
Demonetization and Its Challenges

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ABSTRACT

Prime Minister Modi announced the withdrawal of Rs.500 and Rs.1000 currency notes as legal tender with effect from 8th November. The result is: 23 billion pieces of currency notes have become junk. Which means cash circulation in the country has in one go come down by 86%. This has obviously made even buying vegetables harder. And for all those hundreds of millions who work in informal economy particularly the countryside, life has become a challenge, for their commerce has come to a halt.

Incidentally, at the same time with effect from November 11, 2016, the world witnessed one more case of demonetization move, which happened in Venezuela. While India is a well-established democratic country, Venezuela is a socialist country. While the former is an economically progressive one, the latter is an economically weak nation. While the Indian Prime Minister gave just 3 to 4 hours' time, for demonetization to take effect, the Venezuela counterpart gave three clear takes for the take-off of demonetization. While moral and ethical compulsions were the driving force for embarking on demonetization in India, economic compulsions were the prime reasons for similar steps in Venezuela. The only common factor that is running through demonetization exercise in the two countries is the shortage of new notes, emanated from supplies of new currency falling woefully short of the requirement arisen out of replacement. This article focuses on demonetization and its challenges mostly from the Indian context.

1.0 Demonetization Tsunami in India

November 8, 2016 will go down in the socio-economic-politico history of India as the most defining one, at least in recent times, as Prime Minister Narendra Modi, in a televised message, addressing the nation, announced a historic step: demonetization, the country's most disruptive yet decisive war on the scourge of black money. After keeping his plan under wrap for several months, the PM finally let the cat out of the bag, when he told that the old high denomination currency notes of Rs.1,000 and Rs.500 will cease to exist as legal tender from the midnight. The prime Minister then went on elaborating about the rationale behind such seemingly sudden step, what necessitated it, and how his government has planned to ensure that the common man is not affected by the disruption the move might cause.

2.0 Literature Review

According to Knowledge@Wharton demonetization represents much more than destabilization; it argues that demonetization has struck a body blow on economic activity in India. The decision – which was entirely unsuspected – was announced on 8 November 2016. While the pros and cons of the measure still continue to be debated, the consensus of opinion appears to be that while the proponents of demonetization may have had good intentions, the suffering it has caused to millions of Indians is unwarranted. Since Rs500 and Rs1000 notes make up some 86% of the total currency in circulation in India, especially in the vast rural areas, one economist compared the pain to what individuals might experience if 86% of their blood was removed from their bodies.

In another article in Knowledge @ Wharton there are many benefits that will come with the government's move. "The size of the formal economy which the government can manage through its policy actions will increase, perhaps significantly. This step may have positive implications for tax revenues longer term. There may even be influences on the growth rate of GDP. However, for sectors like real estate, a notorious hotbed for black money transactions, there will likely be disinflationary pressures short term, with prices being pushed downward before they stabilize longer term." Real estate shares have plunged, in some cases by more than 30%.

Wade Shepard (2017), Forbes asserts that due to this cash crunch, India ground to a halt. Businesses shut down, farmers couldn't buy seeds, taxi and rickshaw drivers didn't have any way to receive payments, employers had no way to pay their employees, hospitals were refusing patients who only had old banknotes, fishermen watched their catch wither up and rot, some families had difficulty buying food, and weddings throughout the country were cancelled.

According to an article in InSight the stock of the black economy constitutes a major part of the GDP is significant. Even if 50% of this amount is withdrawn, the kind of relief that RBI will get on its liabilities and the sort of deposits commercial banks will get will lead to a rise in the deposit and later on there will be decrease in lending rates plus fiscal deficit. The black money in circulation is like a steroid in the economy which keeps the demand going gives a feeling that everything is working well. The problem is that investment is not taking place in the economy and the rate of growth of capital formation is down. The only way to bring this up is to divert more funds into investments which will happen when the cost of capital comes down.

In a comprehensive report on Asia's outlook for the year, HSBC noted India could grow at an annual rate of 7.1 percent for fiscal 2018 and 7.6 percent for fiscal 2019, shrugging off any lasting effects from its program to remove 500 and 1,000 rupee bank notes from the financial system in November, labelled demonetization.

