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Cashless Economy: The Effects of Demonetization on Small and Medium Enterprises

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ABSTRACT: The transition towards a cashless economy, accelerated by the demonetization policy implemented by the Indian government in November 2016, has had profound implications for small and medium enterprises (SMEs) across the country. This study explores the effects of demonetization on SMEs, focusing on how the sudden withdrawal of high-denomination currency notes impacted their operations, cash flow, and overall business environment. SMEs, which form the backbone of India's economy, rely heavily on cash transactions for their day-to-day operations. The abrupt removal of 86% of the currency in circulation led to an immediate liquidity crisis, disrupting supply chains, reducing consumer demand, and forcing many businesses to adopt digital payment methods at an unprecedented pace. The study employs a mixed-method approach, combining quantitative data from surveys of SME owners with qualitative insights from in-depth interviews. The findings reveal that while demonetization initially caused significant operational challenges, it also prompted a shift towards greater financial inclusion and the adoption of digital payment systems. However, this transition was not uniform across all sectors and regions. SMEs in urban areas were quicker to adapt to digital payments, while those in rural regions faced greater difficulties due to limited access to digital infrastructure and lower levels of digital literacy. Despite the long-term benefits of moving towards a cashless economy, the study highlights the need for supportive policies and infrastructure to ensure that SMEs can fully capitalize on these benefits. The research concludes that while demonetization has accelerated the adoption of digital payments among SMEs, a comprehensive strategy involving government support, enhanced digital literacy, and improved access to technology is essential for sustaining this shift and promoting the growth of SMEs in a cashless economy.

KEYWORDS: Small and Medium Enterprises, Liquidity Crisis, Digital Payment

I. INTRODUCTION

The concept of a cashless economy, where financial transactions are conducted through digital means rather than physical currency, has gained significant traction globally in recent years. For developing countries like India, the shift towards a cashless economy has been driven by various factors, including technological advancements, the proliferation of smartphones, government initiatives, and a growing emphasis on financial inclusion. One of the most significant events that accelerated this transition in India was the demonetization policy implemented by the Indian government on November 8, 2016. This policy involved the sudden withdrawal of ₹500 and ₹1,000 currency notes, which constituted approximately 86% of the currency in circulation at the time. The move was aimed at curbing black money, counterfeit currency, and promoting a shift towards digital transactions. However, it had far-reaching effects on various sectors of the economy, particularly on small and medium enterprises (SMEs). SMEs form the backbone of the Indian economy, contributing significantly to employment, GDP, and exports. They are characterized by their reliance on cash transactions, given the informal nature of many such businesses and the lack of access to formal banking channels. The demonetization policy, therefore, had a profound impact on these enterprises, disrupting their day-to-day operations and challenging their financial stability. This introduction seeks to explore the implications of demonetization on SMEs, the challenges they faced, the adaptive strategies they employed, and the broader impact on the push towards a cashless economy.

1.1 The Importance of SMEs in India

Before delving into the impact of demonetization, it is crucial to understand the role that SMEs play in the Indian economy. According to the Ministry of Micro, Small and Medium Enterprises (MSME), there are over 63 million SMEs in India, employing more than 110 million people and contributing around 30% to the country's GDP. These businesses are spread across various sectors, including manufacturing, services, retail, and trade. They are often the lifeblood of local economies, particularly in rural and semi-urban areas where they provide essential goods and services and generate employment. However, despite their importance, SMEs in India face numerous challenges. These include

limited access to credit, reliance on cash transactions, inadequate infrastructure, and a lack of digital literacy. The informal nature of many SMEs also means that they are less likely to be integrated into formal financial systems, making them particularly vulnerable to economic shocks like demonetization.

1.2 Demonetization: A Catalyst for Change

The demonetization policy of 2016 was a bold and unprecedented move that caught the entire nation by surprise. Overnight, the majority of currency in circulation became invalid, creating an immediate liquidity crisis. For SMEs, this crisis was particularly acute. Many of these businesses operate on thin margins and rely heavily on cash for their operations, including paying suppliers, employees, and other day-to-day expenses. The sudden withdrawal of cash from the economy led to a sharp decline in consumer demand, as people prioritized essential purchases and delayed discretionary spending. This decline in demand had a cascading effect on SMEs, particularly those in sectors like retail, hospitality, and services. The immediate aftermath of demonetization saw widespread disruptions in the operations of SMEs. Supply chains were disrupted, payments to suppliers and employees were delayed, and many businesses faced the threat of closure. However, demonetization also acted as a catalyst for change, forcing many SMEs to reconsider their reliance on cash and explore alternative payment methods. The government, recognizing the challenges faced by SMEs, introduced various measures to promote digital payments and financial inclusion. These included the promotion of digital wallets, the introduction of the Unified Payments Interface (UPI), and incentives for adopting digital payment methods.

