EFFECT OF DEMONETIZATION ON FINANCIAL INCLUSION IN INDIA

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Abstract

It is proved at the time of Lehman Brother’s bankruptcy on September, 2008 that Indian economy is shock proof for its strong financial structure and strong apex supervision on all types of financial institutions of the country. During 2003-04 to 2008-09 GDP growth rate was high. Paradoxically, at the same time period rate of poverty and unemployment was also high. Over 25% of population in India lived under poverty line during the same period. So, Union Government considered inclusive growth as national policy. Financial Inclusion plays a major role to achieve inclusive growth and to alleviate poverty. Government of India has taken up several measures to achieve total financial inclusion since Khan Committee’s recommendation which was incorporated in the mid-term review policy of RBI in 2005-06. Although the degree of financial inclusion has improved a lot, still India has miles to go to become total digitally financially included economy. To become a well-built economy, India needs to clean out black money, corruption. Central Government announced 2nd financial reforms in November 2016. Government adopted demonetization on 8th November, 2016 to control counterfeit notes, to tackle black money, corruption and terrorism and make India a less-cash digital economy. Considering the above economic scenario, this paper makes an attempt to study the effect of demonetization on financial inclusion. This paper also highlights on the effect of demonetization on various stakeholders of financial inclusion. Side by side this paper also analyzes the India’s movement towards less-cash digitalized economy. The data for the present study has been collected primarily from secondary sources. The secondary data were acquired from reports, journals, economic surveys of NPCI and RBI and Internet. This study seeks to scrutinize the effect of demonetization on financial inclusion. Ordinary individuals in rural as well as in the urban sector of the country was adversely affected. Innate a new type of deposit named “Benami Deposit” have come up with demonetization. Technology needs to be reached at the bottom of the pyramid to make India less-cash digitalized economy. Time and effort required for achieving the objective of digital transaction-based economy through financial inclusion. By way of demonetization rural people at least visit the financial institution like banks, post office etc. for changing old currency notes and this habit helps them to be financially included with the main financial system of the country in the near future.

Keywords: Financial Inclusion, Demonetization, Inclusive Growth

1. Introduction

1.1 Financial Inclusion

A well-built financial system is a pillar of economic growth, improvement and evolution of an economy. To grow a developing economy like India, inclusive growth has now become the national policy objective of the Union Government. Inclusive growth is a strategy of economic development, which should not only aim at equitable distribution of growth but also at creating economic opportunities along with equal access for all. And the ultimate weapon of inclusive growth is financial inclusion.

The term ‘Financial Inclusion’ was introduced in India by Y. Venugopal Reddy, erstwhile Governor of the Reserve Bank of India in the Annual Policy Statement in April 2005. The phrase “Financial Inclusion” is frequently used to provide adequate financial facilities like (a) savings, (b) credit, (c) payment and remittance facilities and (d) insurance by the recognized financial system to those who tend to be excluded from the above-stated services, at an affordable price.

According to Leeladhar (2006), financial inclusion means “the delivery of banking services at an affordable cost to the vast sections of the disadvantaged and low income groups”.

Usha Thorat (2006), the then Deputy Governor of RBI defined the term as “provision of affordable financial services viz. access to payments and remittance facilities, savings, loans and insurance services by the formal financial system to those who tend to be excluded”.

A committee on financial inclusion was formed under the chairmanship of C. Rangarajan and that committee defined the term as “the process of access to financial services, and timely and adequate credit needed by vulnerable groups such as weaker sections and low income groups at an affordable cost”.

Financial inclusion, broadly defined, refers to universal access to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products (Report of the Committee on Financial Sector Reforms, Chairman: Dr. Raghuram G. Rajan). Household access to financial services is depicted in Figure I.

[Source: A Hundred Small Steps - Report of the Committee on Financial Sector Reforms (Chairman: Dr. Raghuram Rajan), IISS, 2007].

**Figure I: Household Access to Financial Services**

Financial inclusion enlarges the resource base of the financial system by emerging a habit of savings among large section of rural population and plays its own role in the progression of economic development.

