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Demonetization and Its Impact on Banking Sector- Issues and Challenges

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ABSTRACT

The move by the government to demonetize Rs.500 and Rs.1000 notes by replacing them with new Rs.500 and Rs.2000 notes has taken the country with surprise. The move by the government is to tackle the menace of black money, corruption, terror funding and fake currency. The proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially squeezed since there are limits placed on the amount that individuals can withdraw. The move by the government is to tackle the menace of black money, corruption, terror funding and fake currency. The government is likely to have long term benefits for the economy by this action. The extinguishing of the major proportion of unaccounted currency would reduce from the liabilities of the government and would add to its finances. This can have very strong implication as the government would get money to spend without borrowing from the market. There could be increased belief of keeping cash in the banks rather than stashed at home and use formal banking channels for their spending needs. With a large part of the cash moving through the banking channels, the banking sector is likely to be flush with funds in the near term and this would help them reduce cost of funds for such period. This paper explains the impact of demonetization on the Banking sector and various issues and challenges it is facing. .

KEY WORDS: *Demonetization, Banking sector, Issues, Challenges.*

1. Introduction

The government has implemented a major change in the economic environment by demonetizing the high value currency notes – of Rs 500 and Rs 1000 denomination with effect from the midnight of 8th of November 2016. People have been given up to December 30, 2016 to exchange the notes held by them.

This proposal by the government involves the elimination of these existing notes from circulation and a gradual replacement with a new set of notes. In the short term, it is intended that the cash in circulation would be substantially taken since there are limits placed on the amount that individuals can withdraw. In the months to come, this squeeze may be relaxed somewhat.

The reasons given for demonetization are two-fold:

1. To control counterfeit notes that could be contributing to terrorism, in other words a national security concern and
2. Second, to undermine or eliminate the “black economy”.

There are potentially two ways in which the pre-demonetization money

supply will stand altered in the new regime: one, there would be agents in the economy who are holding cash which they cannot explain and hence they cannot deposit in the banking system. This part of the currency will be extinguished since it would not be replaced in any manner. Second, the government might choose to replace only a part of the currency which was in circulation as cash. In the other words, the rest would be available only as electronic money. This could be a mechanism used to force a transition to cashless medium of exchange.

DEMONETIZATION

Demonetisation is the mechanism by which the government states to withdraw the money which is current legal tender. The government being sovereign can take such decision. The effect of this announcement is that the currency notes in circulation will now cease to be valid tender and can only be exchanged at the banks. Demonetisation of higher denomination notes as an idea has been around.

DEMONETIZATION IN INDIA

The first Demonetization took place in India in 1946 and Rs 1000 and Rs 10,000

notes were demonetized. Later in 1978, Rs 1000, Rs 5000 and Rs 10,000 were demonetized. This is the third time demonetization has taken place. There is a critical difference in the quantum. The first and second demonetizations affected really high value notes which formed a small part of notes circulation. This can be better understood by annual per capita GDP. In 1960, India's per capita GDP was Rs 400 (then currency), In 1978 per capita GDP was Rs 1722/- Where as today it is Rs 103,000/- (today's currency). Thus in 1960, a 1000 Rupee note was 2.5X and in 1978 it was 0.5X per capita GDP, considerably easy to withdraw. The second aspect is that today the 500/- and 1000/- currency notes represent ~85% of physical money in circulation. At that time, it was considerable less. RBI earlier removed pre-2005 notes of all denominations from circulation as they have fewer security features compared with subsequent notes. The process of removing the older notes from circulation continued for nearly one year. The deadline was extended till December 2015 and those notes continued to remain legal tender till November 8. This was not exactly demonetization but removing from circulation and has now subsumed into the present demonetization.

CURRENT DEMONETIZATION

There are two important issues with respect to the present demonetization. First that the notes ceased to be legal tender from midnight of 8th November just 4 hours after announcement. So in effect the only places where they will be accepted will be banks. Second, even the banks have been given time until when they can accept the notes – 30th December. Third, the cash swap carries restriction. Thus, in effect the announcement forces these notes into the bank's deposits within a short period of time. As per [RBI estimates](#) 9.15 billion notes of 500 denomination (approx. Rs. 7853.75 billion) and 6 billion notes of 1000 denominations (approx. Rs. 6325.68 billion) exist. In addition, RBI estimates that fake 0.2 million notes of Rs. 500 and 0.15 million notes of Rs. 1000 were discovered. The actual number of fake notes in circulation will be higher. These will be worthless from 09 November 2016 but you can get the credit for the money held as these notes in the form of bank deposit. Naturally, those who can disclose deposits equal to the amount they hold in cash will have no problem.

