



A STUDY ON IMPACT OF DEMONETIZATION ON INDIAN ECONOMY: A CRITICAL REVIEW ON BANKING INDUSTRY

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Abstract

Demonetization technically is a liquidity shock; a sudden stop in terms of currency availability. It creates a situation where lack of currencies jams consumption, investment, production, employment etc. In this context, the exercise may produce following short term/long term/, consumption/investment, welfare/growth impacts on Indian economy.

The Reserve Bank of India manages currency in India and derives its role in currency management on the basis of the Reserve Bank of India Act, 1934 and a new redesigned series of Rs 500 banknote, in addition to a new denomination of Rs 2000 banknote is in circulation since November 10, 2016. The new redesigned series is also expected to be introduced to the banknote denominations of Rs 1000, Rs 100 and Rs 50 in the coming months.

Introduction

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Demonetization is the act of stripping a currency unit of its status as legal tender.

In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denominations in its currency system; these notes accounted for 86% of the country's circulating cash. With little warning, India's Prime Minister Narendra Modi announced to the citizenry on Nov. 8 that those notes were worthless, effective immediately – and they had until the end of the year to deposit or exchange them for newly introduced 2000 rupee and 500 rupee bills.

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The term demonetisation is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetised in January 1946 and again in January 1978, according to RBI data. However, with the latest round of demonetisation, the common public and bankers are undoubtedly facing hardship since more than 85 percent of currency in circulation has been rendered illegal in one single stroke. Demonetisation is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. The question that arises is why demonetisation was required at this point of time. There are certain pros and cons of demonetisation. One of the biggest benefits of this move is that it is going to drastically affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalised and prosecuted by the authorities. Enemies of the country which are involved in counterfeit currency and terrorism will not be able to continue it further for quite some time at least.

The smuggling of arms and dealing with the terrorist will not sustain further as all of the money will be on record now. Secondly, the banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial inclusion. The existing white money of people will be known to the government and it will remain with banks so that it can be put on loan, and interest can be generated from it (though interest rates would fall) with a corresponding fall in Inflation.

Literature Review

Mr Brijesh Singh and Dr. N. Babitha Thimmaiah (January 2017) in their research paper studied the effect of demonetization in terms of "Won or lost". By using the secondary data method i.e. articles, they had conducted their study. In the study report they had tried to explain the concept of cashless economy by taking the reference of Woodford (2003). It is not all about how much money you are having in your wallet, you can pay by any of the bank card or banking transfer.



In the research paper they had show the effect of demonetization in the areas like, cash rush, stock market, transportation, agriculture, banking, business, income tax, railways etc. There are no exact proofs of exact black money holding in cash but studies show that around 8% of black money is held in cash. According to the Centre for Monitoring the Indian Economy (CMIE), the transaction cost of demonetization until 30th December, 2016 is estimated around Rs. 1.28 lakh crore. As per R. Gandhi, Deputy Governor of RBI, speaking on 7th December 2016, Rs. 11.5 lakh crore has been already deposited at bank out of total 14.5 lakh crore which means still 3 lakh crore are unidentified. Geeta Rani (November 2016) had presented the research paper to show the effect of demonetization over the retail outlets. She had done her research work by taking the primary data. She had used the Questionnaire method. This was filled by the 50 shopkeepers of the area. As a result she had been ready with some out comes likewise 80% shopkeeper presented their view that from 9th November, 2016 to 10th December, 2016 there was 20% increase in sales due to accepting the old notes. But after that sales had declined. Shopkeeper started paytm and cheque system. Shopkeepers had extended credit period. Top brands like HUL, P&G had affected with only decrease of 20% sales due to brand name. Moreover on the basis of the study she had identified the effect of demonetization category wise. Likewise, salty snacks sale decreased by 10%, chocolates sales had decreased by 50%, biscuits sales had decreased by 20%, juice/fruit drinks sales decreased by 20%, cigarettes sales decreased by 10%, mobile phones sales decreased by 70% gold sales increased by 70% and durable goods sales decreased by 70%. She concluded her paper by giving the views that though demonetization is painful for short term, but it will surely beneficial for the long run moreover most customers are now adopting cashless means like paytm, debit card, cheques etc.

