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Impact of withdrawal of 2000 rupee notes

RBI in its notification dated 19 May 2023 has announced gradual withdrawal of 2000 rupee notes from the system; albeit stating that it continues to be a legal tender. Against this backdrop, we have tried to look into the impact on banking system liquidity considering alternative scenarios and also the possible cost-returns analysis.

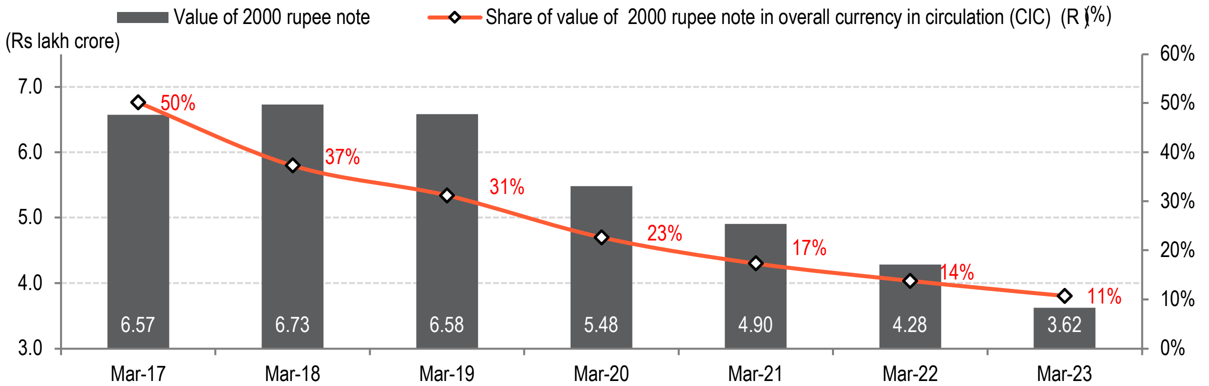
Key findings:

- Move is clearly to encourage a shift in payment behavior of the economy.
- Banks will face possible temporary influx of liquidity leading to increase in deposit base.
- This will widen credit deposit gap; and surplus liquidity with banks which can be used either for investment in government securities or lending purposes.
- This will also lead to marginal inching up of interest outflows on deposits for banks. However, there will be corresponding return on investments and the net impact may be balanced out.

Current state of 2000 rupee notes:

In its notification, RBI clearly stated its main decision towards withdrawal of this denomination has been the persistent decline in share of 2000 rupee currency notes in the overall basket. From around 50% in FY17, the share of 2000 rupee notes in value terms have fallen to 3.6% in FY23. Hence RBI's move clearly reflects the shifting pattern of payment system in the economy.

Figure 1: Continuous decline in share of 2000 rupee notes



Source: RBI, Bank of Baroda Research

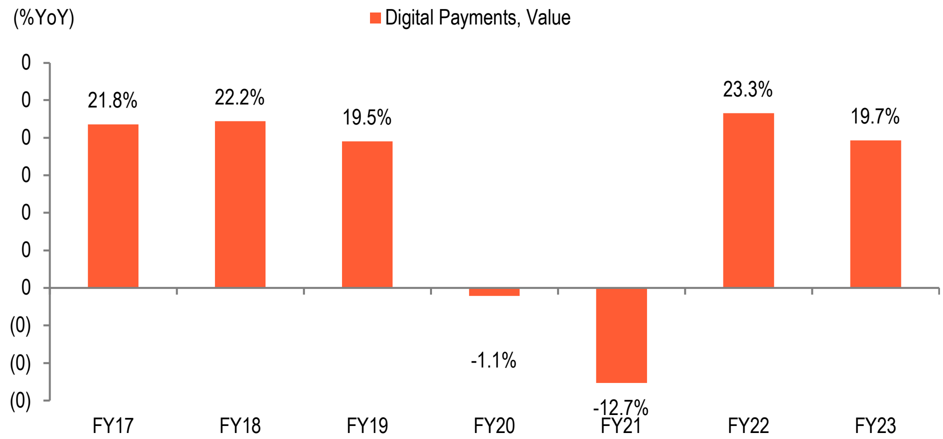
Table 1: 500 rupee notes still dominate the major share in overall basket

Share of major denomination in overall basket	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
2 and 5	0.4%	0.3%	0.3%	0.3%	0.2%	0.2%	0.2%	0.2%	0.1%
10	2.1%	2.1%	1.9%	2.8%	1.7%	1.5%	1.3%	1.0%	0.9%
20	0.7%	0.6%	0.6%	1.5%	1.1%	0.8%	0.7%	0.6%	0.7%
50	1.3%	1.2%	1.2%	2.7%	2.0%	2.0%	1.8%	1.5%	1.4%
100	**11.5%**	**10.5%**	**9.6%**	**19.3%**	**12.3%**	**9.5%**	**8.2%**	**6.7%**	**5.8%**
200	-	-	-	-	2.1%	3.8%	4.4%	4.1%	3.9%
500	**44.4%**	**45.9%**	**47.8%**	**22.4%**	**42.9%**	**51.0%**	**60.8%**	**68.4%**	**73.3%**
1000	39.6%	39.3%	38.5%	0.7%	0.4%	-	-	-	-

Source: RBI, Bank of Baroda Research; Note: Higher share of currency denomination marked in red, the share doesn't translate to 100% because 2000 rupee notes are not included.

Needless to mention that India's economy underwent revolutionary changes in terms of payment dynamics. In terms of CAGR, digital payment in volume terms have grown at a pace of 8.8% in the past 5 years compared to 4% CAGR in real GDP during the same 5-year span. Negative growth witnessed in FY20 and FY21 as volume of activity in the country went down due to the lockdown.

