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Impact of Demonetization on the Functioning of Banks

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Abstract—*To get rid of corruption, black money, counterfeit currency and terror financing, Hon'ble Prime Minister Shri Narendra Modi announced Demonetization on November 8, 2016. Although demonetization holds huge potential benefits in the medium to long-term, brings some discomfort for public and disruption in economic activity in short run. A surge in deposits led to a sharp expansion in the consolidated balance sheet of scheduled commercial banks and created large surplus liquidity conditions. These were managed by the Reserve Bank of India through a mix of conventional and unconventional policy instruments. There has been a sharp increase in the number of accounts under the Pradhan Mantri Jan Dhan Yojana and the deposits in such accounts have also surged. Financial re-intermediation may have received a boost following demonetization. The present study is an attempt to know about the impact of Demonetization on the liquidity condition of banks. The present study also illuminates the impact of such a move on balance sheet and profitability of banks.*

Keywords*: Demonetization, Liquidity, Deposits, Commercial banks, Monetary Policy.*

1. INTRODUCTION

Demonetization is an act to withdraw a specific currency from market. It occurs whenever a change is required and current currency's demerits exceed its merits. This is why the current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. On November 8, 2016, it was decided to demonetize high value currency notes of denomination of 1000 and 500 (called specified bank notes - SBNs). Such notes, valued at 15.4 trillion, constituted 86.9 per cent of the value of total currency in circulation. The decision was in continuation of a series of measures taken by the Government of India during last two years aimed at eliminating corruption, black money, counterfeit currency and terror funding. The decision was guided by the aim of reaping its enormous potential medium-term benefits in the form of reduced corruption, greater digitization of the economy, increased flow of financial savings and greater formalization of the economy. All of these would lead to higher GDP growth and tax revenues that could be used by the Government for inclusive and stronger economic growth within the norms of fiscal prudence, besides contributing to overall improvement in business environment.

2. LITERATURE REVIEW

Singh B. & N. Babitha (January 2017) in their research paper threw the light on the effects of demonetization in terms of "Won or lost". In their study, they used Secondary data and efforts were made to explain the concept of cashless economy by taking the reference of Woodford (2003). This paper explains the effect of demonetization in the areas like, cash rush, stock market, transportation, agriculture, banking, business, income tax, railways etc.

M. Angel Jasmine (February, 2017) has studied about the "Impact of Demonetization in India" in her research paper. The paper was divided into two parts, in first part of the paper the impact of demonization on Indian economy was explained. As per the research, the BSE SENSEX and NIFTY 50 stock had been fall near about 6% on the very next day. Moreover on the later on days, the country felt severe shortage of the cash. Moreover due to lack of cash overall production had decreased. Banks had not enough new currency for the exchange of the old notes, which breakdown the overall economic system. Moreover in the paper impact of the demonetization over world economy also shown. The first thing that happened after demonetization was decrement in to overall consumption of commodities which results in to decrease in the export-import. Moreover there was a major impact over the domestic sectors, reduction in the Government liability, farming and fishing industry, business, drop in industrial output, black money, impact over counterfeit currency, hawala, bank deposits, jewellery an real estate, IT sector etc. Findings in this sectors says that, though demonetization is a good concept to grab theblack money holders, most of black money is kept in form of land, gold, real estate etc. "Not all black money isin cash, not all cash is black money". People face too much inconveniency due to improper planning about post demonetization. Moreover for number of days they had spent their time by standing in queues. To decline overall negative impact of it, ways are to focusing over tax aspect, cash availability, and elimination of loopholes.

Mukhrjee *et al.* (November 2016) studied about the impact of the present government move for demonetization on the credit availability, government finance, spending and levels of various activities. The researchers stated that in a very short period there would be more serious affect on persons earning income in cash as well as spending in cash while impact will be up to a lesser extent on those earnings in non-cash form but spending in cash. Each sector backing demand by cash along with the real sector especially the unorganized one will much adversely effected in very short run time. In case of short term effect having complete replacement, an immense strengthening of informal sector credit market would be seen in the rural market and there would be adverse affect on construction sector. The medium term impact would produce results in terms of enhancements in deposits in the economy.

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. Though 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.

Nithin and Sharmila (2016) studied demonetization and its impact on Indian Economy. They opined that demonetization has short term negative impact on different sectors of the economy and such impacts are solved when the new currency notes are widely circulated in the economy. They also argued that the government should clear all the problems created due to demonetization and help the economy to work smoothly.

Tax Research Team (2016) in their working paper has also stated the merits of demonetization. This paper shows the impact of such a move on the availability of credit, spending and level of activity and government finances.

3. RESEARCH METHODOLOGY

3.1 OBJECTIVE OF THE STUDY:

1. To study the influence of demonetization on Banks operations.
2. To illuminate the impact of demonetization on the balance sheet and profitability of banks.