2.1 Key Points of Demonetization are:

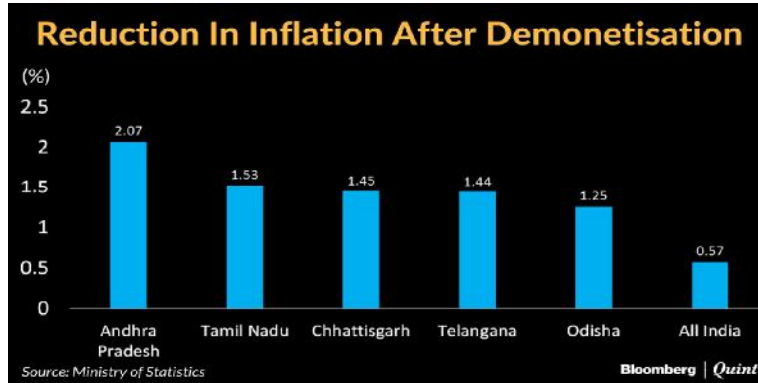
1. November 8, 2016. The central government launches demonetization drive to fight black money, counterfeit notes, corruption and terror funding
2. Around Rs 6 lakh crore money (in the form of Rs 500 and Rs1000 notes) has been collected till November 23rd.
3. High denomination notes of Rs 500 and Rs 1000 that account for 86% of total currency in circulation (Rs. 17,54,000 Cr) in value terms, are withdrawn as legal tender from the midnight of November 8, 2016
4. The move is seen as the most potent way to contain the black money menace.
5. Demonetization could cause most disruption to the shadow economy expected to be around 20% of the country's GDP of over \$2tn.
6. The size of India's black economy is about \$460 bn (or, over Rs30 lakh cr), which is larger than the stated GDP of emerging markets like Thailand and Argentina, according to Ambit Capital Research
7. Cash transactions account for nearly 98% of all transactions by consumers.
8. The biggest currency swap in history, as some suggest could cause economy to pause
9. But it will certainly help the economy take a big leap: towards digital era.

3.0 Scrapped Currency and its Consequences:

A section of experts feel that demonetization drive might slash a percent or two of India's growth, some experts have warned of a decline of 50% or more in the GDP growth for 2016-2017, while a few others have even cautioned of an outright recession ahead. According to a study by the National Institute of Public Finance and Policy (NIPFP), a government think-tank, reckons that the shock move to demonetize Rs. 500 and Rs. 1,000 currency notes could lead to "a contraction of economic activity in the economy " and social unrest.

A report in Hindustan Times citing the NIPFP study said "If the entire currency is not replaced soon, a few sectors such as agriculture, automobiles and construction will be affected. As this suffering is going on, economists say that the current move is good in the long- term interest of the country, for, it is likely to broaden the formal economy and thereby improve the tax compliance. Secondly, the exchange process of notes likely to improve banks' deposits substantially, which means increased lendable resources. Indeed one estimate puts the likely accretion of deposits at a whopping Rs 15lakh cr and if even a 10%of it remained as deposits, the interest rates are sure to fall further down making long-term investment attractive. Thirdly, the fear of government repeating such an exercise once in a while is certain to bring behavioral changes among public which shall reflect in the form of money flowing into tax free investments such as mutual funds and capital market investments. All this cumulatively paves the way for growth in GDP, in the long run.

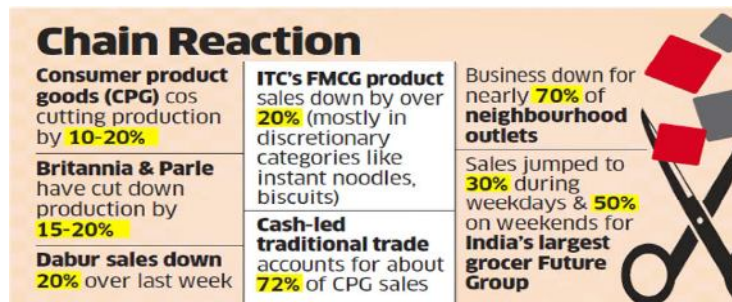
4.0 Slowdown in Economic Growth



The goal of the demonetization move in India is to make the economy stronger and eliminate the parallel cash economy which is unaccounted and untaxed. While this can impact the GDP negatively in the short term, it should have positive long term consequences. For e-commerce companies such as Amazon which already have a digital payments system in place, it should lead to higher online payment and eventually eliminate the painful cash on delivery option. However, in the short term, Amazon is likely to witness a decline in GMV from India as the economy adjusts to the “new normal”.