Financial inclusion originally started from 1969 at the time of ‘Bank Nationalization’. With the bank nationalization banking age transferred from ‘Class Banking’ to ‘Mass Banking’.

Other major efforts by the Government and RBI in the last five decades to achieve the target of complete financial inclusion are:

a) forming pan-India branch network of scheduled commercial banks, co-operatives and regional rural banks,

b) introduction of mandated priority sector lending targets,
c) lead bank scheme,
d) development of self-help groups,
e) allowing BCs/BFs to be appointed by banks to provide door step delivery of banking services,
f) Zero balance BSBD accounts, etc.

The fundamental objective of all these initiatives is to reach the large sections of the hitherto financially excluded Indian population.

1.2 Demonetization
When Government decided to replace the old national currency with a new one then demonetization occurred. Demonetization is the process where Government declares the currently running notes illegal to be tendered after the declaration is made. The reasons for demonetization are to control counterfeit notes for i) regulating terrorism and ii) eliminate the black economy.  
Demonetization of bank notes is not a new concept for India. Previously India Government used this tool twice – once in 1946 and again in 1978. In both the cases the objective was the same - to battle against tax avoidance by black money. The pre-independence Government used the weapon in 1946 for penalize Indian business that were concealing the fortunes amassed supplying the Allies in World War II. In 1978 Janata Party Collation Government demonetized banknotes of 1000, 5000, and 10000 rupees, in the hopes of shortening counterfeit money and black money.

On 8th November, 2016 Prime Minister of India announced to withdraw Rs. 500.00 and Rs. 1000.00 bank notes of Mahatma Gandhi series. On 28th October, 2016 the total bank notes in circulation in India was Rs. 17.77 trillion. In terms of value, RBI in its annual report as on 31st March, 2016 declared that total bank notes in circulation valued to 16.42 trillion. 86% of the total circulated amount (i.e. 14.18 trillion) was by Rs. 500.00 and Rs. 1000.00 bank notes.

In 2012 Central Board of Direct Tax mentioned in a report “demonetization may not be a solution for tackling black money or economy, which is largely held in the form of benami properties, Jewelry”. According to data from Income Tax department, black money holders keep only 6% or less in terms of cash. RBI Governor Dr. Urjit Patel and Secretary, Economic Affairs, Mr. Saktikanta Das explained in the press release that one of the purposes of demonetization was to fight against terrorism funded by counterfeit note.

This demonetization started the journey to less-cash society i.e. move one step forward to digitalization of Indian economy.

2. Purpose and Objective of Study
Before taking up any research it is necessary to have a transparency of the purpose and objective. Objectivity is a very significant characteristic of good research. The objectives speak about the determination of the study. It is here that one layouts exactly what is being planned by the proposed research. In this study main objective of the study is the effect of demonetization on Financial Inclusion in India. The purpose of the undertaken research flows naturally from the problem statement, giving the researcher specific, concrete, and achievable goals.

3. Research Methodology
The study is mainly descriptive in nature. The collection of data is mainly from secondary sources like magazine, newspaper, RBI press release, NPCI website, RBI website, previous studies on the subject etc.

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4 Gopika Gopakumar, Vishwanath Nair (8 November 2016). "Rs 500, Rs 1000 notes may be back, if history is a guide". Live Mint
3.1 Research Questions imposed while undertaking the research
What is the effect of demonetization on Financial Inclusion?
Is demonetization a way to digitalization of Indian Economy?

4. Review of Literature

4.1 Financial Inclusion
The Financial Inclusion was started in India with passing First Co-operative Society Act during 1904. After independence it got momentum in 1969, through nationalization of 14 commercial banks. With the Bank nationalization banking age transferred from ‘Class Banking’ to ‘Mass Banking’.
Under the chairmanship of Rangarajan, ‘Committee on Financial Inclusion’ was formulated by the Govt. of India and it defines financial inclusion as ‘the mechanism of ensuring access to financial services and timely and adequate credit whenever needed by the vulnerable groups such as the weaker sections and low income groups at an affordable cost’. Recently, in 2014 to give leverage Pradhan Mantri Jan Dhan Yojana has been introduced. Figure 1.1 summarizes the key stages in evolution of financial inclusion initiated by the government since 1960’s.

