What is the Scenario of CBDC?

- CBDCs are a **digital form of a paper currency** and unlike cryptocurrencies that operate in a regulatory vacuum, these are **legal tender issued and backed by a central bank.**
- Many countries have decided to have their own CBDC to provide more reliable digital currencies to work as legal tender, prompting displacement of private digital currencies.
  - **Bahamas** has been the **first economy to launch its nationwide CBDC — Sand Dollar.**
  - **Nigeria** is another country to have rolled out **eNaira** in 2020.
  - **China** became the **world's first major economy** to pilot a digital currency **e-CNY** in April 2020.
  - **Korea, Sweden, Jamaica, and Ukraine** are some of the countries to have begun testing its digital currency and many more may soon follow.
- Recently, in its **Budget 2022-23,** the Government of India announced that its **central bank will issue a digital currency** as early as 2022-23.
  - The main objective is to **mitigate the risks and trim costs in handling physical currency,** costs of **phasing out soiled notes**, transportation, insurance and logistics.
  - It will also **wean people away from cryptocurrencies** as a means for money transfer.

What are the Merits of CBDC?

- **A Combination of Traditional and Innovative:** CBDC can gradually bring a **cultural shift towards virtual currency** by reducing currency handling costs.
  - CBDC is envisaged to **bring in the best of both worlds** - the **convenience and security of digital forms** like cryptocurrencies, and the regulated, **reserved-backed money circulation of the traditional** banking system.
- **Easier Cross-Border Payments:** CBDC can provide an easy means to **speed up a reliable sovereign backed domestic payment** and settlement system partly replacing paper currency.
  - It could also be **used for cross-border payments**; it could **eliminate the need for an expensive network** of correspondent banks to settle cross-border payments.
- **Financial Inclusion:** The increased use of CBDC could be **explored for many other financial activities** to **push the informal economy into the formal zone** to ensure **better tax and regulatory compliance .**
  - It can also pave the way for furthering **financial inclusion.**
- There is a need to **enforce strict compliance of Know Your Customer (KYC) norms** to prevent the currency's use for **terror financing** or **money laundering.**

What are the Risks Associated with CBDC?

- **Privacy Concerns:** The first issue to tackle is the heightened risk to the privacy of users—given that the **central bank could potentially end up handling an enormous amount of data** regarding user transactions. This has serious implications given that **digital currencies will not offer users the level of privacy** and anonymity offered by transacting in cash.
  - Compromise of credentials is another major issue.
- **Disintermediation of Banks:** If sufficiently large and broad-based, the shift to CBDC can **impinge upon the bank's ability to plough back funds** into credit intermediation.
  - If e-cash becomes popular and the **Reserve Bank of India (RBI)** places no limit on the amount that can be stored in mobile wallets, **weaker banks may struggle to retain low-cost deposits.**
- **Other risks are:**
  - **Faster obsolescence of technology** could pose a threat to the CBDC ecosystem calling for **higher costs of upgradation.**
  - Operational risks of intermediaries as the **staff will have to be retrained** and groomed to work in the CBDC environment.
  - **Elevated cyber security risks,** vulnerability testing and **costs of protecting the firewalls**
  - **Operational burden** and costs for the central bank in managing CBDC.

How to Overcome the Risks of CBDC?

- In order to obviate some weaknesses of CBDCs, the **usage should be payment-focused** to improve the payment and settlement system. Then it can steer away from serving as a store of value to avoid the risks of disintermediation and its major monetary policy implications.

Note:

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