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India's Demonetization: Time for a Digital Economy

The withdrawal of Rs1,000 and 500 notes from circulation can help India move to digital financial transactions.

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In terms of impact, few events can equal the demonetization of high-value Indian currency notes which took effect from November 9. The stories and rumors have been prolific, arguments and counterarguments endless; queues have reappeared in the age of 4G and the internet, and the media frenzy has been unparalleled. Economists appear to be widely divided over the efficacy and the impact of the move on the black money, which is variously estimated at 23 percent to 75 percent of the GDP. Demonetization is intended to flush out the black money and encourage a move to a cashless (or less cash-based) state and bring the parallel sector into the mainstream economy.

Critics argue that these motives have little economic justification and are more political in nature, in view of the coming state assembly elections in Punjab and Uttar Pradesh. To them, the amount of counterfeit currency in circulation is too small to be of any significance (0.004 percent of total cash in circulation); critics also point out that demonetization is unlikely to bring out much black money, since the bulk of it is held in illiquid assets such as land or gold and jewelry. Meanwhile, the common man has had to bear the economic hardship as 90 percent of all transactions are paid in cash. The brunt of the impact falls on those associated with the informal sector, which accounts for 80 percent of all jobs, where 85 percent of the workers are paid in cash.

Notwithstanding the above critiques, there is no doubt that the move creates a tremendous impetus toward greater financial inclusion. Demonetization has operationalized the Jan-Dhan bank accounts, with around 210 billion rupees ($3 billion) in deposits, based on recent statistics. The Pradhan Mantri Jan-Dhan Yojana (PMJDY) was launched in 2014 to achieve greater financial inclusion, and increased bank account penetration from 35 percent to 53 percent during last three years. But around 74 percent of these new accounts remained non-operational with zero balances.

Financial exclusion imposes a very high cost on people. In India, 98 percent of people use non-banking channels such as hawala, and pay exorbitant costs to remit or receive money from their family members living in other regions. A survey of Indian migrant workers showed an average commission of 4.6 percent when transferring money through informal routes, whereas money transfers in a formal banking system come with little or no cost. Similarly, a meager 10 percent of Indian avail themselves of loans from banks. A person who is economically poor and does not have a bank account must access micro-finance – many times at usuriously high rates of 50 percent or more – and store money in the form of cash, livestock, or jewelry. The value of cash withers with inflation, jewelry runs the risk of theft, and livestock is perishable.

All these factors adversely affect the flow of income, and hence impact consumption. A study involving households in Kenya found people using the MPESA service (a mobile banking service provided by Vodafone) are better equipped to absorb negative income shocks arising from poor health, crop failures, and job loss. Statistically comparable households not using the MPESA service are likely to experience a six to ten percent reduction in consumption in response to similar income-related shocks.

How well these inflows will be utilized toward economic growth remains to be seen. Access to formal banking will increase saving rates, which will enable capital investment in sectors such as roads, ports, and railways. India needs to invest over $400 billion in infrastructure. As capital is scarce, a perfect capital market will ensure a higher return for each additional dollar of saving invested for building India's infrastructure. Importantly, access to banking will increase the productivity of micro, small, and medium enterprises (MSME), and aid the Make in India initiative. It is worth noting that only 5 percent of MSMEs have access to institutional finance, underscoring the need for financial inclusion to drive India's inclusive growth agenda.

People are reluctant to try new things unless it becomes necessary. The demonetization will nudge a larger number of individuals to lessen their dependence on cash transactions and resort to digital payments. Downloads of Paytm wallet (a mobile e-commerce company with a user base of over 150 million) has tripled since November 9. The earlier attempts of the Reserve Bank of India – which has granted permission to 11 Indian companies such as India Post, Reliance Industries, Airtel, Vodafone, etc. to venture into the payment banking sector – came with limited success.

For its part the government needs to facilitate this transition into digital economy. The year-on-year growth rate of registered Internet users in India stands at an impressive 32 percent. India has the second largest Internet user base in the world with more than 350 million users, after China with more than 600 million Internet users and ahead of the United States with an estimated 279 million users.

For a populous country like India, any future strategy for financial inclusion will call for technology to reach the bottom of the pyramid. To facilitate use of Internet and digital transactions, the government can consider forming a Digital Sevak Dal – a network of young people to educate and support the Indian public in cities and rural areas to transition to a cashless economy. The Student Police Cadet scheme in Kerala is an example where schoolchildren visit the homes of poor and the elderly and help with e-literacy and digital transactions. Given the large number of unemployed, and that it requires minimal investment in education, the initiative can create major positive spin-offs.

Meanwhile, the Ministry of Telecommunication can join hands with the Ministry of Road Transport and Highways to facilitate the laying of fiber cables to achieve greater digital inclusion. The initiative can pay for itself, since bringing people onto digital banking platform will prevent leakages from subsidies. A study by McKinsey finds online payment of social benefits can save $22 billion per year.

India's demonetization could be the push the country needs to move to digital banking, but it will take more concerted government efforts to promote a long-term transition.

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