Effect of Demonetization on India's Financial Sector

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Abstract: This paper explores the effect of demonetization on India’s financial sector. By collecting and analyzing data in this field in the past three years from RBI, this paper concluded that demonetization increased the total value and volume of financial transactions in India while eliminating counterfeit banknotes worth of 4 billion rupees and stopping them into circulation, increasing the volume and value of debit and credit cards on the POS and encouraging mobile payments. However, this policy did not provide the bottom class of India with more financing channels to reduce their financing costs, nor did it achieve the government’s initial goals about anti-counterfeiting and anti-black money.

1. Introduction

On May 26, 2014, Mody took office as India's new prime minister. At that time, India was confronted with huge economic challenges. Growth slowed to 6.1 per cent in 2013 and inflation averaged 10.9 percent [6]. To make matters worse, India's government was paralyzed, unable to curb corruption or implement big projects. When Mody’s government came into power, a series of economic policies were formulated to boost economy. Among them, the most famous and controversial policy must be the demonetization announced on November 8, 2016, claiming that the 500 and 1,000 rupee notes in circulation in India would cease to be legal tender or used for transactions, commencing on November 9. Mody's demonetization has triggered an economic shock in India, including a drop in consumption and investment, depreciation of rupees, and an increase of tax revenues for Mody's government in the next three months.

Studies on demonetization in India have mostly taken the form of news reports. Despite discussions on the impact of demonetization in India [3], there are few researches on the direct relationship between demonetization and Indian finance based on the long-term data. This paper will review the development of India's financial industry in the past three years to explore the impact of demonetization on this field and discuss the financial prospects of the country.

2. Effect of Demonetization on India's Financial Sector

Firstly, demonetization encouraged more Indians to have their own bank accounts while there were less incentives for the banking sector than expected. Before implementation of this policy, the development of the banking sector in India was out of proportion to its international economic status, with only half of the population using bank accounts and one in ten with access to bank credit. This, of course, could be attributed to India's vast urban and rural disparities, the wealth gap, traditional agricultural practices and poor infrastructure, but it also had to do with the underground economy and the people’s lifestyle. Bank account used to be something new to rural Indians. Demonetization, however, forced them to open bank accounts. In the short term, both the total number of financial transactions and its total value in India shot up. Financial transactions via debit card issued by the bank at ATMs in November 2016 rose by 42.9 percent compared with October [7]. The total value of financial transactions done by the debit card issued by the bank at ATMs in November 2016 rose by 106.4 percent compared to those in October [7]. However, in the long term, there was only a slight increase of ATMs on site and off site, implying the inability of demonetization to solve problems such as poor infrastructure and expansion of bank branches into the countryside. Jie Liang predicted that demonetization could improve financial services for the bottom class of India by opening up financing channels and reducing their financing costs, especially satisfying farmers’ financial needs, as they always needed small loans in hard times [2]. However, the situation didn’t go as he had predicted, so far, at least. Agricultural credit growth appeared to have slowed after implementation of demonetization, probably as a result of damages to agricultural development caused by the policy itself and a lack of trust of the government from the public. Despite an upward trend last year, it is still not clear whether this was boosted by the recovery of the agricultural production or the decrease of loan cost for farmers. Perhaps only time can
Secondly, the prime minister Mody claimed in his 2016 demonetization speech that the policy aimed at four major goals, namely anti-black money, anti-corruption, anti-counterfeiting and anti-terrorist financing [8]. Since this paper mainly focused on the effect of demonetization on India's financial sector, there will be discussions about whether this policy would contribute to anti-counterfeiting and anti-black money. In terms of anti-counterfeit banknotes, there were about 4 billion rupees counterfeit banknotes in the circulation field of printed currency, based on data released by the Indian government. It seemed that the demonetization could wipe out the 4 billion rupees counterfeit banknotes and stopped them into the circulation, thus eliminating anti-counterfeit banknotes. However, the policy also encouraged the emergency of counterfeit money on a face value of 2000 rupees. Comparing with making counterfeit money on a face value of 500 or 1000 rupees, this obviously helps to increase the profits and reduce the costs of counterfeit notes. Although India has stopped printing rs 2,000 notes, the number of counterfeit rs 2,000 notes continues to grow in the country. Over the past three years, the Reserve Bank of India (RBI) claimed to have found 250,000 fake 2,000 notes in India, times the number of the notes in circulation. As to anti-money laundering, there is still a long way to go for demonetization. In November 2017, the RBI declared that 99 per cent of the notes had been returned to the Bank, which meant that only up to 1% of "black money" worthy about $2.4 billion had disappeared. According to the preliminary estimate of relevant research institutions, black money has accounted for 75% of India's GDP. Only 6% of it exist in cash while the rest take the forms of gold bars and gold products, real estate, financial investment and capital investment [4]. Contributions from
Demonetization to the anti-black money efforts was trivial, considering the volume of black money worthy of more than 600 billion rupees.