3.2 RESEARCH METHODLOGY:

The study is based on Secondary Sources of data. It includes available published literatures such as books, journals, newspapers and relevant government websites. The study tries to look at the extent of demonetization influence on normal banking operations.

3.3 RESEARCH DESIGN:

To study the impact of Demonetization on banking operations, Descriptive Research Method is used.

3.4 DATA COLLECTION:

Secondary source of data collection has been used which is duly acknowledged in the paper.

3.5 Limitations:

- The study is restricted only to the available data.
- All the limitations of secondary data are applicable to this study.

4. BALANCE SHEET AND PROFITABILITY OF BANKS

Demonetization has had a significant impact on the balance sheet of scheduled commercial banks (SCBs), both in terms of size and composition.

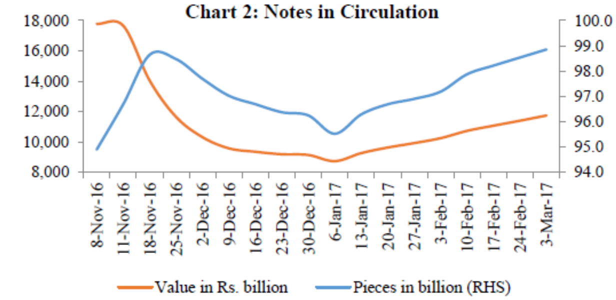
4.1 Balance Sheet Effects

Decline in currency in circulation on account of demonetisation led to a surge in bank deposits. The demonetised notes were accepted at bank counters till December 30, 2016. Between October 28, 2016 and January 6, 2017 (*i.e.*, days immediately prior to and after demonetisation for which fortnightly banking system data are available), total currency in circulation declined by about ` 8,800 billion. This, in turn, was largely reflected in sharp increase of about ` 6,720 billion in aggregate deposits of the banking system even after outflows in NRI deposits during the period.

Remonetisation has been progressing at a fast pace. Between end-December 2016 and early March 2017, there was a net increase in currency in circulation by about ` 2,600 billion. During this period, deposits with banks also declined moderately.

Importantly, currency in circulation in terms of number of pieces and value has been steadily rising since early January 2017 (Chart 2).

Chart 2: Notes in Circulation



Source: RBI

Banks furnish data on their major assets and liabilities on a fortnightly basis. As per data available for the reporting Fridays of October 28, 2016 (prior to demonetisation) and February 17, 2017 (latest available), aggregate deposits of SCBs increased by ` 5,549 billion during the period (Table 8).

Table 8: Changes in Major Assets and Liabilities of SCBs – October 28, 2016 and February 17, 2017

	Liabilities			Assets	
1	Aggregate Deposits	5,549	1	Bank Credit	1,008
2	Borrowings	-56	2	Investment in Government Securities	4,560
			3	Net Other Assets	-75
	Total	**5,493**		**Total**	**5,493**

Note: Data are provisional.
Source: RBI

Bulk of the deposits so mobilized by SCBs has been deployed in: (i) reverse repos of various tenors with the RBI; and (ii) cash management bills (CMBs) issued under the Market Stabilization Scheme (which is a part of investment in government securities in the balance sheet of banks). Loans and advances extended by banks increased by ` 1,008 billion. The incremental credit deposit ratio for the period was only 18.2 per cent. Additional deposits mobilized by commercial banks have been largely deployed in liquid assets. This may be due to the expected transitory nature of the bulk of such deposits and weak demand as reflected in the subdued growth of credit.

4.2 Profitability of Banks

Banks' net profits essentially reflect the difference between interest earned on loans and advances and investments, and interest paid on deposits and borrowings, adjusted for operating costs and provisions. Loans and advances and investments, which are the main sources of interest income, together constitute more than 85 per cent (61 per cent accounted for by loans and advances and 25 per cent by investments) of banks' consolidated balance sheet. Post-demonetisation, there has been a surge in the current account and saving account (CASA) deposits of banks. The sharp increase of 4.1 percentage points in the share of CASA deposits in aggregate deposits to 39.3 per cent (up to February 17, 2017) resulted in a reduction in the cost of aggregate deposits. The cost of CASA at 3.2 per cent is significantly lower than the weighted average term deposit rate at 7.1 per cent. Banks have also lowered their term deposit rates; the median term deposit rate declined by 38 bps during November 2016-February 2017. As detailed in Section II.2, the decline in the cost of funding resulted in decline in the 1-year median marginal cost of funds based lending rate (MCLR) by as much as 70 bps post-demonetisation (November 2016-February 2017).

