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Demonetization and its impact on Indian economy with special reference to Indian banking sector

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Abstract

Demonetization refers to cancellation of legal tender status of currency in circulation. Anticipating positive effects on the economy, nations often adopt demonetization policy. Government of India adopted demonetization policy on November 8, 2016. Prime Minister Narendra Modi announced this policy while addressing the nation in his Mann Ki Baat speech on November 8, 2016. Under this policy, high denomination Indian currency notes of Rs.500 and Rs.1000 were declared to be no longer in use as legal tender which means that these notes were not be acceptable for transaction. After this, RBI announced the release of redesigned new currency notes of Rs.500 and Rs.2000 which were released on November 10, 2016 by RBI and continue to be in circulation since November 10, 2016. Demonetization in India was adopted to fight against various problems such as corruption, black or parallel economy, terror funding, fake currency, money laundering and hoarding, tax evasion etc. In this paper, we are trying to explore the impacts of demonetization on banking and economy and how far is this policy able to curb the above-mentioned problems.

Keywords: Demonetization, corruption, money hoarding, fake currency

Introductions

Indian economy is a middle-income developing economy. It consists of mainly three sectors that are Agriculture & allied sectors, Industry sector and Services sector, which contribute 14.65%, 30.19% and 55.17% respectively to the GDP. Since Independence different governments adopted various policies and reforms to boost economic growth and one such reform is Demonetization.

Demonetization refers to cancellation of legal tender status of currency in circulation. In India, demonetization policy has been adopted three times. First time, it was adopted in 1946 when Rs.1,000 and Rs.10,000 notes were completely banned by Government of India. After this, in 1954, new currency notes of Rs.1,000; Rs.5,000 and Rs.10,000 were introduced by GOI. Further, in 1978, Government headed by Morarji Desai cancelled the legal tender status of these notes. Recently, on November 8, 2016, GOI headed by Narendra Modi demonetised the Indian currency notes of Rs.500 and Rs.1,000 and introduced new currency notes of Rs.500 and Rs.2,000. To make this demonetization successful, Indian Banking System played a major role.

Banks are the most important and central part of an economy. They are financial institutions that accept deposits from public and advance loans to public. They are responsible for the smooth functioning of the economy as they channelize the money to different sectors. In India, when demonetization policy was adopted, the most burden was on the banks because they have a crucial role in maintaining the smooth supply of money. The day-to-day operations of the banks were affected. Also, people started preferring digital payment platforms. Therefore, the security of people from digital fraud became the topic of utmost importance. Hence, the present paper tries to study the impacts that demonetization has on Indian Economy and Indian Banking System.

Literature review

Nerkar (2016) in his paper talks about the advantages and disadvantages that demonetization had on Indian Economy. He opines that demonetization has reduced black money which further reduced terror funding, gambling etc. On the flip side, he believes that initially it created a chaos among common people and also it involved the costs of printing of new currency notes.

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Singh (2017) in his paper concluded that demonetization has short term negative impacts on different sectors of the economy, that is, on agriculture sector, manufacturing sector and service sector.

Katke, Kamat and Kalal (2017) opined that demonetization has badly impacted the sales of Automobile Industry as bookings of cars had been dropped just after it which further led to piling up of inventories. Further, they also pointed out its effect on consumer's buying behaviour as consumers develop a fear and uncertainty which led to postponement of car bookings.

Kumari and Zaidi (2017) conducted a survey in the Meerut city of Uttar Pradesh and found that demonetization has increased the workload on bank employees as number of customers increased in banks. Also, they found that money lending had decreased.

Prabhu, Girish and Mamatha (2017) have concluded in their study that post demonetization there is increase in deposits with banks, increase in number of customers and stress on bank employees.

Veerakumar (2017) studied in his paper the impact of demonetisation on people of India. For this, they collected the data from 100 random people of Coimbatore district of India. He found out that educational qualifications and type of the family does not have any significant association with level of impact of demonetisation. While, gender, age, annual income and occupation have significant relationship with level of impact of demonetisation on people. Further, they find that people agreed that demonetisation helps in reducing black money, corruption, terrorism and other illegal activities.