India is a strong growth market for Amazon and in June this year the company invested an additional \$3 billion in the country. The demonetization move will impact the economic growth in the country in the short term and could well be reflected in Amazon’s revenues from the region. But we believe that, in the long term, Amazon should benefit from this move. Lower inflation, lower interest rates and a lower budget deficits are likely to be the long term positive macroeconomic effects of the move, which should stimulate economic growth and benefit businesses in the region. However, as the country undergoes this huge transformation from a cash dominant economy to a near cashless economy, Amazon might feel the pinch in terms of lower volumes in the region, in the short term.

5.0 The Challenges



Source: <https://www.google.co.in/search>

Once the dust, strangely pertaining to currency cleaning mission, settles down some clear picture may emerge, as to how it can be carried forward in coming months. But the RBI and banks, having already handled physical challenges that emanated from demonetization, through non-stop working, recipient of customer anger, government pressure, employee resistance amidst cooperation, etc., cannot sit back and relax, as the functional business impact is quite intimidating and challenges, as could be grasped from the following:

1. Due to flush of money, deposit accretions well as reduction in loans to a certain extent, their thinning margin or spread or simply put the difference between interest earned and interest paid would receive maximum attention. Interest rate scenario would definitely change, has the carrying cost of deposit would encroach the spread.
2. With economy not picking up coupled with fear of increased credit portfolio, stemming from mounting no-performing assets as well as stressed assets portfolio, banks liquidity risk would mount and pressure on capital adequacy would also be felt.
3. Skill sets to deploy funds in remunerative areas need to be upgraded. This is an uphill task as the likely Capex scenario in the short term period is not encouraging.
4. Indian entrepreneurs are used to padding up project cost and also used to fund part of the project through black money already generated, which is now attacked. Can they put up project with all white money through acceptable debt equity mix in the absence of black money floating around?
5. With the likely reduction in the estimated GDP, the economic activities are likely to shrink with less than normal business activities in banks in the days to come.
6. To protect the spread/bottom line, a proper mix of lowering deposit interest rate coupled with rising the effective cost to borrowers needs to be arrived at. The cash reserve ratio level, arriving out of sudden surge in deposits, is drawing attention of the concerned.
7. Picking up right avenues for deployment of funds would be the mother of all challenges, as banks cannot afford to slip in their decision to deploy funds.
8. Applying ink on the finger of customer of the bank exchanging notes, akin to inking the finger of the voter in an election, is an added burden and also an irritant to the bank employees, doing a thankless job amidst crowd clouding their chair.
9. As quite a good number of decisions have been reserved or 'U' turned or revised in one or the other way, the challenges faced by the banks are becoming insurmountable, amidst daily dynamic changes in the top down approach.
10. In the absence of adequate smaller denomination notes, how is bank expected to handle the situation of large number of higher denomination notes that are having higher value than what is sought to be demonetized?

This is a situation of two steps forward and three steps backward. Moreover, with instructions coming to bankers on day-to-day basis one finds it difficult to comprehend what is valid at a given point of time.