4.1.1 Evolution of Financial Inclusion since 1960’s
1960-70s:
   a) Focus on increasing credit to the neglected economy sectors and weaker sections of society.
   b) Nationalization of banks.
   c) Development of the rural banking ecosystem including Regional Rural Banks.
   d) Lead Bank Scheme launched for rural lending.
1970-80s:
   a) Establishment of National Bank for Agriculture and Rural Development (NABARD) to provide re-finance to banks providing credit to agriculture
   b) SHG bank linkage program launched by NABARD.
2000s:
   a) The term 'Financial inclusion' introduced for the first time in RBI's Annual Policy Statement 2005-06.
   b) Banks asked to offer ‘no frills account’.
   c) Know Your Customer (KYC) norms simplified.
   d) Banking Correspondent and Banking Facilitator concept introduced.
   e) 100 percent financial inclusion drive launched.
   f) Electronic Bank Transfer Scheme introduced to transfer social benefits electronically to bank account of beneficiary.
   g) Introduction of Pradhan Mantri Jan Dhan Yojana.
[Source: Naik, Priya (2013). Financial inclusion-key to economic & social development. CSR Mandate, June-July, 14-1]

4.1.2 Report of the Committee on Financial Inclusion:
The committee constituted for financial inclusion submitted a report in 2008 wherein it was argued that holding a bank account itself confers a sense of identity, status and empowerment and provides access to the national payment system. Therefore, having a bank account becomes a very important aspect of financial inclusion. Further, financial inclusion, apart from opening and providing easy access to a No Frills account, should also provide access to credit, perhaps in the form of General Credit Card or limited OD against the no frills account. It should encompass access to affordable insurance and remittance facilities. It should include credit counseling and financial education/literacy. While financial inclusion in the nar-
row sense may be achieved to some extent by offering any one of these services, the objective of “Comprehensive financial inclusion” would be encompassing all of the above.\(^5\)

4.1.3 Sadhan Kumar Chattopadhyay in a working paper for RBI on Financial Inclusion in India: A case-study of West Bengal (2011), has studied the spread of Financial Inclusion in West Bengal both in Rural as well as urban area. In his study he finds that after spending a considerable amount of resources on account of Financial Inclusion to achieve the target of inclusive growth of the economy, the achievement is not significant. It is also highlighted in the study that unless all people of the society are brought under the umbrella of Institutional Finance, the benefit of higher GDP growth of the country will not percolate down the line. Gap between rural and urban area in connection with financial inclusion is also increased. An index of financial inclusion (IFI) has been developed in the study using data on three dimensions of financial inclusion viz- banking penetration (BP), availability of the banking services (BS) and usage of the banking system (BU). The paper provides a comparable picture between different states on the basis of IFI rankings.

4.1.4 Dr. Namita Rajput and Ms Shelly Oberoi (2014) in their study “REACHING THE UN-REACHED: FINANCIAL INCLUSION IN INDIA- A STUDY” depict the main objective of the study: - (a) To analyze the current status of Financial Inclusion in India; (b) Critical analysis of Government, RBI and banks initiative on Financial Inclusion and Financial Literacy of India; (c) Financial Inclusion in the lens of CRISIL Inclusix Index; and (d) State wise Financial Inclusion. In their work the researchers find that financial inclusion has been made an essential part of the banking sector policy in India. This study has developed a composite index of financial inclusion for each state. Results coincide with the Crisil Inclusix Index. Both reveal that the top most states indulged in Financial Inclusion are basically from Southern India and the bottom most are Arunachal Pradesh, Chhattisgarh, Bihar and Manipur. In the study they have found that most of the financially excluded persons are unaware about the availability of banking service and bank people must also look after the need of account holders and would be account holders. Side-by-side researchers also give emphasis on financial literacy and awareness to the rural masses of the country. They have also pointed out that Financial Inclusion has enough capacity for raising economic growth, standard of living, equality etc.