Shirley (2017) examined the impact of demonetisation on Indian economy and World economy. She points out that due to demonetisation, the worst impacted sectors were real estate, construction material and unorganised sector. In short term, demonetisation leads to short-term liquidity crunch which adversely affects all the economic activities. On world economy, the impact on household sector, fishing and farming industry, businesses, counterfeit currency, hawala etc. were studied by the author. Further, he claimed in his study that demonetization failed in various countries, such as, Zaire, Nigeria, Zimbabwe, North Korea, Pakistan and Venezuela. While, in Australia and USA, it proved to be successful.

Sharma (2018) studies in her paper the extent and impact of demonetisation on Indian Economy. She claimed in her study that the demonetised currency amounted about 86% of total currency in circulation at that time. She concluded that this bold step of government was necessary because of

various economic problems that India was facing at that time such as, hyperinflation, black money, counterfeiting, and tax evasion. Further, she points out various positive and negative impacts of demonetisation on Indian economy. On one hand, demonetisation helps in fall in food inflation, eliminating black money, reducing hawala transactions and pushed people towards digitization. While, on the other hand, it negatively impacts all the economic activities.

Singh and Singh (2018) examined in their paper the causes and impact of demonetisation on Indian economy. They concluded that there are various reasons behind demonetisation, such as rising black money, fake currency rackets, to encourage online transactions and many others. Further, they find that demonetisation affected all the sectors of the economy. Retail sector, followed by agriculture, real estate, construction sector, among others are the most affected by demonetisation. Furthermore, they claimed that demonetisation is proved to successful in removing black money as nearly 90% of total cash in circulation come back to the banking system.

Narsaiah (2019) took out a study and found out that there is no significant impact of demonetization over banking loans and advances of SBI during the pre- and post-demonetization period.

Research methodology

It is a descriptive research paper for which secondary data has been used. The data is taken from reliable sources like RBI, Ministry of Finance etc.

Objectives of the study

- To study the causes behind demonetization.
- To analyse the impact of demonetization on Indian Economy
- To analyse the impact of demonetization on Indian banking sector.

Causes behind demonetization

1. **Black Money:** One major cause behind implementing demonetization is to eliminate or reduce huge sum of black money hoarded by people, mainly, owners of big business houses, politicians and bureaucrats.
2. **Fake Currency:** Another reason of introducing this policy is that it helps in flushing out fake currency notes which circulates in market. Table below shows the amount of counterfeit currency detected in period 2015-16.

Counterfeit Currency Detected, 2015-16					
Denomination	Counterfeit Notes	Notes in Circulation	Counterfeit (%)	Counterfeit Value	Total Value
2,5	2	11,626 million	0	Rs 7	Rs 4,069.1 crore
10	134	32,015 million	0	Rs 1,340	Rs 32,015 crore
20	96	4,924 million	0	Rs 1,920	Rs 9,848 crore
50	6453	3,890 million	0.0000017	Rs 322,650	Rs 19,450 crore
100	221447	15,778 million	0.000014	Rs 2.21 crore	Rs 1,57,780 crore
500	261695	15,707 million	0.0000167	Rs 13.09 crore	Rs 7,85,350 crore
1000	143099	6,326 million	0.0000226	Rs 14.31 crore	Rs 6,32,600 crore

