Demonetization - Challenges and Opportunities for Transforming India into Cashless Economy

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Rationale Behind the Government to Demonitise the High Value Notes:

Prime Minister Narendra Modi's demonetization maneuver was a "shock doctrine" tactic to dismantle the cash-centric black market, to cleanse the country of counterfeit notes, to further digitize the economy, and to get more of the population onto the formal, taxable economic grid. Modi's plan called for the canceled notes to be replaced by new 500 and 2,000 denomination notes, but these were slow to be circulated, and India - the most cash-dependent country in the world - suddenly found itself without enough cash to run its economy.

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 canceled.

The people of India were given 50 days to redeem their canceled banknotes, after which they would become as worthless as the paper they're printed on, which caused hundreds of millions of people to rush to banks, jewelry shops, foreign-exchange counters, and ATMs. Serpentine lines often stetched outside of such enterprises for blocks, where people would stand for hours just to re-validate their wealth.

This redemption period for the old notes came to an end on Friday December 30th - and, surprisingly, nearly the entire stock of 500 and 1,000 rupee notes were recovered by the central bank. But India's demonetization transition is far from being over. While the currency supply is still not completely restored and cash is still being rationed (there are strict bank withdrawal limits of 24,000 rupees a week ($350) or 2,500 rupees ($36) per day from ATMs), India is moving through the demonetization transition.

OBJECTIVES OF THE STUDY:

The following are the objectives of the Study:

1. To Study the reasons behind Demonetization
2. To study the various issues involved in the process of Demonetization.
3. To study the Impact of Demonetization on various sectors.
4. To study the Challenges and Opportunities for Transforming India towards Cashless Economy.

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RESEARCH METHODOLOGY:

The data in the study was mostly collected from the Secondary sources such as - News Articles, Information Bulletins from RBI, Experts opinion and also from different websites etc depicting the research topic.

IMPACT OF DEMONETIZATION ON VARIOUS SECTORS:

Effect on parallel economy: Cash Economy to Witness Contraction

The currency of the aforementioned denominations constitutes around 86% of the total value of the currency in circulation. It is expected to remove black money from the economy as they will be blocked considering the holders will not be in a position to deposit the same in the banks, temporarily halt the circulation of large volumes of counterfeit currency and curb the funding for anti-social elements like smuggling, terrorism, espionage, etc.

Effect on GDP: Downward Bias to GDP Growth

The sudden decline in money supply and simultaneous increase in bank deposits is going to adversely impact consumption demand in the economy in the short term. This, coupled with the adverse impact on real estate and informal sectors may lead to lowering of GDP growth.

Lower Money Supply has a Deflationary Effect: With the older 500 and 1000 Rupees notes being scrapped, until the new 500 and 2000 Rupees notes get widely circulated in the market, money supply is expected to be reduced in the short run. Reduction in money supply can also have a deflationary effect in the economy. However, whether the impact of the reduced money supply will lead to deflation or contraction in demand or a mix of both will vary from sector to sector depending on the nature of goods & services.

Impact on Bond Markets: Surge in deposits will create more demand for government bonds and other high rated bonds in a situation of tepid demands for credit, leading to lower bond yields especially in the shorter end of the curve. At the same time, a reduction in leakages in systemic liquidity will reduce the scope for open market operation purchases in the coming days. We believe that the RBI will continue to sterilize excess liquidity from the banking system to keep the short term rates aligned with the policy rate.

Credit Impact across Sectors: Impact of this policy measure will flow to the economy mainly through the Real Estate sector, which has strong linkages with sectors such as cement and steel and which will turn credit negative in the short-run. A significant impact in the short-run will be on the daily/weekly wage employment in the informal sector. The construction sector has one of the highest employment multipliers. The key segments of the economy where cash transactions play a vital role are real estate, gold and the informal sectors, which may face near term contraction.

Effect on 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 Accounts of commercial banks. This, in turn, will enhance the liquidity position of the banks, which will be later utilized further for lending purposes. However, to the extent that households have held on to these funds for emergency purposes, there are expected to be withdrawals at the second stage.

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Effect on Online Transactions and alternative modes of payment:

With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E wallets and apps, online transactions using E banking, usage of Plastic money (Debit and Credit Cards), etc. will definitely see substantial increases in demand. This should eventually lead to strengthening of such systems and the infrastructures required.

Bank Deposit Rates to Soften:

We can expect a large amount of cash in circulation to be brought within the purview of the formal banking system by way of deposits. This is structurally positive for banks, as part of this cash gets deposited as current account and savings account (CASA) deposits, reducing banks dependence on higher cost borrowing. Deposit deployment remains a challenge in the short to medium term due to the current tepid demand for credit, subsequently pushing deposit rates lower.

