End Use Sectors Hit Hard Due to Induced Cash Crunch

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Key Insight

Much of the impact from the sudden cancellation of the two largest bank notes in India has and will, in the short-term, impact smaller and fragmented cash-driven industries.

In the steel sheet products market, independent cold rollers and galvanisers have been the hardest hit, with key end users (such as real estate, automotive and consumer durables) tapering down purchases to manage rising unsold inventory. Nonetheless, we expect this impact to last no more than six months.

What Happened : India Cancelled Legal Tender of Two Largest Bank Notes

On 8th November 2016, the sudden announcement by the Indian government to demonetise INR500 ($7.50) and INR1,000 ($15) notes in circulation, though welcomed by people across the country, has left many in the lurch. The move is intended to crack down on corruption and so-called "black money" or illegal cash holdings. It is expected that the policy will have a transitory negative impact on the broader economy of India in the short term, though it is likely to have significant structural benefits over the long-run. For the country's steel market, the move has brought about a sharp liquidity crisis for small traders and secondary steel producers (i.e. those operating small induction furnaces using sponge iron and scrap to produce crude steel, which is then supplied to captive and merchant re-rollers). Many of these market participants have reportedly even fully or partially curtailed operations owing to the severe cash crunch.

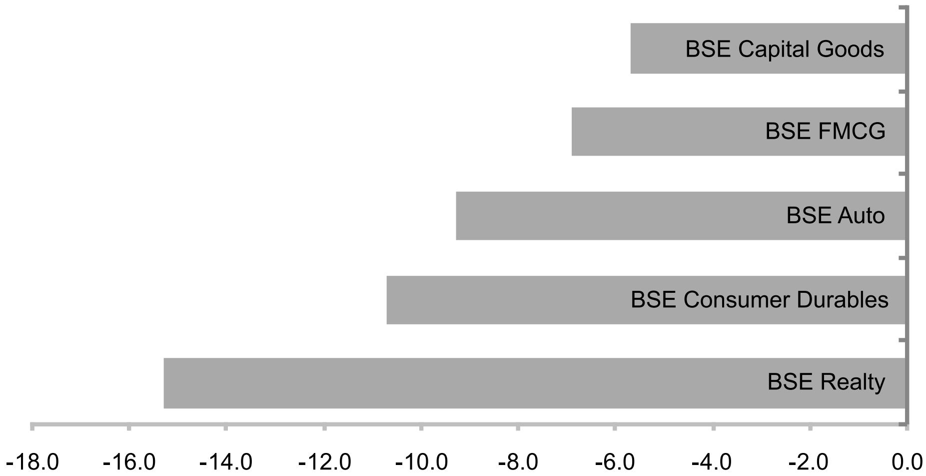
Demonetisation : Broader Economic Implications

The Indian Govt's demonetisation, or rather a currency swap, policy which involves phasing out the INR500 and INR1,000 bank notes and replacing these with new INR500 and INR2,000 bank notes, is a significant effort and a logistical nightmare, considering that these bank notes form approximately 86% of cash being circulated in India. These two highest denomination bank notes ceased to be legal tender from midnight on 8th November 2016, following a related national address by the Indian prime minister. What followed was a series of measures announced by the government to implement this transition, including limits on cash withdrawals and currency swapping from banks and ATMs. These limits/restrictions are very likely to weigh on economic activity in the short-term. Consumer spending in cash-based sectors is likely to suffer the most, until the cash flow is normalised. Sectors like real estate, where black money transactions are more prevalent, may feel the pain for longer.

Offsetting this will be a positive impact on the policy front. The easing of inflationary pressures will open up a window for further rate cuts, if needed. Additionally, a wider tax base in the future may allow the government to step up spending, even while

Real estate, consumer durables and auto were the hardest hit

Fall in BSE* sectoral indices during 8 Nov-29 Dec (%)



Data: CRU,BSE.

*Bombay Stock Exchange

adhering to fiscal consolidation. The medium to long term view is that the economy will converge toward its trend, since a currency swap is simply a transfer of economic activity from the "black economy" (i.e. unaccounted sector) to the non-black sector, as activity previously unaccounted for will now be reflected statistically. Thus, even if future GDP figures are larger, it does not necessarily mean there is additional economic activity to further drive the engine (i.e. the actual size of the economy is unchanged, just the reported size changes).

Nonetheless, this has several important implications for economic aggregates, given the increasing importance of "organised" GDP in defining a country's position in the world order.

Domestically, it will benefit India's tax collections and improve the tax-to-GDP ratio, which is one of the lowest in the region. It will also enable better monetary policy transmission and implementation of government policies. Therefore, while the total size of the economy is unchanged, it does make a difference that a larger portion is now accountable.

Impact on the Steel Market : Cash-heavy Retail Sales to be Impacted, Project Sales To Remain Largely Guarded

Broadly speaking, the demonetisation policy (and resulting restrictions on withdrawal/swapping of currency from banks) has impacted all businesses that have high exposure to cash-based transactions. In the Indian steel market particularly, CRU understands that purchases and sales by large steelmakers are mostly on a real time gross settlement (RTGS) basis, meaning transactions are usually cashless in nature. This means the impact on larger steelmakers has mostly to do with demand slowdown from cash-exposed end-use sectors such as real estate (mostly residential), consumer durables and automobiles (mostly two-wheelers) and a broader slowdown in rural demand (a market segment where cash-based transactions are dominant). An analysis of stock market performance of these sectors during 8th November- 29th December 2016 (see chart as follows) clearly highlights the impact of demonetisation on sales as well as investor confidence.

Meanwhile, smaller secondary steel producers (small EAF and IF-based steelmakers with or without integrated rolling mills), independent re-rollers and coated steel producers are dealing with their own set of challenges. These players have much higher exposure to cash transactions for both purchases and sales compared to their larger counterparts as they mostly operate in the spot / unorganised market for smaller lots.

Since the demonetisation announcement, transactions of this nature have drastically reduced because of prevailing cash crunch and production curtailment by key end users in the consumer durables and residential real estate sector. Subsequently, these non-integrated producers are short of cash for their raw material purchases, be it ferrous scrap or HR coils, as well as payment to casual labour (which forms a considerable part of their labour force) thereby leaving them no choice than to temporarily shut their operations until market normalises.

Nevertheless, as highlighted above, we believe the impact will be short-term in nature, lasting for no more than 4-6 months by which time cash flows are expected to normalise. By this time, many market participants may opt to increase the proportion of cashless transactions in their businesses.