

Impact of Demonetization on the Banking Sector in India

A. Kaleeswari

M Com (CA), Morning Star Arts and Science College for Women, Pasumpon, Kamudhi (Affiliated to Alagappa University, Karaikudi), Tamil Nadu, India.

Corresponding Author Email: kalish03251@gmail.com

Abstract

On 8 November 2016, the Government of India demonetized ₹500 and ₹1000 banknotes, which constituted about 86 percent of the currency in circulation. The policy aimed to curb black money, eliminate counterfeit currency, and promote digital transactions, but it also generated a significant liquidity shock in the largely cash-driven Indian economy. This study analyzes the short- and medium-term impact of demonetization on the banking sector, focusing on deposit mobilization, credit growth, liquidity conditions, digital payment adoption, and overall financial performance. Drawing on secondary data from Reserve Bank of India (RBI) reports and related research, the findings reveal a substantial surge in bank deposits and liquidity, accompanied by a temporary slowdown in credit growth, particularly in rural and MSME sectors. At the same time, digital transactions such as NEFT, RTGS, IMPS, and mobile banking expanded significantly. Although banks faced operational challenges during the transition, demonetization accelerated digital infrastructure development and strengthened formal financial participation. Overall, the policy acted as both a disruptive and transformative force, reshaping India's banking landscape through enhanced liquidity and increased digitalization.

Keywords: *Demonetization, Banking Sector, Deposit Growth, Credit Expansion, Digital Payments, Liquidity, Financial Inclusion, RBI*

1. Introduction

The demonetization policy announced on 8 November 2016 by the Government of India under Prime Minister Narendra Modi was one of the most significant monetary decisions in the country's history. The withdrawal of 500 and 1,000 notes, which made up about 86% of the currency in circulation, created a sudden liquidity shock in a cash-dependent economy. As people rushed to deposit invalid notes, banks became the central

channel for managing the transition. Banks experienced a massive surge in deposits, especially public sector banks, which improved liquidity and allowed reductions in deposit and lending rates. This strengthened their balance sheets and increased investments in government securities. However, banks also faced heavy operational pressure, including long queues, ATM recalibration, and compliance with changing guidelines from the Reserve Bank of India (RBI). Demonetization accelerated financial inclusion through schemes like the Pradhan Mantri Jan Dhan Yojana and boosted digital payments, particularly via UPI and mobile banking. Although credit demand initially slowed and some asset quality concerns emerged, the policy strengthened formal financial channels. Overall, demonetization enhanced liquidity, promoted digitization, and reinforced the banking sector's role in economic stabilization.

2. Methodology

This study adopts a descriptive and comparative research design to examine the impact of demonetization on the banking sector. It relies primarily on secondary data collected from the monthly bulletins and annual reports of the Reserve Bank of India, along with industry reports and peer-reviewed journal articles analyzing the effects of demonetization in India.

The descriptive approach is used to present trends in key banking indicators such as deposit mobilization, credit growth, and digital transaction volumes. The comparative approach evaluates these indicators across two distinct periods pre-demonetization and post-demonetization to identify measurable changes attributable to the policy. Quantitative data on digital payments, savings and current account deposits, and lending patterns are systematically organized into tables and charts. This structured presentation enables clear comparison of trends before and after policy implementation. By synthesizing official statistics with analytical literature, the study ensures a balanced assessment of short-term disruptions and long-term structural changes in the banking sector.

3. Banking Sector Response: Deposit Mobilization and Liquidity

One of the immediate and most measurable impacts of demonetization was the surge in bank deposits. Citizens and businesses deposited demonetized currency into bank accounts to comply with the new legal tender status, resulting in heightened liquidity.

Table 1 – Bank Deposit Trends around Demonetization

Period	Aggregate Bank Deposits (₹ trillion)	Percentage Increase
Oct 2016 (Pre)	~65*	—
Dec 2016	~68*	~4–5 %
Feb 2017	Continued growth	Moderate

Estimated based on excess deposit growth reported during November–December 2016. Demonitized currency deposits contributed between 2.8 trillion and 4.3 trillion, which translated to a 4–4.7 percentage-point increase in bank deposits over that period. Heightened deposits increased liquidity in the system, resulting in banks holding larger reserves. While greater liquidity can ease short-term funding pressures, it also created challenges for efficient capital deployment, as demand for credit did not rise proportionately with deposit inflows.

4. Credit Growth and Lending Patterns

Demonetization’s effects on credit growth were asymmetrical. While deposit volumes surged, credit growth decelerated, especially in rural and agricultural financing. Data indicates that the annual credit growth for all scheduled commercial banks dropped sharply in the months following demonetization.