NBFC's Asset Quality Faces Pressure: We believe in the asset quality of Retail Asset Lenders, especially NBFC's which have developed expertise in the credit assessment of the informal segment and have built models around it to stay under pressure in the short term. Within NBFC's, asset quality of lenders with a large dependence on cash collection remain vulnerable in the short term. In the longer term the implications could be a risk profile shift for the NBFCs, as the stronger borrower profile could potentially migrate to banks.

Payment Banks to Benefit: Payment banks and others entities which are part of the transaction ecosystem are likely to be long term beneficiaries, as more and more cash finds its way into the formal banking channels. We believe the cumulative measures taken to reign in black money will improve banking habits, create financial and transactional history of the informal & cash dependent segments and could, over the long term, make them 'bankable'.

Investment in Financial Products: Investors in the short term will now believe that Cash is not the safest asset and there is little point in hoarding it. This will shift them from physical asset to financial assets where returns are also higher

Impact on Consumption Sectors

Agreement Cost of Real Estate May Rise: We expect that the real estate demand from end users is unlikely to be impacted, since a majority of them are backed by funding from bank loans. Demand from investors for real estate however may come down since in some cases, investors prefer cash transactions. If the proportion of earlier transactions in the real estate sector, which were allegedly done through partial cash payment reduces, the registered prices for real estate will go up. We expect the supply of real estate in the secondary market, which is strongly rumoured to have a large cash component involved, to suffer in the short term, which may in turn improve demand for residential real estate in the primary market.

In the medium term, the prices in this sector could regain on many fronts as developers rebalance their prices (probably charging more on cheque payment).

Used car Sales May Fall: Sales of vehicles in the second hand market for original equipment manufacturers will get impacted, which will cause a ripple effect on New Car sales, as buyers will not be able to dispose of their old vehicles easily.

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Slowdown in Discretionary Spending to Hurt Consumer Durable Sales: Sales of White Goods like TV, Refrigerator & Washing Machine could slump as much as 70% as a good portion of the market is driven by Cash. This may continue for next Six Months till the dust settles down and there is adequate circulation of the new currencies.

Prices are expected to fall only marginally, due to moderation in demand, as use of cards and cheques could compensate for some purchases.

Demand for Gems and Jewellery to Decline: We can expect the demand for gems and jewellery to decline in the next two to three quarters. This would result in a weakening in the credit profile of industry players due to the high working capital cycles and high operating leverage. The unorganised segment will be hit particularly hard, given the large proportion of unaccounted inventory and high proportion of cash sales. Over the medium-term the organised industry players will benefit at the cost of the unorganised players. Gold imports through the unofficial channels are likely to reduce. There will be no significant impact on jewellery exporters because it is mostly an organised market and sales are against invoices.

High End Retail Demand to fall: We expect the impact on high end fashion retail and luxury goods to be more pronounced as discretionary demand in this segment will be curtailed. In case of Quick Service Restaurants, although 60%-70% of the transactions are currently in cash, the impact is likely to be moderate due to the low ticket size of purchases and high likelihood of patrons adapting to plastic money. We expect a limited impact to be caused on the food and grocery retail sub-segment, given the non-discretionary nature of purchases in this segment, since the buying cycle for the current month would have been largely influenced.

Private Educational Institutions: Since Private Educational Institutions take huge amounts of donations in Cash which is 40 % to 50%, we expect that this move will impact the Private Education Institutions receipts.

Medical Institutions (Both Hospitals & Medical Colleges): Again, as Medical Institutions like Hospitals and Colleges take huge amounts of donations in Cash which are more than 100 % of fees, we can keep on expecting that this move will impact not only the admissions but also the receipts.

Political Parties: Elections & Political Parties are major sources of Black Money transactions. Most of the funding of National Political Parties is in Cash which is 40% to 50%, and when it comes to Regional Parties it goes upto 50% to 60%. The sources of more than 90% of such funds are never disclosed. Candidates as well as their donors even the Political Parties will feel cash strapped. An assembly seat candidate spent on an average Rs. 4-5 Crores on Campaigning that is likely to go down drastically.

This is going to cause huge craters on their funding and will reduce their funds drastically. It is going to deal a major blow to political parties fattening their coffers with cash contributions in anticipation of high stakes electoral battles in UP, Punjab, Uttarakhand, Goa and Manipur. This stroke is bound to leave big players hamstrung and suddenly resource-poor.

Dabba Trading (Bucketing): It may kill Dabba Trading. Trades done outside bourses, Satta Bazaar & Illegal Betting market may die a natural death as currency gets a new face. Demonetization was a jolt for Dabba traders, who were thriving in equity markets for many years now.

