Crossing the chasm

In government's push for a cashless economy, policy and regulation must focus on competition, innovation

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THE RBI'S MONETARY Policy Committee wisely decided not to cut policy rates in its meeting on December 7. Though the economy has witnessed a sharp negative shock with a drop in consumer demand, a rate cut can do little to counter the shock of demonetisation. A policy rate decision is usually expected to have an impact on inflation in one to two years. By then, it is hoped that the impact of this negative demand shock will be over. Moreover, measuring the impact of demonetisation on inflation and the GDP is difficult as the story is still playing out. A bad, but not unlikely, scenario is that demonetisation increases uncertainty in the policy environment, and its effects go beyond the immediate demand reduction due to cash shortages. Consequently, it could lead to a postponement of investment revival by a few years making it difficult to forecast the GDP. Consequently, monetary policy-making too has gone into wait and watch mode.

The decision to keep the rate unchanged is also good as an attempt to improve public perception of the RBI. Demonetisation and its handling, as well as the RBI's insistence that the process was carefully deliberated, adequately prepared for, and that there is ample cash with banks, has undermined the public's confidence in the RBI's capabilities and its commitment to the inflation target. Deputy Governor R. Gandhi's statement after the monetary policy meeting raises, rather than answers, questions about the RBI's competence. Most are unconvinced that the RBI board's recommendation to the government to demonetise was based on independent and technically sound analysis.

As a way out of the shortage of cash, government and the RBI have appealed to the public to adopt electronic payments. Indeed, it increasingly appears as if that, rather than black money held in cash, was the main objective of demonetisation. One point often made in the current debate is the difficulty in doing so as half the Indian population is unbanked. This is an important obstacle in the adoption of electronic payments. The pertinent question, however, is: Why does half of India's population not have bank accounts?

Most of India lacks bank accounts because we have tried to apply a command and control approach to banking policy. The lack of a competitive banking system meant that banks themselves were not inclined to open rural branches and ask customers to open bank accounts. Instead, beginning with the nationalisation of banks, it has been a government initiative for many decades. Banks have been given targets. Pushing public sector banks to open branches, and then pushing them to open accounts for the poor has not been a successful strategy. We did not create a competitive banking system. New commercial bank licences have been rare, barely two per decade. Foreign banks are not allowed to open more than 20 branches a year.

No doubt, in these difficult days without cash, there will be some movement to digital payments. Growth figures, given today's tiny base, will look large. But even some of this may be temporary. Permanent adoption of electronic payment systems will depend on the ease of payments and the charges to be paid for these services. Government has made digital payments free till December end to alleviate the cash situation. At some point beyond that, payment service providers will be allowed to charge for their services otherwise they will shut down the service, killing the whole cashless project. It has been reported that Visa, Mastercard and RuPay will altogether lose Rs 1,000 crore in November-December. Regardless of the accuracy of the amount reported, this is not a sustainable model.

Electronic payments have to be easy to adopt. There are plenty of models around the world to learn from. In some countries today, person to person payments are generally made digitally. Having effectively blocked such payments so far by onerous KYC norms and other restrictions, even the young who had the literacy, the means and the attitude to adopt e-payments, have not done so to the extent desired.

Unless the RBI ensures that all electronic payment systems and e-wallets are inter-operable, we could be creating a monopoly. Today the payments regulator, the RBI, prevents a Paytm customer from paying a MobiKwik customer. This is unlike the TRAI that pushes telecom companies to accept calls that originate from other telecom providers. A telecom company cannot refuse to accept incoming calls and force the customer receiving the call to subscribe to its service. However, a payments provider requires the customer receiving payments to download its app and become a subscriber.

In markets with such network externalities, one of the service providers is likely to emerge as a monopoly, unless the regulator steps in. This is undesirable for a number of reasons. It could leave customers vulnerable to higher charges later, which may again reduce the adoption of digital payments. Second, it would reduce the incentive of the monopolist to constantly innovate as he will not be facing competition. Third, it will create systemic risk as it will make the system vulnerable to the health and electronic infrastructure of one provider. If the provider fails, the whole system can crash and again the economy can come to a standstill.

If the government wishes to push faster for a cashless economy, policy and regulation need to focus on competition and innovation. The RBI has been promoting bank-centric payment systems in an economy where banks don't even compete to get customer accounts. It is no surprise that neither banking nor payments have spread to the entire population.

When you wish to influence the behaviour of millions of people, consumers, businesses there has to be a change in the policy framework from targets to one that works through incentives. In this case it has to be about incentives of banks, of payment service providers, of the payments regulator etc. Pushing the economy into cashlessness cannot be forced by putting Rs 2,000 notes in the hands of the public so that people use electronic payments from lack of choice, where card companies provide the service at a loss and where some wallets could emerge as monopolies, from sheer neglect or not putting a competitive policy framework in place. If we are moving towards the goal of cashlessness, a focus on technology and neglect of an appropriate competitive regulatory framework will be short-sighted. The policy framework must be based on competition, interconnection and consumer protection. Policy work and committee processes have been working on cashlessness for many years. This work needs to go into the government's next steps.

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