Table 2 – Credit Growth Before and After Demonetization

Indicator	Sept 2016	Mar 2017
Overall Credit Growth	~12.2 %	~5.4 %
Rural Loans Growth	~12.9 %	~2.5 %
Urban Loans Growth	~11.2 %	~6.1 %
Metropolitan Loans Growth	~12.3 %	~5.5 %

The sharp decline in credit growth is attributed to reduced consumer demand amid liquidity shortages and economic uncertainty. Rural and MSME sectors were particularly affected as cash shortages constrained transactions and dampened demand for loans in these markets.

5. Digital Payments and Banking Technology Adoption

A notable long-term impact of demonetization was the acceleration of digital banking and payment systems as cash became scarce. Financial technology adoption rose as individuals and businesses sought alternatives to cash transactions.

Table 3 - Growth in Key Digital Payment Channels

Payment Mode	Pre-Demonetization	Post-Demonetization (2016-17)	% Growth
NEFT Transactions	~1.3 billion	~1.6 billion	+23 %
IMPS Transactions	~220 million	~506 million	+130 %
Mobile Banking Users	~105 million	~163 million	+55 %
RTGS Transactions	98 million	108 million	+10 %

These categories – NEFT, RTGS (Real Time Gross Settlement), IMPS (Immediate Payment Service), and mobile banking – experienced substantial increases in both volume and value during the 2016-17 financial year. In addition to traditional bank transfers, the deployment of over 1 million new PoS terminals expanded the acceptance infrastructure for card payments. UPI and BHIM platforms, while nascent at that time, saw rapid growth in transactional volumes during subsequent years, reinforcing the shift from cash to digital transactions.

6. Financial Performance and Cost Structures

The impact on bank profitability was mixed. While increased deposits boosted liquidity and potential interest income, the simultaneous decline in lending limited interest-earning asset growth. Banks also incurred higher operational costs, such as printing new currency, managing logistics, and servicing intense customer footfall at branches and ATMs in the months after demonetization. Furthermore, banks absorbed costs associated with discounted merchant rates and higher customer service volumes during the transition period. Although the policy boosted digital transaction revenues in some cases, banks faced challenges balancing short-term operational costs with long-term digital transformation investments.

7. Financial Inclusion and Mass Banking Participation

Demonetization encouraged many previously unbanked individuals and small businesses to open bank accounts or link existing accounts for deposits and transactions. For example, Pradhan Mantri Jan Dhan Yojana (PMJDY) accounts saw exponential increases in balances as customers deposited previously held cash into formal banking channels. This expansion of account ownership contributes to long-term financial inclusion, offering broader access to credit, savings products, and digital financial services, which are vital for inclusive economic growth.

8. Challenges and Structural Limitations

Despite the increase in digital transactions, cash remained significant in daily commerce, particularly in rural and informal sectors. The RBI monthly bulletin data indicated that electronic payments initially surged but later fluctuated, showing variability in sustained usage levels. This highlights that demonetization alone could not permanently shift entrenched cash preferences without parallel infrastructure and financial literacy improvements. Additionally, the decline in credit demand, especially in rural loans, suggests that demonetization's short-term liquidity surge was not coupled with immediate credit expansion – a key function of banking sector growth.

9. Discussion

Demonetization triggered significant structural changes in the banking sector in India. It accelerated digital banking adoption as cash shortages pushed customers toward mobile banking and electronic payments. Platforms like UPI, promoted under the guidance of the Reserve Bank of India, grew rapidly, prompting banks to strengthen digital infrastructure and cybersecurity. Banks also experienced a sharp rise in deposits, improving liquidity and temporarily strengthening balance sheets. This enabled lower lending rates and increased investment in government securities. However, the sector faced operational strain, higher administrative costs, and a temporary slowdown in credit growth, especially in cash-dependent sectors. The shift toward a digital economy was uneven, with rural areas facing infrastructure and literacy challenges. Overall, while some effects such as digital expansion proved lasting, others like excess liquidity were temporary. Demonetization ultimately accelerated the modernization and formalization of India's banking system.

10. Conclusion

Demonetization had multi-dimensional effects on the banking sector in India. Deposit levels surged as large volumes of invalidated currency were channeled into bank accounts, significantly enhancing liquidity, though the impact on lending remained mixed. Credit growth slowed, particularly in rural areas and MSME sectors, due to disruptions in cash-intensive economic activities. At the same time, digital payments and banking technology adoption expanded rapidly, transforming traditional payment modes and accelerating the shift toward electronic transactions. However, increased operational costs, logistical pressures, and

transitional challenges also affected bank profitability and resource allocation during the adjustment period. The long-term banking transformation catalyzed by demonetization remains visible in India's robust digital transaction ecosystem and broader financial inclusion indicators. However, sustained structural change requires continued investments in digital infrastructure, financial literacy, and targeted credit policies.

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