IMPACT OF DEMONETIZATION

There are two types of impact due to Demonetization. They are

1. Short term impact
2. Medium term impact

SHORT TERM IMPACT

1. The demonetization, by removing 86 per cent of the currency in circulation, has resulted in a very severe contraction in money supply in the economy. This contraction, by wiping out cash balances in the economy, will eliminate a number of transactions for a while, since there is no or not enough of a medium of exchange available. Since income and consumption are intrinsically related to transactions in the economy, the above would mean a severe contraction in income and consumption in the economy. This effect would be more severe on individuals who earn incomes in cash and spend it in cash. To a lesser extent it would also affect individuals who earn incomes in non-cash forms but need to withdraw in cash for consumption purposes, since a number of sectors in the economy still work predominantly with cash.

2. In terms of the sectors in the economy, the sectors to be adversely affected are all those sectors where demand is usually backed by cash, especially those not within the organised retailing. For instance, transport services, *kirana*, fruits and vegetables and all other perishables, would face compression in demand which is backed by purchasing power. This in turn can have two effects: while it is expected that supply exceeds demand, there would be a fall in prices, however, if supply too gets curtailed for want of a medium of exchange, prices might, in fact, rise. Thus, while generally people seem to expect prices to fall, it is quite possible that prices would instead rise.
3. A further impact would be a compression of the demand for non-essentials by all the agents in the economy in the face of uncertainty in the availability of cash. The demand from segments which have access to digital medium of exchange would remain unaffected, but that from the rest of the economy would get compressed. This would transmit the effect to the rest of the sectors in the economy as well.

MEDIUM TERM EFFECT

In the medium term, the effects would be related to the extent to which the currency is not replaced within the economy. If the entire currency is replaced, there would not be any major effects on the economy. It is to be expected that the entire currency would not be replaced – to the extent currency is extinguished and to the extent some of the currency remains as bank deposits, there would be some impact on the economy. The first effect would be a

1. Compression of the economy to the extent the extinguished currency was working as a medium of exchange. The currency that is placed in the banks but not withdrawn. It would generate an expansion in deposits in the economy and there is a consistent reference to the resultant increase in credit creation in the economy.
2. The additional deposits appear to be capable of stimulating a significant increase in the potential credit that can be created in the economy. All these changes imply some transitions for the consumers and the banking system

ISSUES AND CHALLENGES IN BANKING SECTOR AFTER DEMONETIZATION

ISSUES: There are a number of issues that need to be managed in banking sector after Demonetization

1. The banks have a transition issue to deal with. Banks have a model of the fraction of deposits that they can safely lend without an excessive risk of withdrawal of the amount. This is important since, while banks can borrow money from the call money market, the costs of such borrowings can be large. These models, might need to be altered in the new regime since the character of the new deposits that come into the bank would be different from the pre-existing deposits.
2. Some of the deposits would be for transactional purposes – e.g. salary earners – another fraction would be depositing only savings into the account. By eliminating high value currency notes, these agents who were operating through cash, would now have to move to non-cash instruments and hence, the balances

in their accounts would not be savings but transaction values which will be retained in the account for shorter durations of time. The banks therefore would need to re-model their decisions on how much of the deposits can be lent out and for what duration. For instance a larger proportion of the deposits would be retained for short-term lending and can even be dedicated to the call money market.

3. People who receive credit from the bank make payments through cheques alone and they in turn make payments through cheques, then the potential credit creation can be realized. But if on receipt of payment, the agent withdraws the money to cash and makes payments, only a fraction of the credit/deposit will return to the banking system. Thus, larger is the extent to which cash is used as a means of transacting, smaller is the total credit that can be generated. With a withdrawal of cash from circulation, the deposits will continue to remain in the bank, it would merely shift from account to account or from

bank to bank and, even on the earlier deposits, the amount of credit that can be generated would be larger. Hence, the banks would need to remodel their investment decisions corresponding to a given level of deposits.

4. Another issue that might arise as a transition issue is because of the mismatch between people's preferences for cash and the availability of cash. In the interim, until people adjust to the use of non-cash instruments, there would be an increased demand for the cash that is available and that might generate a situation where the agents have to pay a premium to access legal tender. In periods of scarcity of coins for instance, it is commonly known that people pay a premium to get the change. While this can be considered a transition issue, there are two different implications of such a development:

- I. If the premium on cash is high, it would encourage both the shift to non-cash instruments on one hand and

to informal substitutes of cash on the other.

- II. This might undermine the confidence that people have in the currency and hence, encourage move to other currencies.

