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“ANALYTICAL STUDY OF EFFECT OF DEMONETIZATION ON BANKING SYSTEM OF INDIA”

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ABSTRACT

On 8th November 2016, The Government of India has demonetized the currency of Rs.500 and Rs.1000, sought to discourage 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 states 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 quantum of amount 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 Yojana and the amount deposits in these accounts have also increased. A significant 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 circulation¹

¹ “Impact of Demonetization on Indian Banking Sector: A Step towards Governance, by Nitin Bansal”, Pacific Business Review International Volume 11 Issue 7, January 2019. Available at http://www.pbr.co.in/2019/2019_month/Jan/4.pdf. Last seen at 20/04/2023.

INTRODUCTION

Demonetization refers to stripping of currency from circulation where the old currency is replaced with new currency. The concept of demonetization is not new in modern era as Indian government had demonetized bank notes twice that is in 1946 and 1978 respectively with a motive to combat tax evasion through black money. In 1946, Rs.1000 and Rs.10,000 notes were demonetized whereas in the second instance that is in 1978, the government withdrew Rs.10,000, Rs. 5000 and Rs. 1000 notes. On 8th November, 2016 demonetization was announced by the Prime minister Mr. Narender Modi to strip of Rs.500 and Rs.1000 notes from circulation which forms 86% of the cash currency in the market with the objective to eradicate corruption, black money, terrorism, and counterfeit notes and to make India a Cashless economy as it makes the spending convenient and increases the transparency of transactions. The sudden implementation of demonetization had an impact on the various sectors of Indian economy including banks as banks forms the core sector of Indian economy, banks played a major role to in the implementation of demonetization. The present study aims to showcase the effect of demonetization on bank and its operations.²

Cash is the preferred mode of transaction in India and only less than half the population uses banking system for monetary transactions. Indians are a resilient lot. By nature, we Indians, may behave it in our blood to bounce back from shocks-natural and man-made and get on with things. On 9th of November, when the citizens of India- were told that the 500 and 1000 INR currency notes in their pockets will no longer continue to be legal tender, the entire country was in a stupor. The next few days that followed were long queues outside ATM's (banks were suddenly the most 'in demand' commodity); wage earners requested their bosses for short leave to tend to the same. With demonetization effort 86% of India's currency was nullified that aimed to wash the stock of 'black market's cash supply' and counterfeit notes out of the economy and convert it into the licit, banked, and taxable, part of the economy.

² "Impact of Demonetization on Indian Banking Sector by Syeda Wajeda Hussaini", International Journal of Advanced Research in Science, Communication and Technology (IJARSCT) Volume 7, Issue 2, July 2021. Available at <https://ijarsct.co.in/Paper1791.pdf>. Last seen at 20/04/2023.

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.
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.

IMPACTS ON INDIAN ECONOMY

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%.

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.

- 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.

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.
6. **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.
7. **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.

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.
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.³

PROBLEMS/ISSUES DUE TO DEMONETIZATION

The most serious issue is that the massive decline of the cash economy has had a tremendous impact on the access to essential commodities since trucks and other goods vehicles have stopped because of insufficient money to buy diesel and the fact that employers have been forced to retrench labour because of cash. The informal economy - the largest employer of labour and a very large producer of goods, usually cheaper than those in urban markets - has been very badly hit. Most economists, in India and abroad, believe that our GDP growth will fall to at least 5.6%, if not 4.6%. The rupee, which is Rs 68.12 to \$1, will fall to Rs 110 to \$1. About \$5 billion have already left India. Such a major crisis is called recession.

- Formation of long winding queues in front of each bank as well as ATMs from morning to evening.
- A considerable hue and cry from the public for getting their money exchanged.

³ "Demonetization and its impact on Indian economy with special reference to Indian banking sector", International Journal of Advanced Academic Studies, by Deepak and Amisha Goel. Available at <https://www.allstudyjournal.com/article/814/4-3-2-655.pdf>. Last Seen at 20/04/2023.

- Little violation at some places by public.
- A few deaths were accounted resulted from stress of not getting money, ultimately due to demonetization of currency.
- Bank employees must work for longer hours.
- People are unable to withdraw huge amount for the big occasions at their home.
- Swipe machines found to be not working properly at many places whatever may be the issue(i.e., personally observed in trade fair).
- Illiterate or less educated people are not so much aware about the cashless transactions.
- Lack of ATM's especially in rural areas creates big problem.
- In present time, there are still villages/areas which are unbanked even today resulting their routine work disturbed as they must go to nearby villages or cities to get exchange their notes.
- Most of the cashless transactions are connected through internet which demand proper network that is still inadequate in some parts of India.
- Many illegal agents (Dalals) are emerged who are indulged in exchange of notes with a huge commission resulting in moral degradation.
- As some newspapers as well as news channels reported that back door policy on its way at some places in some banks with the involvement of some bank officials.
- Even some bank employees are found to be guilty indulging in conversion of 'black money' to 'white money'.
- Less educated or illiterate people may have to face security issues in case of providing information relevant to their financial instruments to get transactions done through others.

RECENT JUDGMENT

Recently, the Supreme Court has passed a verdict on the Demonetisation of currency notes of Rs 500 and Rs 1,000 in a majority 4-1 by a five-judge Constitution Bench.⁴

⁴ "Supreme Court's Verdict on Demonetisation". Available at <https://www.drishtias.com/daily-updates/daily-news-analysis/supreme-court-s-verdict-on-demonetisation>. Last seen at 20/04/2023.

What are the Rulings of the Verdict?

1. Majority Ruling:

- The majority held that Centre's notification dated November 8, 2016, is valid and satisfies the test of proportionality.
- The RBI and the Centre had been in consultation with each other for six months prior to the November 8 notification issued under Section 26(2) of the RBI (Reserve Bank Of India) Act, 1934.
- The statutory procedure under Section 26(2) of the RBI Act was not violated merely because the Centre had taken the initiative to "advise" the Central Board to consider recommending demonetisation.
- The government was empowered under the provision to demonetise "all series" of banknotes.
- On hasty decision, the court said such measures undisputedly are required to be taken with utmost confidentiality and speed. If the news of such a measure is leaked out, it is difficult to imagine how disastrous the consequences would be.
- Demonetisation was done for the "proper purposes" of eliminating fake currency, blackmoney, and terror financing.

2. Minority Ruling:

- The government could have issued a notification under Section 26(2) of the RBI Act only if the RBI had initiated the proposal to demonetise by way of a recommendation.
- Therefore, the government's notification issued under Section 26(2) of the RBI Act was unlawful.
- In cases in which the government initiates demonetisation, it should take the opinion of the RBI. The opinion of the Board should be "independent and frank".
- If the Board's opinion was in the negative, the Centre could still go forward with the demonetisation exercise, but only by promulgating an ordinance or by enacting a parliamentary legislation.
- Describing the Parliament as the "nation in miniature", "without the Parliament, democracy will not thrive".

What is the Test of Proportionality?

- The test of proportionality is a commonly employed legal method used by courts around the world, typically constitutional courts, to decide cases where two or more legitimate rights clash.
- When such cases are decided, one right typically prevails at the expense of the other and the court thus must balance the satisfaction of some rights and the damage to other rights resulting from a judgment.
- The principle of proportionality ordains that the administrative measure must not be more drastic than is necessary for attaining the desired result.

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 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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