4.1.5 Dr. Anupama Sharma, and Ms. Sumita Kukreja (2013) have depicted that “for developing nations the era is of inclusive growth and the key for inclusive growth is financial inclusion. Financial inclusion or inclusive financing is the delivery of financial services, at affordable costs, to sections of disadvantaged and low income segments of society”. They have also mentioned about the initiatives of RBI and GOI to achieve Total Financial Inclusion such as (a) opening of No-Frill accounts, (b) relaxation of KYC norms, (c) use of technology, (d) introduction of BC-BF model, (e) opening of branches in rural unbanked areas, (f) simplified branch authorization etc. Financial Inclusion has yet to achieve the desired results and there are miles to go but no doubt it is playing a significant role and is moving towards inclusive growth of the economy.

4.1.6 Dr. M. M. Gandhi (2013) in his study depicted that access to finance by the poor, disadvantaged and underprivileged group is a prerequisite of poverty alleviation on one hand and the economic growth on the other. In the struggle against poverty, the financial inclusion is a crucial element. Large sections of the rural population have no access to financial services and their only recourse is to borrow from moneylenders at the exorbitant charges causing exploitation. The main reason why the large section of the rural population still remains at below poverty level is financial exclusion, which is proving to be a major obstacle in the path of India’s economic growth. The Reserve Bank of India (RBI)’s dictate (2005) obligated the banks to adopt the national policy of financial inclusion and

take initiatives and suitable measures therefore. The objective data derived from the RBI’s reports and 
other empirical studies unequivocally pinpoint that the main reasons of financial exclusion are lack of 
opportunities and access to finance, financial illiteracy, besides poor performance, apathy and negative 
approaches of the Banks. Therefore, financial inclusion, today, has become the national objective and 
major concern for the economic policy.

4.1.7 Mandira Sarma (November 2010) in her work “Index of Financial Inclusion” developed an 
index of Financial Inclusion for measuring Financial Inclusion with the use of following parameters:-

<table>
<thead>
<tr>
<th>Dimensions</th>
<th>Sub-indicators</th>
</tr>
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<tbody>
<tr>
<td>Banking penetration (BP)</td>
<td>- Number of bank accounts as a proportion of total population</td>
</tr>
<tr>
<td>Availability of banking services (BS)</td>
<td>- Number of bank branches per 100000 population</td>
</tr>
<tr>
<td></td>
<td>- Number of ATM per 100000 population</td>
</tr>
<tr>
<td></td>
<td>- The number of bank employees per customer</td>
</tr>
<tr>
<td></td>
<td>- Availability of electronic/internet based banking services</td>
</tr>
<tr>
<td>Usage of banking services (BU)</td>
<td>- Volume of deposit as compared to GDP</td>
</tr>
<tr>
<td></td>
<td>- Volume of credit as compared to GDP</td>
</tr>
</tbody>
</table>


Depending on the value of the IFI, countries are placed in one of the following three categories in the study of the above said researchers:
1. $0.5 \leq \text{IFI} \leq 1$ – high financial inclusion
2. $0.3 \leq \text{IFI} < 0.5$ – medium financial inclusion
3. $0.0 \leq \text{IFI} < 0.3$ – low financial inclusion
The IFI can be used to compare the extent of financial inclusion across different economies and to monitor the progress of the economies with respect to financial inclusion over time.

4.2 Demonetisation
Researchers Arpit Guru and Shruti Kahanijow (2010) analyzed the black money income. Need for amendment in DTAA & ITEA and analyzed that black money is spread everywhere in India up to a large extent which continuously stashed towards abroad in a very large amount. They also identified how and in what ways black money had caused menaces in our economy.