Source: RBI Annual Report 2015-16

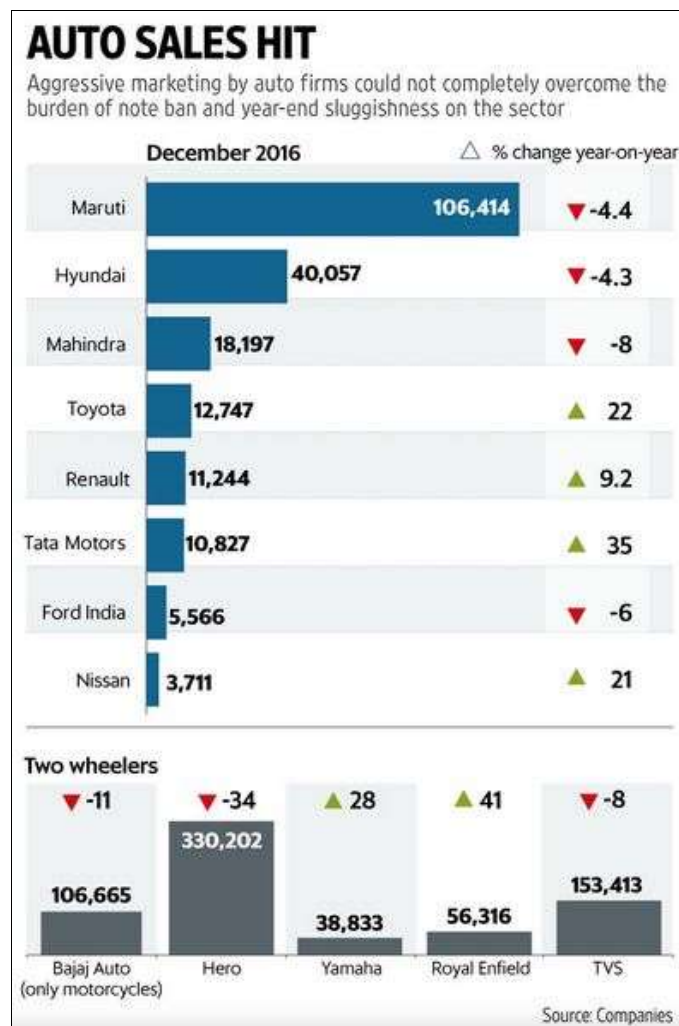
- 3. **Corruption:** GOI adopted this policy to break the tentacles of corruption. High denomination currency notes are vulnerable to be used for unfair purposes. It is easier to bribe someone in high denomination-high valued currency notes. With demonetization, high denomination currency notes are declared worthless which make it difficult for corrupt people to practice corrupt exercises.
- 4. **Digitization:** For making India a cashless economy and to promote digitization, demonetization is adopted. It was assumed that chances of tax evasion and corruption will plummet or reduce as the transactions will be online, recorded and monitored.
- 5. **Terror Funding:** Black money is used for terror funding and other anti-social activities. Therefore, with a view to reduce such activities, the bold step of demonetisation has been taken by the government.

- 1. **Economic slowdown:** With demonetization, consumption demand slacked which further resulted in decrease in production. As cash in hand decreased, consumption was affected adversely. Consequently, post-demonetization there was a sudden drop in GDP growth rate in the following quarters. Before demonetization, in second quarter of FY 2016-17, GDP growth rate was 8.87% at 2011-12 prices. But, just after demonetization, it reduced to 7.55% in third quarter of FY 2016-17. Furthermore, growth rate of GDP was 7.04% in fourth quarter of FY 2016-17 and in first quarter of FY 2017-18, it was just 5.99%.

Impacts on Indian economy

Growth rate of GDP showed an erratic pattern after implementation of demonetization.

Automobile and real estate sector are among the badly hit sectors due to demonetization as demand for automobiles and properties have reduced. In December 2016, immediately after demonetization, a fall of one-fourth was noticed in sales of two-wheeler industry. Moreover, the leading industries dealing in car manufacturing also witnessed a reduction of 4% in its sales.



Source: <https://blog.hiringplug.com/post/109/the-effects-of-demonetisation-on-the-corporate-sector>

- 2. **Scarcity of Cash:** Demonetization creates sudden and short-term shortage of cash. This results in decrease in economic activities. This also put many challenges in front of people as Indians prefer to hold cash for transaction purposes. Even their simple daily chores

were badly affected as some people had no cash even to buy their daily pre-requisites. Some even had to take off from their jobs just to stand in queues to exchange their old currency notes. Consequently, the daily wage earners were greatly affected. Also, demonetization was

announced when the Indian wedding season was at its peak. Therefore, people faced many difficulties because of shortage of cash.

It even led to some extreme consequences/outcomes as there was news of people dying because of shock when they had no money to marry their children or fatigue due to standing in queue for a long period and working for long hours in banks.