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Effect on various economic entities:

The key segments of the economy where cash transactions play a vital role are real estate / construction, gold and the informal sectors as such. The role of cash transactions in case of real estate and gold is mostly dubious, however in case of the informal sectors it is the lifeline. For example, small and marginal farmers in the fruits and vegetables category typically require off-loading of their produce in the local Mandi in cash and could see an immediate impact. A sudden demonetization will adversely impact this segment of the economy and it will witness immediate contraction, though this impact will diminish over time.

With cash transactions lowering in the short run, until the new notes are naturalized widely into circulation, certain sections of the society could face short term disruptions in facilitation of their transactions. These sections are:

- Agriculture and related sectors
- Small traders
- SME
- Services Sectors
- Households
- Professionals like doctors, carpenters, utility service providers, etc.
- Retail outlets

The nature, frequency and amounts of the commercial transactions involved within these sections of the economy necessitate cash transactions on a more frequent basis. Thus, these segments are expected to have the most significant impact post this demonetization process and the introduction of new notes in circulation.

Others Severely Hit:

Hawala Traders, Bookies, & Scrap Dealers.

Challenges and Opportunities for the Govt. for Cashless Economy:

Greater usage of digital payments will save trillions of rupees for the Indian economy as it will help bring down the cost of cash according to a report by payments company Visa Inc Titled "Accelerating the Growth of Digital Payments in India: A five-years Outlook". The report looks at the challenge of transitioning India to a less-cash society over the next five years and outlines an action roadmap for lowering the cost of cash to 1.3% of Gross Domestic Product from 1.7% now.

Increasing the Volume of Electronics Payments Provides numerous benefits to the government such as -

Drives Economic Growth:

Increased card penetration can increase GDP;

Shift from cash payment reduces social costs.

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Increases Financial Inclusion:

Greater acceptance of e-payments provides an on-ramp to financial inclusion.

Requires an enabling regulatory framework.

Reduces the Shadow Economy:

Cash enables and perpetuates shadow economies.

Electronic payment penetration correlates to size of shadow economy.

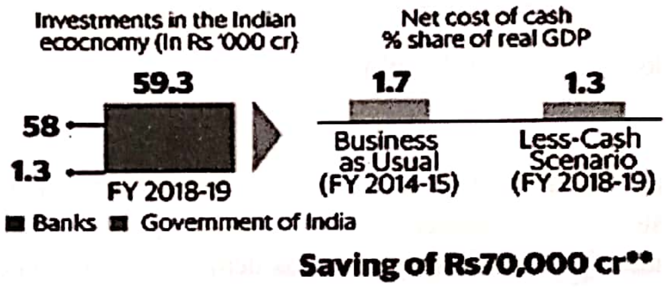
Enables Digital Commerce:

Electronic payments facilitate trusted transactions online.

Reduction in Cash Payments, enables e-Commerce growth, although in India Cash-on-delivery played an important role.

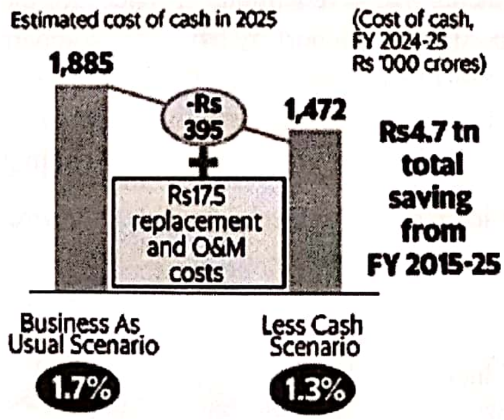
Benefits of Going Cashless Economy:

An investment of about Rs.60,000 crores over 5 years, India could reduce its cost of cash from 1.7% to 1.3% of GDP.



For the purposes of calculating the savings, we only count the additional mPOS and customer and merchant acquisition costs as the remaining capital cost is likely to be incurred by banks in the business-as-usual scenario. FY 2018-19 GDP estimate, Rs.132 trillion.

A 0.4% reduction in the cost of cash could provide India with additional saving of Rs.4 tn by FY 2024-25.



