

# Impact of Demonetization on Indian Banking Sector

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**Abstract –** The paper discusses about the move of demonetization taken by central government of India on 8th November 2016, with respect to its reasons and effects on different sectors on India. The sectors cover micro-Business, E-wallet businesses, online retail stores and so on. This paper is based on the experience of impact of demonetization in different sectors and to analyze the current and immediate impact of demonetization on Indian economy. The paper is based on secondary data collection methods. Government of India has demonetized the currency of Rs.500 and Rs.1000 on 8th November 2016, aimed to address corruption, counterfeit currency, black money and terror financing. The total value of demonetized currency was Rs. 15.4 trillion, which constituted around 86.9% of total currency in circulation. The study conducted in this paper reveals that demonetization influenced various economic sectors differently. The highly impacted period due to demonetization was experienced especially during November and December 2016. This impact was moderated prominently in the month of January 2017 and immoderate to a longer extent by mid of February 2017. As an impact of demonetization on Indian banks, there is a positive change in the financial statements of scheduled commercial banks. The huge amount of deposited in the banks has raised and created surplus liquidity conditions. A significant increase in total number of accounts opened under the scheme of Pradhan Mantri Jan Dhan Yojna and the amount deposits in these accounts have also increased. A weighty impact of demonetization has also been monitored in the use of electronic banking transactions. This study is descriptive in nature and the data has been taken for the period of pre-demonetization and post- demonetization.

**Keywords:** Demonetization, Banks, Liquidity, Digitalization, PMJDY, Currency in Circulation

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## INTRODUCTION

Demonetization is the act of stripping a currency unit of its status as legal tender. It is a process of removing a currency from general usage or circulation of money in a country. It is an act where the old unit of currency gets retired and replaced with a new currency unit. RBI issues new two thousand rupee notes and five hundred rupees notes which was in circulation from 10<sup>th</sup> November 2016. Notes of one Hundred, fifty, twenty, ten, five, two and also one rupee were remain unaffected by this decision. It was also be considered as withdrawal of a specific currency from market.

Demonetization has been used to stabilize the value of a currency or combat inflation. The Coinage Act of 1873 demonetized silver as the legal tender of the United States, in favor of fully adopting the gold standard, in order to stave off disruptive inflation as large new silver deposits were discovered in the American West. Several coins, including two-cent piece, three-cent piece, and half dime were discontinued. The withdrawal of silver from the economy resulted in a contraction of the money supply, which contributed to a recession throughout the country. In response to the recession and political

pressure from farmers and from silver miners and refiners, the Bland-Allison Act remonetized silver as legal tender in 1878.

In a more modern example, the Zimbabwean government demonetized its dollar in 2015 as a way to combat the country's hyperinflation, which was recorded at 231,000,000 percent. The three-month process involved expunging the Zimbabwean dollar from the country's financial system and solidifying the U.S. dollar, the Botswana pula, and the South African rand as the country's legal tender in a bid to stabilize the economy.

Some countries have demonetized currencies in order to facilitate trade or form currency unions. An example of demonetization for trade purposes occurred when the nations of the European Union officially began to use the euro as their everyday currencies in 2002. When the physical euro bills and coins were introduced, the old national currencies, such as the German mark, the French franc, and the Italian lira were demonetized. However, these varied currencies remained convertible into Euros at fixed exchange rates for a while to assure a smooth transition.

Lastly, demonetization has been tried as a tool to modernize a cash-dependent developing economy and to combat corruption and crime (counterfeiting, tax evasion). In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest denominations in its currency system; these notes accounted for 86 percent of the country's circulating cash. With little warning, India's Prime Minister Narendra Modi announced to the citizenry on Nov. 8, 2016 that those notes were worthless, effective immediately – and they had until the end of the year to deposit or exchange them for newly introduced 2000 rupee and 500 rupee bills.

## HOW PAPER CURRENCY CAME IN INDIA:

For this, we have to look into history of birth of paper currency on India as how use of paper currency had been started in India.