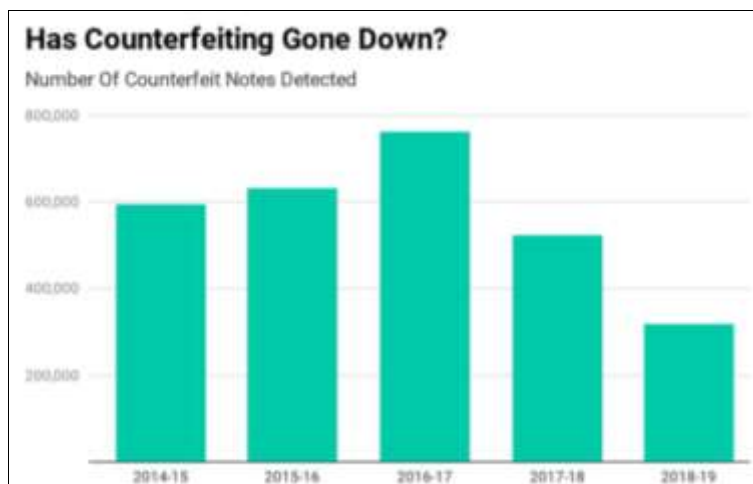
- 3. **Effect on Black Money:** On November 8, 2016, while introducing demonetization, Prime Minister Narendra Modi says, “Our generation did not get the opportunity of fighting for the freedom of our nation but today we have the historic opportunity to weed out the menace of corruption and black money to secure the future of our nation.”

The main objective of demonetization was to wipe out the black money from the economy as black money hoarded by people became a worthless piece of paper after it. Those who wanted to replace the old currency notes with the new

ones now will have to show where that money came from does.

But demonetization does not seem to be that effective in removing black money as it was expected because black money hoarders did not hoard money in form of cash rather they preserved their money in form of physical assets like gold, buildings, properties etc. Also, according to RBI Report for 2017-18, 99% of old banned bank notes of Rs.500 and Rs.1000 was returned to the RBI. This surely showed that this demonetization did not prove effective in reducing black money.

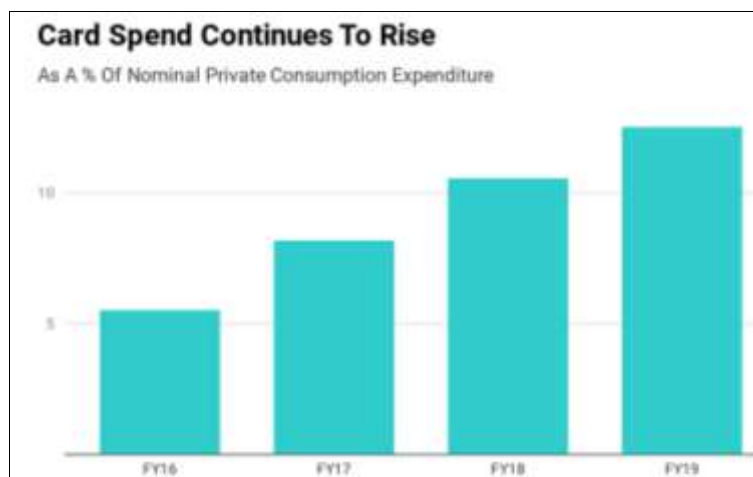
- 4. **Impact on counterfeit (fake) currency:** Counterfeit currency is also known as fake currency. One of the objectives of demonetization was to kick out fake currency from circulation as it is used for funding terrorism which cripples down an economy. With demonetization, counterfeit currency is eliminated automatically as this currency can't be used for transactions. Graph below shows that after demonetization amount of fake currency diminished over time.



Source: RBI Annual Reports 2017, 2018, 2019.

- 5. **Digitization:** Demonetization promotes Digital India program. It helped in promoting e-commerce and e-payment methods. As cash in hand reduced, people suffered problems to meet their daily basic transactions. This shortage of cash led to automatic inclination of

people to the digital modes of payment. People had to pay for their transactions via e-wallets and plastic cards. Graph below shows that spending via cards increased after demonetization.



Source: RBI, MOSPI

6. Impact on International Trade: To analyse the impact of demonetization on international trade of India, consider the following table which shows the data of India’s exports and imports of merchandise and services from September, 2016 to February, 2017.