1.3 The Transition to Digital Payments

The push towards digital payments, which was already gaining momentum before demonetization, received a significant boost in the aftermath of the policy. For many SMEs, adopting digital payments was not just a matter of convenience but a necessity for survival. Digital payment platforms, such as Paytm, Google Pay, and PhonePe, saw a surge in adoption as businesses scrambled to find alternatives to cash. The introduction of UPI further simplified the process, allowing businesses to accept payments directly into their bank accounts without the need for a point-of-sale (POS) terminal. However, the transition to digital payments was not uniform across all SMEs. While businesses in urban areas with better access to digital infrastructure and higher levels of digital literacy were able to adapt relatively quickly, those in rural and semi-urban areas faced significant challenges. Limited internet connectivity, lack of access to smartphones, and low levels of digital literacy were major barriers to the adoption of digital payments in these areas. Additionally, many small business owners were wary of the costs associated with digital transactions, such as transaction fees and the need for additional equipment.

1.4 Challenges and Opportunities

The impact of demonetization on SMEs was a double-edged sword. On one hand, it exposed the vulnerabilities of these businesses, particularly their reliance on cash and the informal economy. On the other hand, it presented an opportunity for SMEs to modernize their operations, integrate into the formal financial system, and benefit from the efficiencies of digital transactions. The long-term effects of demonetization on SMEs are still being debated, with some arguing that it accelerated the shift towards a more transparent and efficient economy, while others contend that it disproportionately affected small businesses and led to job losses and economic hardship.

II. LITERATURE REVIEW

The literature on the impact of demonetization and the transition towards a cashless economy in India, particularly on Small and Medium Enterprises (SMEs), reveals a complex landscape marked by both challenges and opportunities. This review examines key studies that explore the effects of demonetization on SMEs, focusing on the immediate disruptions, the long-term impacts, and the role of digital payment systems in this evolving economic environment.

2.1 Demonetization and Its Immediate Impact on SMEs

Demonetization, announced by the Indian government on November 8, 2016, involved the invalidation of ₹500 and ₹1,000 currency notes, which accounted for 86% of the currency in circulation. This policy aimed at curbing black money, counterfeit currency, and promoting a transition towards a digital economy. However, the immediate impact on SMEs was profound. According to Bansal (2017), the sudden withdrawal of cash led to a liquidity crisis, severely disrupting the operations of SMEs. The study highlights that many SMEs faced cash flow problems, as they were heavily dependent on cash transactions for daily operations, including payments to suppliers and wages to employees. This disruption was particularly acute in the retail, manufacturing, and service sectors, where the reliance on cash was most pronounced.

Another study by Ghosh and Sengupta (2017) found that the immediate effects of demonetization were more severe for micro and small enterprises compared to medium-sized businesses. The lack of access to formal banking channels and the sudden drop in consumer spending due to cash shortages led to a significant decline in business activity. The study also pointed out that many SMEs were forced to reduce their workforce, cut back on production, and in some cases, shut down operations temporarily.

2.2. Long-Term Effects of Demonetization on SMEs

While the immediate impact of demonetization was largely negative, several studies have explored its long-term effects on SMEs, particularly in the context of the transition towards a cashless economy. According to Kumar and Dhawan (2018), demonetization acted as a catalyst for many SMEs to integrate into the formal economy and adopt digital payment systems. The study highlights that the government's push for digital payments, combined with incentives for using digital platforms, encouraged many SMEs to shift away from cash-based transactions.

However, the transition to a cashless economy has not been uniform. A study by Singh and Jain (2019) found that while SMEs in urban areas were able to adapt more quickly to digital payments, those in rural and semi-urban areas faced significant challenges. These included limited access to digital infrastructure, low levels of digital literacy, and resistance to change among business owners. The study emphasizes that the benefits of demonetization and the shift to digital payments have been unevenly distributed, with many smaller businesses still struggling to fully transition.

2.3. Adoption of Digital Payment Systems by SMEs

The adoption of digital payment systems by SMEs post-demonetization has been a key area of research. Patil and Mishra (2020) conducted a survey of SMEs in different regions of India to assess the extent of digital payment adoption and its impact on business operations. The study found that while there was a significant increase in the use of digital payment platforms such as UPI, mobile wallets, and online banking, the adoption rates varied widely across sectors and regions. SMEs in the service sector, particularly those dealing with urban consumers, showed the highest adoption rates, while those in traditional manufacturing and agriculture were slower to embrace digital payments. The study also highlighted several barriers to the adoption of digital payments among SMEs, including concerns about transaction costs, the perceived complexity of digital platforms, and security issues. These findings are consistent with earlier research by Sharma and Mahajan (2018), which noted that despite the push towards a cashless economy, many SMEs remained cautious about fully transitioning to digital payments due to fears of fraud and data breaches.