Figure 2: Digital payments gaining prominence



Source: RBI, Bank of Baroda Research

Impact on Banks using scenario analysis

There can be two extreme cases. One where the entire stock of 2000 rupee notes are exchanged for smaller denomination notes; and the other where some 2000 rupee notes gets deposited in bank deposits. For the first case, impact on system level liquidity will be neutral.

However, for the second case, we have charted out three scenarios. In this section, we consider three different scenarios, where we analyze what will happen to bank deposit growth and credit-deposit gap if 25% of total INR 2000 notes are deposited, 50% are deposited and 75% are deposited.

Scenario 1: If 25% of the total INR 2000 notes (Rs 3.62 lakh crore) are deposited then we can expect bank deposits to go up by Rs 90,000 crore.

Scenario 2: If 50% of the total INR 2000 notes (Rs 3.62 lakh crore) are deposited then we can expect bank deposits to go up by Rs 1.8 lakh crore.

Scenario 3: If 75% of the total INR 2000 notes (Rs 3.62 lakh crore) are deposited then we can expect bank deposits to go up by Rs 2.7 lakh crore.

Table 2: Possible increase in deposits

	Rs lakh crore
Total value of INR 2000 note in circulation	3.62
% of total that may come back as deposits:	
25	0.9
50	1.8
75	2.7

Source: RBI, BoB estimates, Bank of Baroda Research

Bank deposits as of 31 Mar 2023 were at Rs 180 lakh crore. Assuming 11.5% growth in FY24, deposits were earlier expected to come in at Rs 201 lakh crore. Now, following the withdrawal of Rs 2000 note, and based on our scenario analysis above, deposits can range between Rs 202-204 lakh crore.

Further, for FY24, we have assumed a credit growth of 12-14%. This implies that credit outstanding is expected to rise from Rs 137 lakh crore in FY23 to Rs 155 lakh crore this fiscal year. The gap between incremental credit and incremental deposit, which was earlier assumed to be ~Rs 3 lakh crore, will now increase to ~Rs 4-6 lakh crore.

Table 3: Credit-deposit gap

	Rs lakh crore
Deposits as of 31 Mar 2023	180
Deposits as of 31 Mar 2024 (BoB estimate)	201
Estimated increase in deposits (after INR 2000 note deposits)	0.9-2.7
Credit as of 31 Mar 2023	137
Credit as of 31 Mar 2024 (BoB estimate)	155
Incremental deposit- Incremental credit gap (FY24 estimate)	~3
New incremental deposit- Incremental credit gap (FY24 estimate)	~4-6

Source: RBI, BoB estimates, Bank of Baroda Research

In any of the three scenarios, banks will be flushed with liquidity which can be then deployed either for lending or for investment purposes. However, this will come at a cost. Assuming average term deposit rate for >1Y deposit at 6.63%, cost for banks for servicing these additional deposits (Rs 0.9-2.7 lakh crore) will go up by Rs 6,000-18,000 crore.

Whether this Rs 3.62 lakh crore be parked in SDF/Gsec by banks?

If say Rs 2.7 lakh crore of deposits is invested at the SDF, average interest cost on part of the RBI due to higher frequency of reverse repo operation on account of surplus liquidity in the system, amounts to Rs 0.17 lakh crore, on the assumption that the entire amount is kept in the SDF window by banks.

If invested in government bonds then the Rs 2.7 lakh crore of deposits could earn around 7% in which case there would be earnings of Rs 0.19 lakh crore.

The net gain could hence will be marginal around Rs 0.02 lakh crore even if the entire amount is not used for lending but invested in government bonds.

But, excess demand in the bond market would lead to increase in price of those securities and lower yields. Hence yields across the board are likely to fall by 5-10 bps depending on the quantum of funds that move into deposits rather than be exchanged for other notes.

The pronounced impact will be on short end of the curve which are more prone to the transitory changes.

Possible Expenditure on part of RBI

In 2021-22, the total volume of currency in number increased by 61,655 lakh. Total cost of printing currency was Rs 4,985 crore. The average cost of printing a currency note was around Rs 8/piece. Hence, if the entire amount of Rs 3.6 lakh crore of Rs 2000 notes was exchanged for say, Rs 500 notes, then the ~181 crore pieces of Rs 2000 notes would work out to ~ 724 crore pieces. The cost would be Rs 5,792 crore.

Sectoral impact

The following sectors/areas would be the ones that would generally be using the 2000 note and could face temporary disruption.

- **Real estate:** Construction activity is to some extent cash-dependent and this move may impact activity in the short run. Often land deals are partly settled in cash.
- **Agriculture:** It is also heavily cash dominated. Apart from large farmers, medium and small farmers may face issues while making payments for inputs and labour.
- **Transportation:** Large part of freight moved through roads also involve significant cash payments as it is in the unorganized sector.
- **MSME:** Small traders who buy raw materials, pay salaries/suppliers using INR 2000 note may get temporarily impacted.
- **Elections:** State and General elections are due towards the end of CY23/early CY24. Elections held in different parts of the country also use cash to meet expenses. As the need remains, conversion to Rs 500 notes would be preferred.
- **Jewellery:** Sales of jewellery in the hinterland are still conducted in cash and there can be disruption in the informal segment.

- **Forex:** There is a grey market for foreign currency which made use of the Rs 2000 note. Here too there would be disruption as buyers-sellers change over to the Rs 500 denomination.

Disruption on account of withdrawal of the Rs 2000 note will be minimal and restricted to specific sectors. Activity here will most likely shift to the Rs 500 note as it is unlikely that the terms of payment may change as it is largely in the informal segment. Banks will have surplus liquidity to begin with which if invested in bonds can give a marginal net return. There can be a tendency of a substantial part of the notes to be exchanges; but this has to be tracked in the next two months when a clearer picture emerges.

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