Table 1: India’s month-wise Overall Trade (Merchandise plus Services)

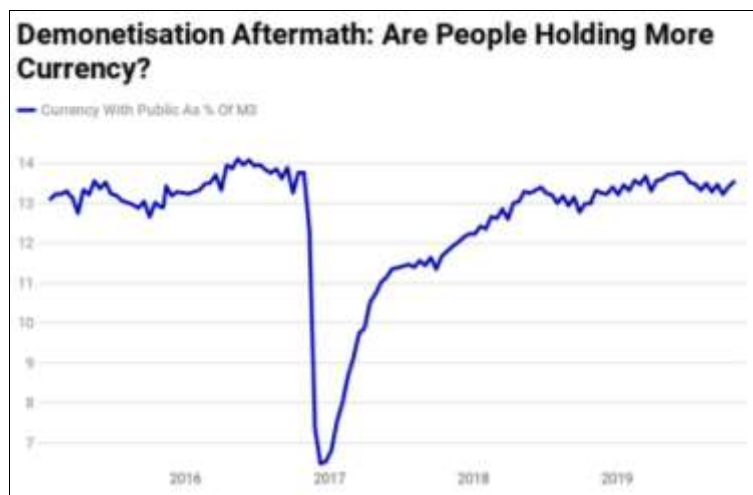
(US\$ Millions)			
	Exports	Imports	Trade Balance
September, 2016	36541	40153	-3602
October, 2016	36474	42175	-5701
November, 2016	33404	41785	-8381
December, 2016	37860	42896	-5036
January, 2017	35926	40670	-4744
February, 2017	37787	41483	-3697

Source: Monthly Bulletin on Foreign Trade April 2018

The data shows that in November, 2016, India’s exports and imports decreased by 8.42% and 0.92%, respectively as

compared to October, 2016. But this decline was for very-short period as from December, 2016, both exports and imports regained their momentum. Similarly, trade balance also worsens in November, 2016 but it started improving from December, 2016. Therefore, the data suggests that there is no major impact of demonetization on India’s international trade.

7. Effect on cash hoarding: With implementation of demonetization, cash hoarding reduced at first, as people had to deposit their old Rs.500 and Rs.1000 notes in the bank. But, as per the Indian habits of hoarding money for transaction and precautionary motives, cash hoarding started rising not long after when new currency notes became available in appropriate amount. It implies that cash hoarding decreased drastically just after demonetization, but within a short period, it again started increasing as before.



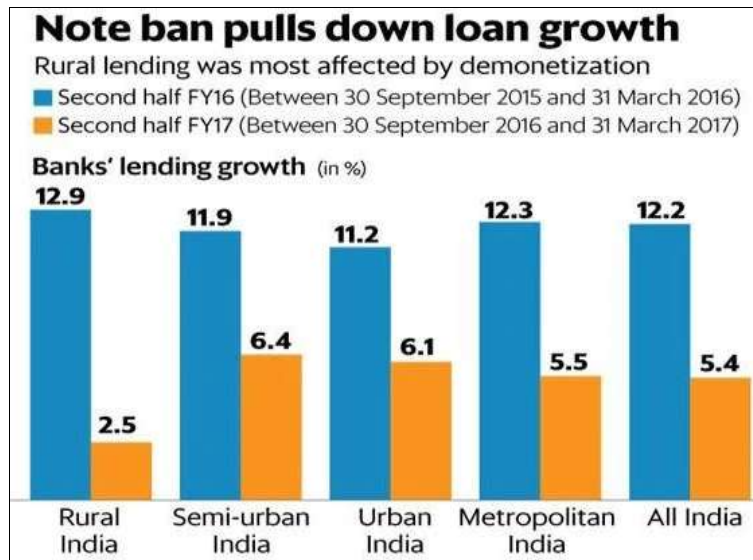
Source: RBI Money Supply Data

8. Impact on Employment: Employment is also affected by demonetization. The Centre for Monitoring Indian Economy (CMIE) has estimated that over 1.5 million jobs were lost after demonetization. In the manufacturing sector, medium and large scale industries reported job-loss of 5% and revenue loss of 20%. In the informal sector, many daily workers were rendered jobless due to paucity of cash in the system. For example, thousands of people lost their jobs in tea gardens of West Bengal and Assam. 90% of bangle factories of Firozabad, UP had to shut down because of cash crunch. However, e-commerce and digital payment platforms witnessed unexpected boost. Example can be given of Razorpay which witnessed 150% hike in the morning after the demonetization was announced, which by afternoon, shot up to 200%. Also, Paytm received more than 25,000 signups. Hence, it can be concluded that demonetization had mixed effects

on employment. On one side, it adversely influenced daily wage-earners, MSMEs, contract workers while on the other side, e-commerce and digital payment platforms experienced hike in its users.