CHALLENGES

1. **FALL IN COST OF FUNDS:** Over the past two months, with bank deposits swelling, deposit rates have fallen by substantial 50-75 basis points across banks and tenures. Such a steep fall is unlikely again, banks retaining a portion of the deposits (in the form of CASA and term deposits), will continue to trim deposit rates. This should lead to reduction in banks' cost of funds through the next fiscal (2018). The uptick in deposits will be commensurate with the market share of banks. PSU Banks that command a lion's share (over 70 per cent) of the deposits will be the biggest gainers of the rise in deposits, leading to lower cost of funds.
2. **Slackness in lending:** Banks flush with liquidity, in a falling interest

rate scenario, is a perfect recipe for boosting lending. But tepid borrowing appetite by highly-leveraged corporate and banks' reluctance to lend, has failed to spur loan growth, even after a substantial fall in lending rates over the past year.. According to the RBI's latest figures (as on December 23), credit growth has fallen to a meager 5.1 per cent, down from 10-odd per cent levels last year. The growth had already fallen to 5 per cent levels in November, as credit to industry (corporate) shrunk by 3 per cent. Credit growth has been closely linked to the pace of economic growth, growing at 2.5 to 3 times the real GDP growth in the past. The multiple at which bank credit has grown in relation to real GDP has however shrunk over the last two to three years. This is partly explained by the Centre's move to a new series of GDP two years back and weak credit off take in public sector banks.

3. **LOWERS CORPORATE LENDING:** Even within the modest 10-11 per cent credit growth in 2017-18, the growth will be concentrated

in pockets. In the last three years, PSBs have grown at a far slower pace, because of their huge exposure to the corporate segment — 40-50 per cent of lending is to large corporate. Credit growth of PSBs plummeted to 4 per cent in 2015-16 from 7 per cent in 2014-15. In contrast, private sector banks were able to clock a robust 26 per cent year-on-year rise in lending in 2015-16. This disparity is likely to continue and the growth in 2017-18 too will be driven by private banks, as corporate lending will continue to remain weak.

4. **Margin pressure:** With deposit rates trending lower, banks, no doubt, have gained from lower cost of funds. But moving to the new marginal cost of funds based lending rate (MCLR) structure has forced banks' hands to pass on the benefit to new borrowers at a faster pace. Effective January most banks have slashed their MCLR by a sharp 75-90 basis points. The price war will put pressure on yields on advances and margins, thus offsetting gains of lower cost of funds.

5. **Retail vs. corporate:** The pressure on margins can be felt more by retail-oriented banks, because transmission of rate cuts will happen faster there and new growth will be at lower lending rates. On the corporate side too there will some reduction in rates, but less dramatic. Also growth in corporate loans will only pick up with a lag, despite rate cuts. The general risk appetite for corporate lending is low for banks and hence the pressure on growth and pricing will be low. Overall margins will remain stable to marginally negative for FY18.

6. **Asset quality woes yet to bottom out:** Before we gaze into the crystal ball and predict how asset quality will pan out in FY18, let us look back at the performance of banks until the September 2016 quarter. Four quarters after the RBI's asset quality review (in the December 2015 quarter), the NPA problem still loomed as a key risk to banks' earnings. Despite the massive clean-up, between March and September 2016, gross NPAs went up from 7.8

per cent to 9.1 per cent of total advances. Factors that were likely to weigh on the performance of banks (up until demonetization), were large slippages into NPAs from the watch list that certain banks such as SBI, ICICI Bank and Axis Bank had created (of stressed accounts). Also while the pace of quarterly slippages had moderated (from a whopping Rs. 1-1.5 lakh crore in the second half of FY16 to Rs. 50,000-odd crore in the first half of this fiscal), provisioning requirement was unlikely to fall substantially due to higher provisions than older NPAs.

CONCLUSIONS

The demonetization undertaken by the government is a large shock to the economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be “black money” and hence, should be rightfully extinguished to set right the perverse incentive structure in the economy, this argument is based on impressions rather

than on facts. It is possible that these cash balances were used as a medium of exchange. In other words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be factored in while assessing the impact of the demonetization on the economy and its agents.

It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. For example, if a small trader deposits 2 lakh Rupees in the Jan Dhan account since the currency in which he held these balances in for transactional purposes has been scrapped, it would be incorrect to interpret this as success of the programme in bringing in people who were hiding black money. Nor can they be interpreted as additional balances that the banking sector can lend out on the same basis as earlier deposits, since the deposits now would remain in accounts for much shorter periods that deposits based on savings would be.

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