Sukanta Sarkar (2010) conducted a study on the parallel economy in India: causes, impacts and government initiatives in which the researcher focused on the existence of causes and impacts of black money in India. According to the study, the main reason behind the generation of black money is the Indian Political System i.e. Indian govt. just focused on making committees rather than to implement it. The study concludes that laws should be implemented properly to control black money in our economy.

Tax Research Team (2016) in their working paper stated in favour of demonetization. Its main objective is to analyze the impact of demonetization on Indian economy. This paper shows the impact of such a move on the availability of credit, spending, level of activity and government finances. The present paper focuses onto effect of demonetization on financial inclusion.

5. Analysis and Interpretation:
Prime Minister of India Narendra Modi announced the demonetization on 8th November, 2016. In his announcement PM cancelled the tender of more than 22 billion pieces of Rs. 500.00 and Rs. 1000.00 notes (approx. 86% of total circulation of currency notes) with effect from mid-night of 8th
November, 2016. PM also announced to introduce new Rs. 2000.00 and Rs. 500.00 notes of the Mahatma Gandhi New Series in alteration of old banknotes. The underneath causes of demonetization is to fight against black money, terrorism, corruption etc. and make India a less-cash digitalized economy. As approximately 90% of the total transactions are made in cash in India, so alternative platforms like mobile banking, cards, internet banking, POS transactions increased after the announcement of Demonetization. This development also helps to move one step ahead to complete financial inclusion digitally. It is also the fact that presence of number of huge high value currency notes in the economy have created favorable environment for terrorism, black money, corruption etc. Therefore, demonetization was on the anvil as one of the most important ladders to make economy free from these evils. The key steps was already taken in last two years by the Union Government i.e. (a) Aadhaar seeding to gas and other services (b) Attachment of PAN number with high value transactions etc.

Government of India aimed to fetch back the unaccounted money to the formal financial sector by limited exchange of old bank notes over the Bank counter and unlimited deposit of old bank notes in the account till the end of December, 2016. This is also the fact that Indian economy runs basically with cash due to shortage of Bank branches in the rural and semi-urban areas in comparison with urban areas. The details of density of bank branches are as follow:

As per RBI report on December, 2015 it was observed that each rural and semi-urban branches gave services to 12863 people compared with 5351 people in each metropolitan and urban branches. In rural areas there were 7.8 bank branches for one lakh people in rural India in comparison with 18.7 bank branches in urban areas.

6. Effects of Demonetization

a) Jan-Dhan Bank account introduced by PM Narendra Modi: - Demonetization effected Jan-Dhan Bank account enormously. After opening of the Jan-Dhan account in the rural as well as urban areas, no transactions were made in almost 24% of the Jan-Dhan account i.e. the status of the accounts are dormant. Now in the effect of demonetization most of the dormant account becomes operational for depositing old notes. In this connection one new type of deposit see the light of the world namely “Benami Deposit”. The rich persons in the area utilized the jandhan bank account of the poorer section of the society and perk their unaccounted money in the Jan-Dhan bank accounts.

b) Common People: - In India 90% of the total monetary transactions made by the common people is in Cash. After demonetization when 86% of the currency notes tender as cancelled from the mid-night of 8th November, 2016, the common people faced economic hardship. Due to lower level of digital financial literacy and inclusion, small percentage of rural population used cards, net banking, POS etc. in these days of hardship.

c) Informal Economic Sector: - The contract labors, village farmers, fishermen, daily wage workers, small enterprises are receives and makes payment almost all their transactions in cash. After so much effort from the part of the Government, they are not financially included either ordinarily or digitally to the formal financial sector of the economy due to low level of financial literacy. Demonetization has headed to a situation of cash crunch which made a negative impact to day-to-day livelihood of these people. Informal service providers like food - home-delivery makers, auto rickshaw poolers, footpath ironers, road-side bistros etc. losses their day-to-day business as they are not digitally included.

d) Rural MSME/ SHG groups: - Business of rural MSME sector and SHG groups were also affected due to demonetization. Though the said group of people has their bank account but most of them are not digitally included. It is not possible for the Bank to issue Debit Card or Credit Card in the name of SHG groups. So for every transaction members of the group have to visit bank branches which were rushed by the people of the economy in the time of demonetization either to deposit the old currency notes or to exchange the same.

e) E-WALLET Company: - Business of E-wallet companies increases with demonetization. Following table shows the fact:
In case of Mobile banking it was observed that Mobile Banking transactions increased by 200% at the time of demonetization in comparison with the data 1 year ago.