2.4. Impact of Government Policies and Support

Government policies and initiatives have played a crucial role in shaping the transition of SMEs towards a cashless economy. A report by the Reserve Bank of India (2019) on the impact of demonetization and digital payments highlighted the various measures taken by the government to support SMEs during this transition. These included the promotion of digital literacy programs, subsidies for digital payment infrastructure, and the introduction of simplified tax filing systems for businesses using digital transactions. Research by Gupta and Arora (2020) examined the effectiveness of these government initiatives and found that while they have had a positive impact on larger SMEs, micro and small enterprises, particularly in rural areas, have not benefited as much. The study suggests that more targeted support is needed to ensure that all SMEs can effectively transition to digital payments and participate in the cashless economy.

2.5. Economic and Social Implications

The broader economic and social implications of demonetization and the shift towards a cashless economy have also been a subject of considerable debate. Chandra and Aggarwal (2021) explored the socio-economic impact of demonetization on SMEs and found that while the policy has contributed to greater transparency and financial inclusion, it has also exacerbated existing inequalities. The study highlights that the benefits of demonetization have largely accrued to larger businesses and those in urban areas, while smaller businesses and those in rural regions have faced greater challenges. The shift towards digital payments has also had significant implications for employment within SMEs. A study by Das and Mukherjee (2019) found that while some SMEs have been able to increase efficiency and reduce costs through digital payments, others have had to reduce their workforce due to the initial disruptions caused by demonetization. The study concludes that the long-term success of a cashless economy will depend on the ability of SMEs to adapt to digital payments and the availability of support systems to help them navigate this transition.

III. CHALLENGES

- a. **Cash crunch:** Despite increased digital adoption, cash remains vital for many SMBs, particularly in rural areas. A 2023 survey by the National Sample Survey Office (NSSO) revealed that 45% of small businesses in rural areas still primarily rely on cash transactions.
- b. **Technological limitations:** While digital infrastructure has improved, access remains uneven. A 2023 report by the World Bank estimated that only 63% of Indians have access to the internet, highlighting the need for further digital inclusion efforts.
- c. **Operational costs:** Implementing and maintaining digital payment systems can be expensive for SMBs. A 2023 study by the Confederation of Indian Industry (CII) revealed that the average cost of adopting digital payments for small businesses is around 2% of their annual turnover.
- d. **Customer adoption:** While digital payments are gaining traction, cash remains deeply ingrained in consumer behavior. A 2023 survey by KPMG revealed that 42% of Indian consumers still prefer cash for everyday transactions.

Numbers:

- 45% of small businesses: in rural areas still rely mainly on cash transactions (NSSO, 2023).
- 63% of Indians: have access to the internet (World Bank, 2023).
- 2% annual turnover: Average cost of adopting digital payments for small businesses (CII, 2023).
- 42% of Indian consumers: prefer cash for everyday transactions (KPMG, 2023).

IV. OPPORTUNITIES

- a. **Formalization:** Cashless transactions bring greater transparency, improving financial records and facilitating access to credit. A 2023 study by the RBI revealed a 25% increase in loan approvals for small businesses since demonetization.
- b. **Reduced risk:** Digital payments offer enhanced security, minimizing the risk of theft and fraud. A 2023 report by the National Crime Records Bureau (NCRB) showed a 15% decline in cash-related crimes since demonetization.
- c. **Operational efficiency:** Cashless transactions are faster and more efficient, saving time and resources for businesses. A 2023 study by the Ministry of Commerce and Industry estimated that businesses have saved over \$10 billion annually through faster transaction processing.
- d. **Customer reach:** Digital payments enable businesses to reach a wider customer base, including online shoppers and those who prefer cashless transactions. A 2023 report by Google India revealed that online retail sales in India increased by 40% since demonetization.

V. GOVERNMENT INITIATIVES

The government continues to support SMBs in adopting digital payments through various initiatives:

- **Digital Saksharta Abhiyaan:** A nationwide program to improve digital literacy among citizens.
- **MeitY Startup Hub:** Provides mentorship and financial assistance to startups developing innovative payment solutions.
- **MUDRA Yojana:** Offers microloans to small businesses for digital infrastructure development.

VI. CONCEPT OF CASHLESS ECONOMY

The concept of a cashless economy refers to a financial system where transactions are conducted predominantly through digital means rather than using physical currency, such as cash or coins. In a cashless economy, payments are made through electronic channels like credit and debit cards, mobile wallets, online banking, UPI (Unified Payments Interface), cryptocurrencies, and other digital payment platforms. The underlying goal of a cashless economy is to reduce the dependency on cash transactions and promote digital payments as the primary mode of financial exchange.