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Major Observations Post Demonetization:

The following are the major observations post Demonetization:

1. Banks have pumped in more cash deposits with the effect of demonetization of the higher denominations.
2. Jan Dhan accounts are filled with money, Government started this scheme for financial inclusion purpose, but people were reluctant to keep money in the bank; but after demonetization started, citizens are ready to come back to the banking network and thereby our banking system strengthened, citizens will be the beneficiaries of financial inclusion!
3. Many businessmen in India are declaring their black money as income and paying advance tax, we have seen many such examples in the recent days as many of them are coming forward and declaring cash lying with them as black money and paying taxes!
4. The fake currency is 100% out of circulation in one stroke! This is probably one of the greatest changes that are taking place.
5. All business men are depositing cash lying with them as current year income with Advance Tax which is a boon for the Indian Economy.
6. All jewellers are being issued forms to declare their Gold stock on day to day basis!
7. Defaulters of bank, property tax, electricity bills, and telecom bills have taken full advantage by clearing their long pending bills.
8. Defaulters of all kind of taxes have cleared their dues and are upto date, with the effect of the government's Demonetization scheme.
9. Small vendors started going digital and already using APPS, digital forms of transactions and digital wallets!
10. Cash to create chaos and terror lying with terrorists, Maoists, Naxalites, Jihadis gone waste!
11. Hawala sources dried up for funding of terrorists, Maoists, Naxalites, conversion lobby and Jihadis. As we know there is a considerable decrease of violence in Kashmir after this decision. Once the funding stopped, there won't be any riots in the valley and we are already witnessing the live effect!
12. Kashmir back to normal, schools are opened, normalcy in the valley, no schools burnt, you won't find any stone pelters these days!
13. More than 55 lakh money disputes settled in one day in Lok Adalats
14. Fiscal deficit of India has drastically reduced as compared to the previous years.

CONCLUSION:

The government more of demonetization of the high value currencies i.e. currency notes of 500 and 1000 with an objective to unearth the black money, and to curb the corruption, counterfeit currency as well as terror financing, was considered as biggest cleanliness drive against the black money in the history of Indian economy. But there is other view of experts on demonetization, as some argues that it will hit the black money and others argued in negative.

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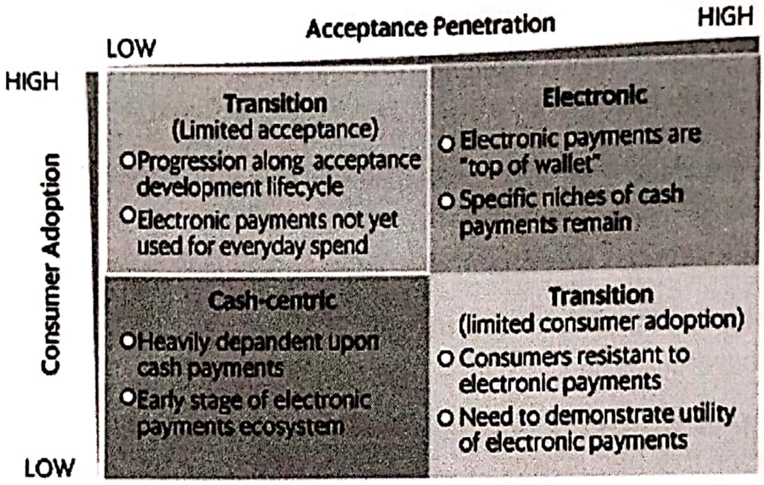
Currently high-value currency notes accounts for the value of 86% of the notes in circulation in India. Central government's recent decision to demonetize the high value currency is one of the major step towards the eradication of black money in India. The demonetization drive will affect some extent to the general public, but for larger interest of the country such decisions are inevitable. Also it may not curb black money fully, but definitely it has major impact in curbing black money to large extent.

Key Suggestions to The Government for Cashless Economy:

The following key suggestions will be useful to the government to Penetrate the growth of Digital Payments:

1) Expand Acceptance:

A country's approach to expanding acceptance will depend upon its readiness for electronic payments



Source:http://www.livemint.com/r/LiveMint/final-digital-payments_web.jpg

Market readiness can be classified according to levels of:

a) Number of accepting Merchants

b) Number of acceptance points (per population).

Consumer Adoption:

Access to electronic payments

Frequency of usage

2) Energize Innovation:

a) Establish an acceptance development fund of around Rs.1000 crore to increase acceptance of digital payments in under-penetrated categories.

b) Provide Fiscal Incentives for promoting digital payments.

c) Introduce new regulations on mandatory digital payments in certain cases, reduce import duties on payments infrastructure; and make digital payments of salaries mandatory.

d) Allow foreign companies to participate in the digital payments ecosystem independently and develop a repository to track payment history of customers.

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3) Bolster Financial Participation:

a) Facilitating inter-ministerial collaboration at the centre and engagement with states to leverage existing programmes and platforms, for example, mKisan.

b) Designing programmes tailored to meet the needs of various types of underserved segments such as women and farmers.

c) Strengthening efforts to promote financial participation at the last mile, working in collaboration with existing microfinance institutions in different states.

d) Crafting approaches to inculcate financial literacy programmes at the school level and in higher education, and as part of public service education.

e) Introducing Certification standards and constructing innovating models for business correspondents.

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