Impact of Demonitisation on Banking Sector- An Overview

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Abstract— In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denomination notes. These notes accounted for 86% of the country's cash supply. The government's goal was to eradicate counterfeit currency, fight tax evasion, eliminate black money gotten from money laundering and terrorist financing activities, and promote a cashless economy. This paper contains the concept of demonetization, past history and impact of demonetization, impact of demonetization on banking sector.

I. INTRODUCTION

Demonetization is a radical monetary step in which a currency unit's status as a legal tender is declared invalid. This is usually done whenever there is a change of national currency, replacing the old unit with a new one. Such a step, for example, was taken when the European Monetary Union nations decided to adopt Euro as their currency. However, the old currencies were allowed to convert into Euros for a period of time in order to ensure a smooth transition through demonetization. Zimbabwe, Fiji, Singapore and Philippines were other countries to have opted for currency demonetization.

In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denomination notes. These notes accounted for 86% of the country's cash supply. The government's goal was to eradicate counterfeit currency, fight tax evasion, eliminate black money gotten from money laundering and terrorist financing activities, and promote a cashless economy. By making the larger denomination notes worthless, individuals and entities with huge sums of black money gotten from parallel cash systems were forced to convert the money at a bank which is by law required to acquire tax information from the entity. If the entity could not provide proof of making any tax payments on the cash, a tax penalty of 200% of the tax owed was imposed.

II. LITERATURE REVIEW

1.The article "Impact of Demonetisation on Indian Economy: A Critical Study" by Kushwaha, Kumar, and Abbas (2018) explores the effects of the 2016 demonetization policy in India. The authors analyze its impact on various sectors of the Indian economy, including banking, small businesses, and informal sectors. The study highlights both the short-term disruptions and the long-term benefits, such as a push towards digital payments and increased tax compliance. However, the paper also critically discusses the challenges faced by the lower-income population, particularly in terms of liquidity and employment.

2. The article "A Study on Demonetisation and its Impact on Indian Economy" by Samuel and Saxena (2017) examines the immediate effects of India's 2016 demonetization policy. The authors discuss the rationale behind the government's decision to demonetize high-denomination currency notes, aiming to curb black money, corruption, and counterfeit currency. The study highlights both positive and negative outcomes, such as the promotion of digital transactions and formalization of the economy on one hand, while on the other, it addresses challenges like disruptions in daily commerce, cash shortages, and difficulties faced by small businesses and rural populations.

3. The article "Demonetization: Effects on Indian Economy" by Vij (2018) examines the impact of India's 2016 demonetization policy on various economic sectors, including banking and agriculture. It highlights both the positive outcomes, such as

increased digital transactions, and negative effects like short-term liquidity challenges.

4. The article "Impact of Demonetisation on Indian Stock Market" by Pathak and Patel (2017) analyzes how India's 2016 demonetization affected the stock market. The study focuses on market volatility, investor sentiment, and sectoral performance, revealing both short-term disruptions and long-term trends in market recovery.

5. The article "Demonetisation in India and its Impact" by Nataraj (2017) examines the broad economic and social effects of India's 2016 demonetization. It discusses the policy's goals, including curbing black money, and highlights both positive outcomes like increased digital payments and negative consequences such as cash shortages and disruptions to daily economic activities.

III. CONCEPT OF DEMONETISATION

Demonetization is the act of stripping a currency unit of its status as legal tender. Demonetization is the process in which a particular currency or valuable mineral is degraded as a legal tender. This happens when a certain currency is no longer in regular use within the country of origin, or when a newer currency comes into circulation.

IV. BACKGROWND OF THE PAPER

On November 8, 2016, the government announced a historic measure, with profound Implications for the economy. The two largest denomination notes, Rs 500 and Rs 1000, were “demonetized” with immediate effect, ceasing to be legal tender except for a few specified purposes.The move is aimed at controlling black money, fake currency circulation and terror financing India has amongst the highest levels of currency in circulation at 13% of GDP. Notes in circulation as of Nov 4, 2016: Rs. 17,742 bn (13% of GDP). {Value of Rs.500/Rs.1000 notes in circulation (86.5% of notes in circulation): Rs. 15,347 bn (11% of GDP)

V. OBJECTIVES OF PAPER

- To study the experience of impact of demonetization in various countries in past years;
- To analyze the immediate impact of demonetization on Indian economy;
- To work out the probable consequences of the demonetization.
- To study the impact of demonetization on banking sector.

VI. INDIA’S PAST EXPERIENCE WITH DEMONETIZATION

The French were the first to use the word Demonetize, in the years between 1850 -1855. Since then, many countries have used the word and the policy with immense restriction and discomfort, for it disrupts economics and population at large.

India has demonetized before: First time on 12 Jan 1946 (Saturday), second time on 16 Jan 1978 (Monday), Third time on 8th November 2016 (Tuesday).