Impacts on Indian banking sector

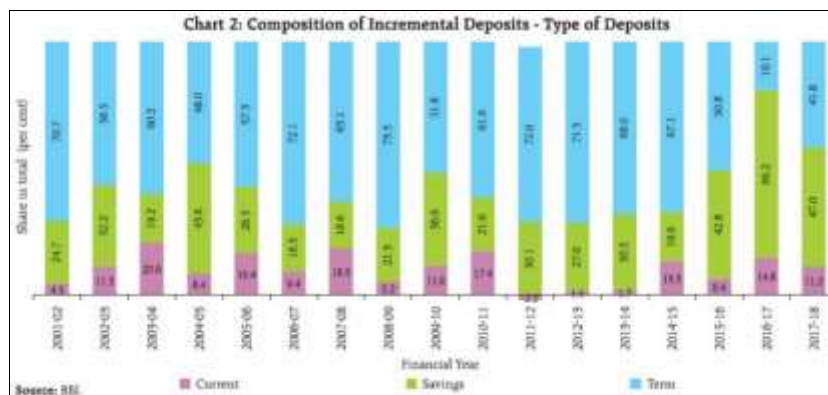
1. Effect on Banking Operations: After demonetization, people rushed to banks to deposit or exchange their old Rs.500 and Rs.1000 notes. Main operation banks performed at that time was to replace old notes with the new ones. As demonetization was a secretly taken step by government, there was no prior information to the banks. This increased complexity for the banks to perform their daily banking operations. Also, at that time most people came to bank to deposit or exchange their old currency notes. So, it surely affected other banking operations like lending as shown by diagram below.



Source: <https://www.google.com/amp/s/www.livemint.com/Opinion/j6FWY6uYX5sGxcqW4WR1dN/How-demonetisation-crippled-bank-lending.html%3ffacet=amp>

2. **Effect on deposits with banks:** With demonetization, in 2016-17 it was seen that percentage share of savings deposits in total deposits suddenly increased and that of term deposits decreased. In last 16 years, term deposits

were witnessed to be least at 19.1% at this time. Also, percentage share of savings deposits was 66.2% which was also highest among past 16 financial years.



Source: RBI Bulletin, 2018.

3. **Cost of Replacement:** Reprinting of new notes incurred cost of printing. Also, there were only three centres where printing of new notes was done. So, there was two-way transportation cost to supply new notes all over India and to bring back old notes. There was also cost of replenishment of ATMs with new currency notes.

4. **Workload on Bank Employees:** Demonetization was a sudden announcement for all people. So, banks were also not ready to cope with the situation. Immediately after demonetization, people rushed to the banks to exchange their old currency notes. There were huge queues in the banks which increased the workload on bank employees. Also, people were worried about their money, so they were full of questions and always found to be querying bank employees about it.

from the economy seems to be unachieved as 99% of old currency notes were returned to the RBI. It also posed difficulties in front of people and bank employees. Slowdown in GDP growth rate is also a bitter fruit of demonetization. Former RBI Governor Raghuram Rajan and Nobel Laureate Abhijeet Banerjee are also of the view that the slowdown in the economy is structural and because of a deficiency of demand. This lack of demand was also because of demonetization. There are some positive effects also as fake currency is reduced by a noticeable amount. It also promotes digitization and transparency in the transactions and banking operations which further helps in reducing tax evasion as all transactions are now recorded. To summarise, it can be said that demonetization brought mixed effects on the economy.

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Conclusion

To recapitulate, it can be inferred that demonetization did not prove to be as effective as it was visualised and expected. The main objective of removing black money

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