Until the 18<sup>th</sup> century, people in India used to use silver and gold coins to carry out their day to day transactions. But, then some European companies established their own banks in the region to carry out their business transactions like the Bank of Hindustan in Calcutta. They introduced the very first versions of Indian paper notes which then boosted the further popularized the use of paper currency. The Bank of Bengal went on to release notes that featured a small image of a female figure meant to represent the idea of commerce as well as the banks name and denomination in three scripts: urdu, bengali and nagri. However, it was only after the paper currency act of 1861 that the british colonial government involved in producing money establishing the paper currency as we know it today.

## REVIEW OF LITERATURE

Sharma (2015) studied the reasons of demonetization in India and evaluated its impact on black money, fake currency, terror financing, note bank politics, economic growth of India, cashless economy and stock market for pre and post demonetization period and asserted that demonetization decision was taken on right time as economy was performing well and could absorb the short term shocks.

Singh (2015) examined the effect of demonetization on labor class of Lovely Professional University and depicted the various reasons of failure of demonetization. It is mentioned that demonetization was a great step but it could not eradicate black money and having undesirable impact on poor class people.

Gupta and Jain (2015) examined the significant changes in the utilization of digital banking services in India after demonetization using paired sample T test and revealed that the usage of digital banking services in both the terms i.e. volume wise and value wise has been increased after demonetization.

According to Kaur (2017) cashless payment system in the economy has multiple benefits i.e. time saving, minimization of cost, green banking and many more. In this study the future of all the transactions throughout the country is expected through cashless transaction system only.

Singh and Singh (2016) described that demonetization was like a surgical strike on black money and in first 3 days Rs. 35,000 crores deposited in banks and around Rs. 1500 cores black money were destroyed.

Dutt ., (2016) studied the impact of demonetization on the basis of demand for cash by various agents in economy. There are four types of transactions which are unaccounted transactions, illegal transactions, informal sector transactions, and accounted transactions. The effect of demonetization was on all these transactions.

Paras (2016) discussed about the digitalization of Indian economy. He discussed various projects taken by government of India like Digital India, Bharat Net, Digi Gaon. It is stated in the study that digitalization reduces the tax evasion and enhance the tax revenue to the government.

## OBJECTIVES OF DEMONETIZATION:

According to RBI, the most important reasons for the demonetization of 500 and 1000 rupee was the rise of fake currencies of same notes, and also the higher occurrence of black money. The main objectives are:

- 1) To tackle black money in the economy.
- 2) To lower the cash circulation in the country which is directly related to corruption in our country.
- 3) To eliminate fake currency and dodgy (unreliable or dishonest) funds which have been used by terror groups to fund terrorism in India.
- 4) To analyze the impact of demonetization on the financial statements (balance sheet) of Scheduled commercial banks in India.
- 5) To study the deposits trend under Pradhan Mantri Jan Dhan Yojna accounts.
- 6) To study the positive and negative outcomes of demonetization on banking operations.
- 7) To assess the impact of demonetization on the liquidity position of Scheduled commercial banks.
- 8) To evaluate the impact of demonetization on currency in circulation and GDP ratio.

## RESEARCH METHODOLOGY:

The paper is based on secondary data. The data has been collected from internet, books, journals and other research papers. This research paper is based on secondary sources of data. The used data has been taken from authenticated sources such as books, journals, RBI website and relevant government websites. The research is descriptive in nature. The period of the study is from November 2016 to March 2017.

## DATA ANALYSIS AND INTERPRETATION

### Balance sheet effects of scheduled commercial banks:

As an effect of demonetization, there was a decline in currency in circulation led to an upswing in the bank deposits. The demonetized currency was taken by banks at bank counters till December, 30th 2016. There was an acute decline in the circulated currency by about Rs. 8800 billion between 28th October 2016 and 6th January 2017 (i.e. days exactly prior to and later demonetization for which banks usually provides fortnightly data). As a result it majorly enhanced about Rs. 6720 billion in aggregate deposits of the banking system.

During this period re-monetization has shown a significant progress at a faster pace. Beginning with the last week of December 2016 to the first week of March 2017, a positive change in the circulated currency to the extent of Rs. 2600 billion has been reported. During this time period there was a moderate decline in deposits with banks.