In case of Digital Wallet transaction it was observed that in the period of demonetization it was increased by more than double in terms of value.

f) **Position of ATM/POS transaction**: - Demonetization causes cash-crunch in the Indian economy. This is because of people wants alternative ways to fulfill their needs. Monthly position of ATM and POS transactions depicted in the following table: -

**ATM AND CARD STATISTICS**

<table>
<thead>
<tr>
<th></th>
<th>No. of Transactions (Actuals)</th>
<th>Amount of transactions (Rs. Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ATM</td>
<td>POS</td>
</tr>
<tr>
<td>May-16</td>
<td>738151679</td>
<td>212441570</td>
</tr>
<tr>
<td>Jun-16</td>
<td>732762442</td>
<td>194510490</td>
</tr>
</tbody>
</table>

From the above table it is observed that no of transactions in ATM was decreased in the month of November-2016 in comparison with previous months. This is due to

a) non-availability of new denomination notes of Rs. 500.00 and Rs. 2000.00
b) Time taken for calibrating the ATM machines for new denomination notes
c) Restriction of per day cash withdrawal

From December -2016 Government of India withdraw the restriction of cash withdrawal by day by day. Simultaneously the count of ATM hitting also increases over time.

In case of POS transaction, it was increased by more than doubled in the month of December-2016 in comparison with the average POS transactions from May-2016 to October-2016. From November-2016 it was observed that the count of POS transaction increased in comparison to average POS count.

RBI calculated that 98.7% of Rs. 1000.00 old note came back to banking system which was deposited in bank and post office within 31st March, 2017. As Government issued new Rs. 500.00 notes, the data does not give the break up of old and new notes.

In demonetization RBI makes a profit of Rs. 16,000.00 Crore and for printing new notes in place of old one Government spend Rs. 21,000.00 Crore.

In an interview with Times of India published on 3rd September, 2017, Dr. Raghuram Rajan, former Governor of Reserve Bank of India depict that estimated GDP loss will 1 to 2% which is lot of money over 2 lakh Crore.

The benefit of demonetization is electronic transaction like ATM, POS; net banking money transfer would go upward as mentioned by Dr. Rajan. He also says that enough preparation was required for demonetization.

7. Conclusion:
By way of demonetization India Government withdraw 86% of the currency notes from the economy in terms of Rs. 500.00 and Rs. 1000.00 notes. Aim of the Government was to convert black money to white one. Side-by-side the aim of the Government is to achieve financial inclusion along with less-cash digitized economy. It is fact that common people faces the hardship due to non availability of currency notes. It affects a lot to the poor people of the economy like the contract labors, village farm-
ers, fishermen, daily wage workers, small enterprises and informal service providers like food - home-delivery makers, auto rickshaw poolers, footpath ironers, road-side bistros etc. who lose their day-to-day income. So, circulation of money in the economy specifically in the rural sector decreases which affects the inclusive growth of the economy. Rating agencies lowered their forecasting on GDP growth rate of the country. Though it has been observed that growth rate stands on 7% as per calculation of the Government. With all these pain for the common people it has been proved that India can move towards the less-cash digital financially included economy if money circulation decreases. Government took another step towards less-cash economy by banning cash transactions of more than two lakhs with effect from 1st April, 2017. Simultaneously for India more time and effort are required to become a less-cash digital economy. By way of demonetization rural people at least visit the financial institution like banks, post office etc. for change of old currency notes and this habit helps them to be financially included with the main financial system of the country in near future.

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b) A Hundred Small Steps - Report of the Committee on Financial Sector Reforms (Chairman: Dr. Raghuram Rajan), [IJS, 2007].


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