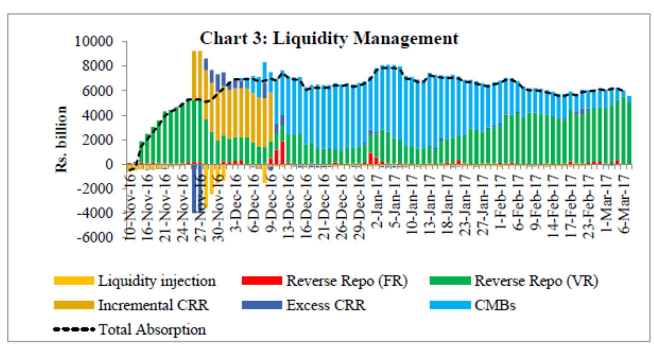
Banks earned return of around 6.23-6.33 per cent under reverse repos and market stabilization scheme (MSS)[6] as against the cost of CASA deposits of around 3.2 per cent. Accordingly, for an average deployment of about ` 6 trillion in a quarter under reverse repos and MSS securities, banks' net interest income from increased deposits is estimated at about ` 45 billion in a quarter after demonetisation. Banks continue to enjoy the increased share of low cost CASA deposits, although it is gradually declining with the increase in currency in circulation. The increase in net interest income would need to be adjusted for the cost of managing withdrawal of SBNs and injection of new bank notes (such as calibration of ATM machines, staff overtime, security arrangements, lower fees/waiver of fees on digital modes of payments), the exact details of which are not available at this stage.

4.3 Liquidity Conditions

With the return of SBNs to the banking system, while currency in circulation contracted, deposits in the banking system surged. The sudden increase in deposits (given the gradual replacement of SBNs by new notes) created large surplus liquidity conditions in the banking system, which could be divided into four distinct phases in terms of how liquidity was managed by the Reserve Bank using different instruments (Chart 3). The active liquidity management was necessitated to ensure that the operating target remained aligned to the policy repo rate.

In the **first phase (November 10 to November 25),** the Reserve Bank absorbed the excess liquidity through variable rate reverse repos of tenors ranging from overnight to 91 days under its Liquidity Adjustment Facility (LAF). The outstanding amount of surplus liquidity absorbed through reverse repos (both variable rate and fixed rate auctions) reached a peak of ` 5,242 billion on November 25.

In the **second phase (November 26 to December 9),** the liquidity surplus was managed through a mix of reverse repos and the application of the incremental cash reserve ratio (ICRR) of 100 per cent on the increase in net demand and time liabilities between September 16 and November 11, 2016. The ICRR helped drain excess liquidity in the system to the extent of about 4,000 billion during the fortnight ended December 9, 2016.



FR: Fixed Rate; VR: Variable Rate; CRR: Cash Reserve Ratio; CMB: Cash Management Bill.
Source: RBI

In the **third phase (December 10 to January 13),** surplus liquidity conditions were managed through a mix of reverse repos and issuances of cash management bills (CMBs) under the MSS. With the enhancement of the limit on issuance of securities under the MSS from 300 billion to ` 6,000 billion on December 2, 2016 by the Government of India, the Reserve Bank withdrew the ICRR effective the fortnight beginning December 10, 2016. Between December 10, 2016 and January 13, 2017, surplus liquidity in the system was managed by a mix of fine-tuning reverse repo operations and auctions under the MSS. The peak liquidity absorbed was 7,956 billion on January 4, 2017 (` 2,568 billion absorbed through reverse repos and 5,466 billion through CMBs). Subsequent to the advance tax payment in mid-December, a part of the excess liquidity was offset by the build-up in government cash balances. The surplus liquidity in the system declined to 7,269 billion on January 13, 2017.

In the **fourth phase (since January 14)**, the Reserve Bank has increasingly used reverse repo operations to absorb surplus liquidity, particularly the liquidity released through the maturing CMBs, as the magnitude of surplus liquidity has been moderating in sync with remonetisation. Of the total surplus liquidity (net of injection under the LAF) in the system of ` 5,537 billion on March 7, 2017, ` 500 billion was absorbed through CMBs under the MSS and the remaining through variable rate reverse repo auctions under the LAF.

The surplus liquidity is expected to decline going forward as remonetisation progresses further, which will result in decline in deposits with the banking system. Despite this, however, surplus liquidity conditions are likely to persist for some more time.

5. CONCLUSION

Demonetization is a tool used by central government to fight against corruption and black money. In the same path, it influenced and brought changes in all the corner of the economy. Banks are major institutions affected by demonetization. Banned denominations were ploughed back and allowed the citizens to exchange with the banks. While exchanging, it disturbed temporarily and influenced its regular operations. Though it affected badly to major extent of bank operations, it helped the economy to find growth and development of the country through financial institutions like Banks

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