- In the first time, the measure did not succeed, as by the end of 1947, out of a total issue of Rs. 143.97 crores of the high denomination notes, notes of the value of Rs. 134.9 crores were exchanged. Thus, notes worth only Rs. 9.07 crores were probably ‘demonetized’, not having been presented.

It was really not a revolutionary measure and even its purpose as a minatory and punitive gesture towards black-marketing was not effectively served. There was no fool-proof administrative method by which a particular note brought by an individual could be proved as the life-savings of the hard-working man who presented it or established as the sordid gains of a black-marketer. Another loophole of which considerable advantage was taken was the exemption of the princely States from scrutiny or questioning when such notes were presented by them. In the end, out of a total issue of Rs.143.97 crores, notes of the value of Rs.134.9 crores were exchanged up to the end of 1947 as mentioned in the Report of the Board of Directors of the Reserve Bank. Thus, notes worth only Rs.9.07 crores were probably “‘demonetized”, not having been presented. It was more of “conversion”, at varying rates of profits and losses than “demonetization”.

- In the second time, The Finance Minister H.M. Patel in his budget speech on 28 Feb 1978 remarked the demonetization of high denomination bank notes was a step primarily aimed at controlling illegal transactions. It is a part of a series of measures which Government has taken and is determined to take against anti-social elements. The FM did not say anything about the success of the exercise, one can almost guess that it did not create much impact like in 1946.

- In January 1946, banknotes of 1000 and 10000 rupees were withdrawn and new notes of 1000, 5000 and 10000 rupees were introduced in 1954.
- The Janata Party coalition government had again demonetized banknotes of 1000, 5000 and 10000 rupees on 16 January 1978 as a means to curb counterfeit money and black money.
- In 2012, the Central Board of Direct Taxes had recommended against demonetization, saying in a report that "demonetization may not be a solution for tackling black money or economy, which is largely held in the form of Benami properties, bullion and jewelry".

VII. THE IMPACT OF THE PAST DEMONETIZATION

- Deposit growth → rose sharply
- Currency in circulation → moderately sharply
- SLR security → sharp increase in investment in government securities by banks
- Credit growth →initially subdued but started picking up after 4 months (by
- May 1978)
- GDP growth → no major impact as high denomination notes which were
- Cancelled Only accounted for 0.1%

VIII. DEMONETIZATION AND ITS IMPLICATION ON INDIAN ECONOMY

The demonetization drive initiated by the Indian Government is going to have far reaching
Impact on the Indian Economy. It is being considered as one of the most significant step in tackling the black money issue that has gripped our country since many years.
Some of the effects of the demonetization measure are:

a) The total currency in circulation as on Oct 28, 2016 was INR 17.54 lakh crores. According to the Reserve Bank of India (RBI), 86% of this component is in currency notes of INR 500 and INR 1000 denomination. Therefore, the currency that is being attempted to be demonetized is around Rs. 15 lakh crores. It is being estimated (internal estimates) that around 20% of this currency is in black. We believe that this money either will not come back into the system for exchange for new notes or will be surrendered as black money and taxes thereon will be paid.

b) The deposit of these notes with the Commercial Banks ends on December 30th, 2016.Thereafter, currency notes will have to be deposited with RBI till Mar 31st, 2017.We believe that after this date, the RBI will reduce Notes in Circulation to the extent of the money not deposited. To match its liability, it will have to reduce it asset or increase its liability. Increasing its liability would mean increase in its Net Non-Monetary Liabilities (or reserves) and declare special dividend (just an accounting entry) to the Government. The Government, in turn can reduce its bonds on the RBI's balance sheet by buying its bonds back from the reserves transferred by the RBI. The government will have multiple options about what it could to do with this special dividend. It may reduce domestic outstanding debt, prepay external debt, reduce fiscal deficit as interest cost drops, and reduce its borrowing for following years. Improvement in debt/Gross Domestic Product (GDP) ratio should also help improve the country's sovereign rating by the International Agencies. RBI's balancesheet also frees up for supporting liquidity requirements of the banking system.

b) On the other hand, the banking sector is going to see a surge of liquidity as deposits get collected. Based on our assumption (internal estimates) that (20% of currency will not be tendered back), there is going to be tendering of currency from the public to the tune of Rs. 12 lakh crores (80% of Rs. 15 lakh crores). Due to the temporary restrictions on withdrawing cash, our internal estimate is that at least 50% of the cash will remain within the banking system, i.e. of Rs. 6 lakh crores. This sudden surge in deposit of 6% of current aggregate deposits will help in improvement of liquidity.