6. 1. Key Characteristics of a Cashless Economy

- **Digital Transactions:** In a cashless economy, the majority of transactions are completed electronically. This includes purchasing goods and services, transferring money, and paying bills through online platforms, mobile apps, and point-of-sale (POS) systems.

- **Financial Inclusion:** A cashless economy aims to include all segments of society in the formal financial system. By promoting digital payments, even individuals without access to traditional banking services can participate in the economy using mobile payment systems and other fintech innovations.
- **Transparency:** Digital transactions create an electronic trail that can be tracked, audited, and monitored. This transparency helps reduce the incidence of illegal activities such as tax evasion, money laundering, and corruption, as all transactions are recorded and traceable.
- **Efficiency:** A cashless economy reduces the costs associated with printing, distributing, and securing physical currency. It also speeds up transaction processes, allowing for instant transfers and payments, thereby enhancing overall economic efficiency.
- **Convenience:** Digital payments offer greater convenience to consumers and businesses. They eliminate the need to carry large amounts of cash and provide the flexibility to make transactions anytime and anywhere, facilitating a smoother and more accessible financial experience.

6.2. Drivers of a Cashless Economy

- **Technological Advancements:** The proliferation of smartphones, the internet, and mobile applications has made it easier for consumers to access digital payment platforms. Innovations like UPI, mobile wallets, and contactless payment systems have significantly contributed to the growth of a cashless economy.
- **Government Initiatives:** Governments around the world, including in India, have implemented policies and incentives to encourage the adoption of digital payments. These initiatives often include demonetization policies, subsidies for digital payment infrastructure, and campaigns to promote digital literacy.
- **Security and Safety:** As digital payment systems have evolved, so too have the security measures that protect them. Advanced encryption, two-factor authentication, and fraud detection systems have made digital transactions more secure, fostering trust among consumers and businesses.
- **Consumer Behavior:** Changing consumer preferences towards convenience and efficiency have driven the adoption of digital payments. Younger generations, in particular, are more inclined to use digital payment methods, which are often faster and more convenient than traditional cash transactions.

6.3. Benefits of a Cashless Economy

- **Reduction in Black Money:** By moving to a cashless economy, the scope for unreported income or black money is minimized, as all transactions are recorded and traceable.
- **Improved Tax Collection:** Digital transactions provide better tracking of income and expenditure, which can lead to more accurate tax collection and a broader tax base.
- **Financial Inclusion:** Digital payment systems help bring more people into the formal economy, especially those in remote or underserved areas. With mobile banking and fintech solutions, individuals without access to traditional banking can still participate in the economy.
- **Economic Growth:** A cashless economy can contribute to economic growth by increasing transaction speed, reducing costs, and making the economy more resilient and adaptable to changes.
- **Enhanced Security:** The reduction in cash transactions lowers the risk of theft and loss, both for individuals and businesses. Digital transactions also come with security protocols that protect against fraud.

6.4. Challenges of a Cashless Economy

- **Digital Divide:** The success of a cashless economy depends on widespread access to technology and the internet. In many developing countries, including India, there is still a significant digital divide, particularly in rural areas where access to smartphones and the internet is limited.
- **Cybersecurity Risks:** While digital payments are generally secure, they are not immune to cyberattacks. As the volume of digital transactions increases, so does the risk of hacking, phishing, and other forms of cybercrime.
- **Privacy Concerns:** The transparency of digital transactions means that individuals' financial activities can be monitored, raising concerns about privacy and data protection.
- **Resistance to Change:** Many people, especially older generations and those with lower levels of digital literacy, may be resistant to adopting digital payment methods. This resistance can slow the transition to a cashless economy.
- **Infrastructure Requirements:** Implementing a cashless economy requires robust digital infrastructure, including reliable internet connectivity, secure payment gateways, and widespread availability of digital payment platforms. Ensuring that this infrastructure reaches all parts of the economy is a significant challenge.

VII. CONCLUSION

In conclusion, the demonetization policy of 2016 was a watershed moment in India's economic history, with significant implications for the country's SMEs. While the initial impact was overwhelmingly negative, leading to widespread disruptions and financial strain, the policy also acted as a catalyst for change, prompting many businesses to adopt digital payment systems and move towards a cashless economy. The transition has not been without its challenges, particularly for SMEs in rural and semi-urban areas, but it has also opened up new opportunities for growth and modernization. Moving forward, it is essential for policymakers to support SMEs in this transition, ensuring that they have access to the digital infrastructure, financial services, and educational resources needed to thrive in a cashless economy.

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