6.0 Move towards Digitization Short-term Pain but Long term-gain:



Source: <https://www.google.co.in/search>

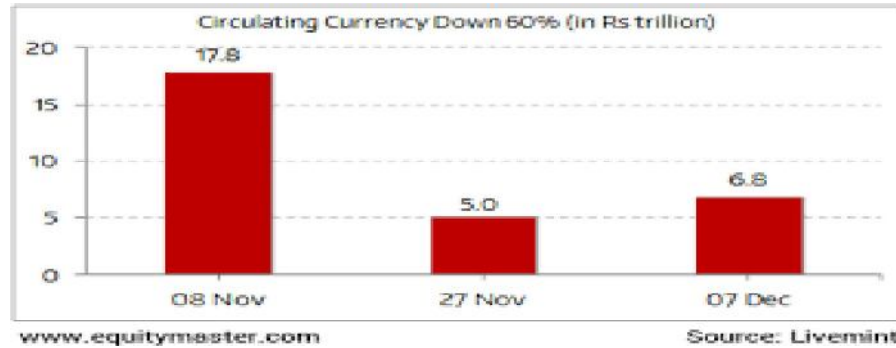
The COD is considered as a necessary evil in the Indian e-commerce market. While it boosts sales of online companies, it obstructs their cash flows and makes it difficult to scale operations. There are several additional costs involved with this payment method and the risk of returns and thefts with this form of payment are higher. The recent government push towards a cashless economy will encourage more online payments and reduce the total share of COD in e-commerce sales from the current high of nearly 80% of total transactions. This should help e-commerce companies including Amazon to reduce overhead costs and other risks associated with the COD model. However, in a region where a small section of the population owns credit or debit cards (12% according to a 2014 report), a shift towards a digital payments will be difficult and can impact revenues significantly in the short term.

7.0 The world without money to be a reality soon

7.1 Top 10 cashless countries:

- (a) Belgium: 93% transactions cashless
- (b) France: 92% transactions cashless
- (c) Canada: 90% transactions cashless
- (d) UK: 89% transactions cashless.
- (e) Sweden: 89% transactions cashless
- (f) Australia: 86% transactions cashless.
- (g) Netherlands: 85% transactions cashless
- (h) US: 80% transactions cashless
- (i) Germany: 76% transactions cashless
- (j) South Korea: 70% transactions cashless

7.2 Progress toward a Cashless Society



The idea of cashless economy is compelling. This is so as most developed countries are in the digital mode where the use of plastics, e-Wallets and Internet banking is all pervasive. Besides being an effective way to track all transactions in the economy, it reduces the burden of holding cash and hence enhances the safety of the same. It is not surprising that the ratio of currency held GDP is in the region of 3-5% in most of these countries with only small denomination notes being in circulation. In case of India, it has been in the region of 12-14% which is definitely high. It is for this reason that in the current context of demonetization, the idea of having less cash has gained currency.

India has intrinsically been cash-driven economy as most economic transactions are carried out in a non-banking mode. At the commercial level, with around 40-45% of the GDP emanating from the unorganized sector, the most common form of transaction is cash—and this includes virtually the entire farm sector. At the household level, this is mostly due to holding cash being a habit for three reasons: transactions, precautionary and speculative. Cash transactions are more transparent for the receiver who gets immediate payment and hence the transactions motivation works both ways. Cash is held for emergencies in all Indian homes which is hard to dislodge until such time that there is an alternative available like cashless hospitalization for all, which looks virtually impossible. Speculative motive is where cash is held for dealings in areas where money can be made without the notice of the taxman. This is something which will get addressed once we move to a cashless world.

It can be said that the move towards a cashless economy is required and the benefits in the long run would be enormous. Besides enhancing efficiency, it also keeps a check on black money generation as there is a trail of all transactions. In the medium run, the government also benefits through higher revenue collections. The route is, however, long and punctuated with impediments given the diverse nature of people. The time taken for fulfillment would depend on how fast people are responsive. Just like it is still a challenge to convince people not to buy gold but switch over to the 'gold bond' schemes of government, divesting oneself from each will be even harder. The right set of incentives is required to

hasten the process but more importantly the requisite infrastructure has to be in place with the security safeguards to ensure that the last mile is covered adequately.

8.0 Conclusion:

Merely responding to the events unfolding after demonetization speaks volume about the poor planning and thoughts that have gone into the buildup of this mammoth exercise. Even the new and freshly introduced notes found their way into the undesirable hands for due exchange, which may be due to some lapse in banks and other administration tools employed for the same. Despite lapse of more than a month, the bitter pain inflicted on non-targeted common populace through a disorganized implementation of the move of demonetization, has graduated negatively from “Hope to Despair” after testing the patience and tolerance of the public. In order to catch a few, many are made to struggle on a day-to-day basis.

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