Usually bank provides the data of its prominent assets and liabilities on fortnightly basis. According to the data provided by banks for the period of 28th October 2016 (pre demonetization) and 17th January 2017, the total deposits of scheduled commercial banks have enhanced by Rs. 5549 billion during this period.

**Table 1: Variations in prominent assets and liabilities of Scheduled Commercial Banks (28th October 2016 to 17th January 2017)**

Liabilities	Amount	Assets	Amount
Total deposits	5,549 -56	Bank credit	
Borrowings		Investment in Govt. Securities Net other assets	1,008 4,560 -75
Total	5,493	Total	5,493

Source: RBI website

Bulk of the money deposited in banks were deployed in (a) reverse repo of various tenors with the reserve bank of India; (b) Investment in government securities by issued cash management bills; (c) Loans and advances given by banks increased by Rs. 1,008

billion. During this period the incremental credit deposit ratio(ICDR) was only 18.2%.

### Liquidity concerns

With the announcement of demonetization, bank customers returned specified bank notes (SBN) to the banks (i.e. Rs. 500 and Rs. 1000 notes). This surprise step increased the quantum of deposits enhanced surplus liquidity concerns in the banking sector. The Reserve Bank of India has managed the excess liquidity concerns in 4 phases as mentioned in chart 1.

- First phase from 10th November 2016 to 25th November 2016: The RBI applied liquidity adjustment facility through changing reverse repos of different time periods ranging from 15 days to 91 days and adjusted excess liquidity of banks.
- Second phase from 26th November 2016 to 9th December 2016: The excess liquidity was absorbed with the variable reverse repos and the incremental cash reserve ratio of 100% on the increase in net demand and time liabilities from 16th September to 11th November 2016. It helped to drain about Rs. 4,000 billion excess liquidity during the fortnight ended 9th December 2016.
- Third phase from 10<sup>th</sup> December 2016 to 13<sup>th</sup> January 2017: The excess liquidity was managed with the mix of various reverse repos and by issuance of cash management bills through an enhancement of the limit from Rs. 300 billion to Rs. 6,000 billion on 2nd December 2016 by the Indian government. The maximum surplus was managed on 4th January 2017 of Rs. 7,956 billion, out of which Rs. 2,568 billion managed by reverse repos and Rs. 5,466 billion through cash management bills.
- Fourth phase from 14th January 2017: The surplus liquidity was managed by mix of reverse repo operations, specially the liquidity released through the maturing cash management bills

The government also instructed to deposit maximum amount of Rs. 50,000 in Pradhan Mantri Jan Dhan Yojna accounts on 15th November 2016. On 1st March 2017, although the balances declined to Rs. 643 billion but still

were 41% higher as on 9th November 2016. The accounts opened under PMJDY contributed 4.6% in total accumulation of aggregate deposits of scheduled commercial banks in the period of post demonetization.

**Table 2: Amount deposits in PMJDY: Number of Accounts (in million)**

Bank Group	As on 9th November 2016			As on 1st March 2017			Variation (1.3.17 over 9.11.16)		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total
Public sector banks	114	89.3	203.6	122	100.8	223	7.8	11.5	19.3
							(6.8)	(12.9)	(9.5)
Regional rural banks	37.1	6	43.1	40	6.4	46.4	2.9	0.4	3.3
							(7.8)	(6.8)	(7.7)
Private sector banks	5.3	3.1	8.4	5.4	3.6	9	0.1	0.5	0.6
							(1.3)	(16.8)	(7)
Scheduled commercial banks	157	98.4	255.1	168	110.9	278	10.8	12.5	23.3
							(6.9)	(12.7)	(9.1)

Note: Figures in parentheses are percentage variations. Source: Website of Pradhan Mantri Jan Dhan Yojna

## DEMONETIZATION IN INDIA:

### 1) BEFORE NOVEMBER 2016

This act is not happening first time in India, but it has happened twice, first in the year of 1946 and then in the year of 1978. In January, 1946 Rs.1000 and Rs. 10000 bank notes were withdrawn and in the year 1978 Rs.1000, Rs. 500 and Rs. 10000 notes were withdrawn on 16<sup>th</sup> January by the janata party government.

