of the India's cash in circulation!

Why did Modi introduce this seemingly crazy policy?

As Chief Minister of the State of Gujarat, between 2001-14, Modi introduced several reforms focused on improving general living standards through reducing corruption and red tape for businesses. On the bigger stage, as Prime Minister, Modi has continued in a similar vein, announcing and implementing several far-reaching reforms. Yet, given that 98% of transactions by volume and 68% of transactions by value are conducted in cash, this demonetisation policy is by far and away the most dramatic monetary change to date.

Why has it been implemented? Two key reasons. Firstly the government stated that the massive demonetisation was an effort to stop counterfeiting of the current banknotes, which are allegedly used for funding terrorism. Secondly, introduction of the new notes is an attempt to crack down on the enormous black-market economy in a country where just 5.5% of Indian earners pay income tax!

These are no doubt the major factors for the policy implementation but the cause and impact should be viewed in the wider context of the other reforms aimed at disrupting the black-market economy, as listed below:

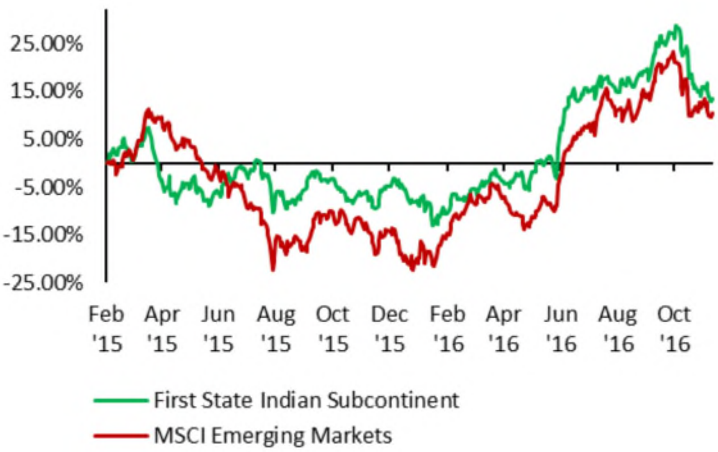
- Introduction of a **Unified national tax on Goods and Services** - Indian businesses have historically found it difficult to expand beyond their home state because of a fragmented tax system and poor infrastructure. A single goods and sales tax alongside demonetisation should mean they can do so with significantly greater ease.

- Introduction of a scheme to ensure that all families have a **bank account**. In the past two years, over 220 million bank accounts have been opened, many of which have only been activated in the past four weeks because of the withdrawal of the two major banknotes.

- Modi's government also reformed the **Bankruptcy and Insolvency code**, capping the time for insolvency resolution for individuals and companies to 180 days. This simplifies the process for many businesses and should, with the aid of demonetisation, further enhance business confidence.

There has been mixed reaction to the decision, with former prime minister and Congress leader Manmohan Singh suggesting that demonetisation was "organised loot and legalised plunder" that could see India's growth dip by two percentage points. The Opposition parties called for nationwide protests which initially garnered some support but are now more sporadic, suggesting that confidence in the success of Modi's economic reforms over the medium term remains high. There are several state elections in 2017 and these will act as a good gauge as to whether, in contrast to Western elections, the public are happy with the status quo.

Market Impact of the policy decision



Since last March when we wrote about the positive outlook that a newly elected Modi had ushered in, the First State India fund that we started to invest into has enjoyed a period of sustained outperformance relative to the broad MSCI emerging markets index.

This latest policy has however led to a degree of weakness in the Indian stock market. This can be partly attributed to the sheer scale of the upheaval in India but also partly due to the effect of Trump's victory on emerging economies as a whole, with fears that his protectionist policies will impact on emerging market growth.

Prior to the demonetisation's implementation there was a widely-held view that India's GDP growth would reach 8% in 2017. Indeed, the latest growth figures released showed that the economy grew 7.3% in the quarter July-Sept, the fastest globally of any economy of an equivalent size.

Since the policy announcement economists have, however, started to scale back their growth forecasts to a range of 3.5% to 7% in 2017, the main catalyst for this being a dramatic slowdown in consumer spending brought about by demonetisation. Only about 25% of the currency that was cancelled is back in circulation and retailers have highlighted that a scarcity of other lower denomination notes has led to reduced sales.

Does the Indian growth story remain intact?

The surprise policy decision will almost certainly have had a negative impact on the short-term growth figures, possibly reducing growth by as much as 2%; however, positive fundamentals such as the demographics, infrastructure enhancements, diversification of the economy and strong political leadership all still point to a continuation of the positive growth trajectory.

If over the longer-term demonetisation is successful in raising income tax receipts, the multiplier effect of increased government spending should, it is hoped, offset a large degree of the short-term concerns.

A good example of where this has already been seen is in relation to the Indian Railways programme. Approximately £20 billion has been promised over the longer term to the railways, with one of the objectives being to increase the average speed of trains by five km per year every year for five years. With 23 million passengers daily (2% of the population) this type of efficiency improvement has been shown to have a 5x multiplier effect on the larger economy. Another area which has also benefitted directly from these reforms is digital payments.

Despite these positive signs perhaps of greatest importance over the next twelve months for the longer-term growth trajectory of the Indian economy will be the results of the state elections in 2017. Strong support for Modi's party will be a sign that large proportions of the population are (or believe that they are) benefitting from the reforms irrespective of how dramatic they are.

What the Indian government's positive and aggressive range of economic reforms shows is that they have the mettle to make real, meaningful changes to kick-start and bolster India's economic growth prospects. Good enough reasons to support Indian equities in 2017, we believe.