Sherline T.I (December 2016) has undertaken the research on “Demonetization as a prelude to complete financial inclusion “. The main objective of the study was to understand the importance of demonetization as a measure of financial inclusion. Financial inclusion mainly stands for, the delivery of the financial services at the affordable cost to the low income segments of society. As per the report financial inclusion can boost the savings as well as credit availability. The study shows that this move of the Government has likely to create long term benefits. Moreover medium to long term Current account and Saving account (CASA) ratio could improve. Moreover demonetization would reduce cash transaction the real estates, which may decrease the price of that avenues which make it affordable to general public. Moreover the near future inflation will decrease due to less cash transaction.

Short and Long Term Impacts

The Short-term Impacts:

There will be a disruption in the current liquidity situation as households are likely to get affected by the note exchange terms laid by the government. Though clarity is unfolding on this, commodity transactions and general cash market transactions are likely to feel an immediate impact. Unorganized sector proceedings, including small trade market activities, will remain volatile in the short-term. Roadside vendors, cab drivers, kirana stores, etc., have already stopped accepting Rs 500 and Rs 1,000 notes. It is important to note that a significant percentage of the Indian workforce is employed in this sector, which is likely to be affected by immediate liquidity issues. Overall, negative impact on disposable income is expected along with likely disruption in the consumption patterns of the general populace. It is estimated that there will be a negative GDP impact in the current quarter as consumption gets a shock in the immediate term. However, quantum and degree of this impact cannot be ascertained at this time

The Long term Impact

This essentially represents a change in regime for the real and financial economy. Domestically, there could be some turmoil as the effect will be disproportionately felt by the lower and upper income classes. Internationally, the government is likely to get thumbs up for the move and more countries could potentially see this as a viable option to curb black money and stem illegal financial activity. Last, though this move by the government may not be a first, having being tried by earlier governments as a tool to fight corruption. Such an action achieves larger significance for a globally connected India as it shows boldness in tackling an issue which has remained a thorn in the growth success story of this generation.

Positive Impact on Banks

The biggest beneficiary from this policy will be the banking sector. This is mainly due to the queues of people depositing cash in the banks – which will result in substantial liquidity with the banks. As the deposits with the banks will increase so will increase the CASA, which will increase the Net Interest Income and the Net earnings of the banks. However, this will not be abnormally high since the RBI has increased the CRR in the short term to mop up some of this liquidity.



As stated above higher CASA means large amount of deposits are in current and savings account this way the banks get funds at no or very low cost (interest). Banks do not pay interest on the current account deposits and pays a very low % of interest on savings account deposits. Hence, it is a good measure to get deposits at no or very low cost.

As the banks get a lot of liquidity in their hands, they are expected to enhance the borrowing cycle by lending the money at a lower rate of interest. Hence, the interest rate on borrowing will lower down. Overall, the demonetization move can help the banking sector make huge gains if the government and the RBI tread carefully by implementing policies to stimulate growth in other sectors of the economy and increase the liquidity in the system.

Negative Impact on Banks

Given the sheer size - the decision to withdraw 85% of the cash in circulation has thrown India into disarray. Such a large and unexpected policy change naturally carries with it a large collateral damage at least in the short run. This is particularly true for India where a large section of the economy is comprised of the informal or unorganized sector (not registered with the government and hence not subject to taxation) which functions on cash. It will show a drastic negative impact on banks to hold large reserves in the banks especially on 100 rupee denominations. Due to Demonetisation there is a huge surge of liquidity in the banking sector.

If that amount stays idle in the banking system it would be a loss to the bank. So to absorb liquidity RBI has change the CRR to 100% recently, but again, this is a loss to the banking sector as they don't receive any interest. So, banks has an option to decrease it's loan interest and encourage people for loans. Housing loans might become cheaper. It wil benefits people who has a plan to buy house. If more people applys for loan bank will increase it's profitability. Anyways there is a win win situations for both banks and consumers. The other option is to buy government bonds and securities. But right now there is a crunch of bonds in RBI. So with the help of government of India new bonds would be issued and the excessive liquidity can be used in completing the pending projects and thereby developing the economic growth.

Conclusion

If the money disappears, as some hoarders would not like to be seen with their cash pile, the economy will not benefit. On the other hand if the money finds its way in the economy it could have a meaningful impact. However experiences from different countries show that the move was one of the series that failed to fix a debt- burdened and inflation-ridden economy. People became more conscious about online banking. Bank employees had work continuously without taking day off. Their co-operation matters a lot. Though total black money had not been grabbed by this tool, this tool proves fruitful for at least creating fear in the minds of black money holders. It was compulsory for the Government to take some steps like demonetization to decrease corruption, terrorism, black money etc.

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