This will lead to demand for fixed income securities, particularly government securities.

d) According to a World Bank estimate in 2007, around 20-25 % of India's GDP is the size of the parallel black economy. The steps taken by the Indian Government has led to a scare in the parallel black economy and should lead to better tax compliance going ahead. This will have a telling effect on the other heavens of black money i.e. real estate and gold. Both these sectors are going to witness reduced demand. Lower

Demand for gold resulting ultimately in lower import of gold is expected to improve the current account balances. The Indian rupee should remain stable and display appreciating bias against hard currencies, as the current account improves and may also move into surplus.

e) The sudden change due to reduced cash transaction will lead to reduction in economic activity. We believe that the services sector growth will be majorly affected. This will lead to lowering of inflation expectation and moderation of headline inflation too. However, the effect on inflation would depend on the moderation in economic activity in those sectors that have heavy cash transactions. RBI will find larger room to reduce repo rates with moderation in inflation.

f) There are some other positives expected over the medium to long term. A more compliant economy should increase tax collections and tax to GDP ratio should improve from both direct and indirect tax. In future, an increase in use of plastic money rather than hard currency would also lead to higher money multiplier which will be more productive. To sum up, the fight against corruption, terror funding, counterfeit currency and the Black economy should result in:

- Increased systemic liquidity leading to higher demand for bonds
- Rate reductions due to lower inflation and inflationary expectations
- Stable to appreciating INR as Current account deficit improves due to lower

Demand for gold

1. Higher tax to GDP
2. RBI freeing up balance sheet as liability declines
3. Government would be able to bring down its outstanding debt liability and improve fiscal deficit

- Immediate near-term impact – decline in cash transactions may lead to Reduction in consumption demand leading to some decline in the GDP growth

IX. IMPACT OF DEMONETIZATION ON BANKING SECTOR

Indian banking sector an overview: The Indian banking sector consists of 26 public sector banks, 25 private sector banks, 43 foreign banks, 56 regional rural banks, 1589 urban cooperative banks and 93550 rural cooperative banks, in addition to cooperative credit institution. Indian banking industry has recently witnessed the roll out of innovative banking models like payments and small finance banks

As directed by the Government, the 500- and 1000-Rupee notes which now cease to be legal tender are to be deposited or exchanged in banks (subject to certain limits). This will automatically lead to more amounts being deposited in Savings and Current Account of commercial banks. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there would be withdrawals at the second stage.

With demonization, more people are depositing money into the banks. This means the banks have more liquid funds and more money to lend. Many banks have also slashed their deposit rates including SBI, ICICI Bank, HDFC Bank.

- Canara Bank, ICICI Bank and HDFC Bank have cut their fixed deposit rates by up to 1%. State Bank of India cut their fixed deposit interest rates by 0.15% on select maturities.
- HDFC Bank and ICICI Bank have cut their deposit by up to 0.25%.
- United Bank of India has slashed their rates by 1% only on the short-term deposits.

In the banking world, when deposit rates are cut, it generally means the lending rates will also be slashed down. Since banks are paying lower deposit rates to customers, this allows them room to carge lesser on loans.

X. POSITIVE IMPACT OF DEMONETIZATION ON BANKING SECTOR

- Increased share of savings moving to banks, high CASA ratio(lower cost of funds)
- Demonetization enhanced the liquidity position of the banks
- Lower bond yields resulting in high treasury gains
- Jan Dan Bank accounts are full, probably because people who did not want to keep their money in bank, are coming back to banking network, after demonetization. According to RBI 11.5 lakh crore money have been deposited in banks.
- The banks which were struggling because of the NPA (Non performing assest) problem , will now have a lot more money to lend for agriculture, infrastructure and social sector as also for trade and industry.
- Paradigm shift towards cashless economy.

XI. NEGATIVE IMPACT OF DEMONETIZATION ON BANKING SECTOR

Banks use third parties like cash logistics companies for cash transportation. Moving out Rs 15 lakh crore of currency notes and moving in Rs 7 lakh crore plus from currency chests would have cost several thousand crores.

- During November and December 2016 bank work was largely centered on accepting and exchanging specified bank notes. As a result, other activities like lending during busy season is affected which will reduce their earnings for the next quarter and profitability.
- Further as all ATMs are to be recalibrated for issue of new denomination notes like ₹2000 and ₹500 it will add substantially to their operational expenses. It will reduce their income during the next quarter.
- Reduction in deposit interest rate due to high liquidity.
- With any sharp infusion deposits and relatively limited avenues to lend, the credit deposit ratio for banks would become unfavoranble and thus impact margins.
- The bank officials have been putting in extra hours every day to try and conduct as many transactions as possible. People's perception of the whole situation seems to be limited to the chaos and queues outside the banks.

CONCLUSION

Banks have gained deposits substantially after demonetization which they can invest for improving their profitability. There non-performing advances have also come down. Besides as banks will reduce their cash holdings due to more digital interface it will add to their long term profitability and cash loss for various reasons like theft, dacoity and misappropriation will be avoided. Thus, demonetization is not an unmixed blessing but merits are more than demerits and the economy will move forward with less cash holdings by banks.

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