### 2) IN NOVEMBER 2016

On Tuesday, 8<sup>th</sup> November Prime Minister of India Narendra Modi announced the demonetization of Rs. 500 and Rs. 1000 notes with effect from midnight, making these notes invalid.

But, it has been taken care by government that the public that a person who changed his higher value cash will get exactly the lower denominations

### PROCEDURE FOR EXCHANGE OLD NOTES:

The RBI laid down a detailed procedure for the exchange of the denominated bank notes with new Rs. 500 and Rs. 2000 bank notes of the Mahatma Gandhi new series and Rs. 100 bank notes of the preceding Mahatma Gandhi series. Citizens will have until **30 DECEMBER 2016** to tender their old banknotes at any office of the RBI or any bank branch and credit the value into their respective bank accounts. Cash withdrawals from bank accounts will be restricted to Rs. 10000 per day and Rs. 20000 per week from 9<sup>th</sup> November 2016 to 24<sup>th</sup> November 2016.

For immediate cash needs the old bank notes of value upto Rs. 4000 per person can be exchanged for the new Rs. 500 and Rs. 2000 bank notes as well as Rs. 100 bank notes over the counter of bank branches from 10<sup>th</sup> November 2016 by filling up a restriction from along with a valid ID proof. Cash withdrawals from ATMs will be restricted to Rs. 2000 per day per card up to 18<sup>th</sup> November 2016 and the limits will be raised to Rs. 4000 per day per card from 19<sup>th</sup> November 2016.

## EFFECTS OF DEMONETIZATION:

Demonetization created effect on different sectors in different manners resulting into boom for some sector like E-wallet businesses and somewhere resulting into temporary slowdown like vegetable vendors or small seasonal businesses, where most of the transactions are on cash basis. Some sectors are discussed here:

- 1) TAX:** Having closed the voluntary disclosure window for undisclosed money, it has been reported that government will keep a close watch on deposit over Rs. 2 lakh in cash. This would mean increased tax net, higher tax collection and a better tax to GDP ratio. As the money gets accounted and more taxes are collected, government might be tempted to reduce tax rates going forward.
- 2) INTEREST RATES:** One of the biggest impacts of demonetization would be high value transactions, especially land and gold. This would result in lower inflation, tempting the central bank to reduce interest rates. But, the bigger impact on interest rates will be the liquidity with which banks will be flushed.
- 3) LIQUIDITY:** Movement of goods and money will be hit in the short.
- 4) GST:** Demonetization comes at an important as the country heads to a new tax regime with the implementation of GST. Demonetization would increase the tax net and along with GST result in reduction of black money generation. Along with GST, demonetization will lead to a higher tax.
- 5) EFFECT ON MONEY SUPPLY:** With the older 500 and 1000 rupees notes being scrapped, until the new 500 and 2000 rupees notes get widely circulates in the market, money supply is expected to reduce in the short run. To the extent that black money does not re-enter the system, reserve money and hence money supply will decrease permanently. However gradually as the new notes get circulated in the market and the mismatch gets corrected, money supply will pick up.
- 6) EFFECT ON DEMAND:** The overall demand is expected to be affected to an extent. The effect of demonetization on different sectors in different manners resulting into boom for some sector like E-wallet businesses and somewhere resulting into temporary slowdown local vegetable vendors or small seasonal businesses.
- 7) EFFECT ON PRICES:** The Price level is expected to be lowered due to moderation

from demand side. The demand driven fall in prices could be understood as follows:

- a) **CONSUMER GOODS :** Prices are expected to fall only marginally due to moderation in demand as use of cards and cheques would compensate for some purchases.
  - b) **REAL ESTATE AND PROPERTY:** Prices in this sector are largely expected for sales of properties where major part of the transaction is cash based, rather than based on banks transfer or cheques transactions. In the medium term, however the prices in this sector could regain some levels as developers rebalance their prices. The Indian real estate market which is largely fragmented and unorganised has had a reputation of being a safe haven for black money and therefore we expect to see impact on the sector the impact is likely to be seen in secondary markets.
- 8) EFFECT ON VARIOUS ECONOMIC ENTITIES:** With cash transactions lowering in the short run, until the new notes are spread widely into circulation, certain sections of the society could face short term disruptions infacilation of their transactions .These