Thirdly, demonetization boost the transition of India from cash transactions to the digital economy. In a radio address on November 27, 2016, Modi called on people across the country to learn how the E-economy works, including different ways of using e-banking and bank accounts, the effective use of different banking apps on mobile phones, and how to conduct business without cash. Besides, the Indian government launched the slogan "Go Cashless, Go Digital", under which a number of measures were taken, such as encouraging people to open accounts in banks, accessing payment tools such as credit cards and debit cards, electronic payment, along with exemption of relevant banking fees for transactions. Indian consumers had been forced to embrace mobile payment and electronic payment thanks to fund shortage caused by demonetization and incentives. The graph shows the volume and value of the debit and credit cards at POS in India after implementation of demonetization, showing an immediate increase as a result of currency exchange and inconvenience of using cash caused by the policy. With the new currency gaining acceptance, both the volume and value of debit and credit cards at POS is shrinking, but still higher than that before demonetization. It is undeniable that demonetization has prompted electronic payment in the long term. In addition, mobile payment features easier and quicker application compared with debit and credit cards, a result of demonetization. According to INVESTOPEDIA, Paytm's app downloads increased 300% as of November 13, 2016, and its rival, Mobikwik, quadrupled. Before the demonetization, the daily maximum transaction was 3 million while after the demonetization, the daily transaction peaked at 7 million. Before November 9, each Paytm user conducted an average of 3 transactions per week while within three weeks after November 9, an average of 18 transactions took place for each user [5]. Considering the wealth gap in India, a direct conclusion from the data of value of mobile banking is not available yet. To some extent, the volume of mobile banking could better indicate the mobile payment penetration. On the whole, the increasing volume of mobile banking indicated its growing popularity in India. Some news websites have seen a recent rise in cash usage in India, concluding that cash would not be replaced as a result of demonetization. However, this is not necessarily true. The weak nature of India's financial system cannot be transformed overnight, despite contributions from demonetization to drive the development of financial technology in India. As Vijay Sharma, founder of India's largest payment platform Paytm, put it, demonetization has given E-payments a huge boost even though some people are returning to cash [5]. Now every Indian knows e-wallets. The spread of electronic payment drives economic growth. Xiaodan Gao, Mingzhi Wang and Na Zhang found that payment systems stabilized the real economy by absorbing adverse effects in the short run [1]. In the long term, the spread of electronic payment will bring more liquidation into the financial system, promoting transparency and efficiency of economic activities while cracking down on tax evasion and improving tax efficiency in India.

Graph 3: Volume and Value of Debit and Credit at POS in India from 2016 to 2018 (data are collected from RBI)
3. Conclusion

The policy of demonetization did have an impact on India’s financial sector. In the short term, it increased the total number and value of financial transactions in India, wiping out counterfeit banknotes worthy of 4 billion rupees and stopping them into the circulation field. In addition, it also increased the volume and value of the debit and credit cards at POS and encouraged mobile payments. In the long term, the policy of demonetization did not improve financial services in the bottom class of India by offering them financing channels and reducing their financing costs. Nor did the policy achieve the government’s initial goals about anti-counterfeiting and anti-black money. However, the policy of demonetization did prompt electronic payment in the long term.

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