Sections are:

- Small traders
  - SME
  - Services sector
  - Households
  - Political parties
  - Retail outlets
- 1) **EFFECT ON BANKS:** 500 and 1000 rupees notes which now cease to be legal tender are to be deposited or exchanged in banks. This will automatically lead to more amounts being deposited in saving and current account of commercial banks which will enhance the liquidity position of the banks.
  - 2) **EFFECT ON ONLINE TRANSACTIONS AND ALTERNATIVE MODES OF PAYMENT:** With cash transactions facing a reduction, alternative forms OG payment will see a surge in demand. Digital transaction system, E-wallet and applications online transactions using E-banking using a plastic money (debit and credit card) will definitely see sustainable increase in demand.

"A digital wallet is an electronic device which allows an individual to make electronic commerce transactions like payment of bills or online bookings etc. An individual bank account can also be linked to the digital wallet.

Example: paytm, pay U India etc.

#### • **Amendments made to the income tax act in view of demonetization**

In view of demonetization, Lok Sabha, the lower house of the Indian Parliament, has recently passed Income Tax amendment bill which highlight following propositions and amendments:-

- With regard to unaccounted demonetized cash that has been voluntarily declared by the citizens on and before 30th December, 2016 will be taxed at the rate of 50%. The breakup of 50% will be Tax @ 30% + Penalty@10% + surcharge @ 33%. This surcharge is named as 'Pradhan Mantri Garib Kalyan Cess.
- Further to above, the person who disclose this unaccounted income will have to put in 25% of his unrevealed income in a yet to be announced by Central Government 'Pradhan Mantri Garib Kalyan Deposit Scheme, 2016'. This deposit will not attract any interest and can be withdrawn by the depositor only once in 4 years from the date of deposit. As per the Government proposal, the amount will be utilised for public welfare programs such as infrastructure, housing, irrigation, education, health or toilets etc.
- People who still have any income undisclosed but is later found out by the Income Tax authorities will be taxed at an exorbitant rate of 85% tax in addition to penalty which may then go over 90%.

#### **SIGNIFICANCE AND CONCLUSION**

Demonetization in India is a great effort taken by Indian government to combat with black money and corruption. It is a bold decision taken by government. This move will have major impact on the parallel economy but sudden announcements and failure to prepare in advance has created temporary chaos and discomfort among the general public. The main purpose of demonetization is eradicating the black money and reduces the corruption. But, Indian financial market real estate market, FMGG sector, auto assets backed loans etc. all are declined for a short time.

Demonetization though it has created some positive and negative impact on different sectors but in long run it definitely will have the impact in controlling black

money and fake currency or we can say the move will hence “short-term plan” but growth gains in the long term. Most of the transactions are entertained through electronic means which makes transparency in the system. Hence, it is beneficial for Indian economy and its growth. It may not control the amount of black money in the nation directly, but nonetheless, it is beneficial for the Indian economy in the future.

The demonetization of the currency (Rs. 500 and Rs. 1000 notes) on 8th November 2016 was one of the step taken by government of India. This decision way fetch positive results in the long term. This study concluded that the step of demonetization improved the liquidity position of the scheduled commercial banks in India and banks invested the excess amount in various investment opportunities which helped the banking sector to increase their profitability position. It is also concluded that the objective to open the Pradhan Mantri Jan Dhan Yojna Account has been realized and people used PMJDY accounts during demonetization period which will change the attitude of the customers to use physical currency and customers will shift to digital banking services which will again be helpful for the banking sector as well as customers. Study also suggests that the step will help the banking industry to maintain adequate liquidity, minimization of non performing assets, optimization of electronic banking services which will reduce the cost of products and services of banks and enhance the profitability of banking sector. This move will also help to reduce fiscal deficit, control on inflation, lower corruption, improved tax compliance, elimination of counterfeit currency and sustainable economic growth in long run. In the “post demonetization” era the currency in circulation is lower than pre demonetization period. Experts are of the opinion that demonetization has helped to reduce the circulation of black money to certain extent.

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