Central Bank Digital Currency – Is This the Future of Money

Syllabus - Indian Economy and issues relating to planning, mobilization, of resources, growth, development and employment

In News: The Reserve Bank of India (RBI) has said that it is working towards a phased implementation strategy for its digital currency (i.e. Central Bank Digital Currency).

Introduction:

- **About currency -** In modern economies, currency is a form of money that is issued exclusively by the sovereign (or a central bank as its representative). It is a liability of the issuing central bank (and sovereign) and an asset of the holding public. Currency is fiat, it is legal tender. Currency is usually issued in paper (or polymer) form, but the form of currency is not its defining characteristic.
- **About Central Bank Digital Currency** - A CBDC is the legal tender issued by a central bank in a digital form. It is the same as a fiat currency and is exchangeable one-to-one with the fiat currency. Only its form is different. CBDC is a digital or virtual currency but it is not comparable to the private virtual currencies that have witnessed high growth over the last decade.
    - Central banks across the world have drawn up plans to launch their digital currency to battle cryptocurrencies. China has said that its e-CNY has been tested in 70 million transactions.
- **About private virtual currencies** - They are not commodities or claims on commodities as they have no intrinsic value. They do not represent any person's debt or liabilities. There is no issuer and they are not regulated.

Need for a CBDC

- **Reduce settlement risk** - The payments using CBDCs are final and thus reduce interbank settlement risk in the financial system.
- **Globalization of payment systems** - CBDCs would also potentially enable a more real-time and cost-effective globalization of payment systems.
    - For example, it is conceivable for an Indian importer to pay its American exporter on a real time basis in digital Dollars, without the need of an intermediary. This transaction would be final, as if cash dollars are handed over, and would not even require that the US Federal Reserve system is open for settlement. Time zone difference would no longer matter in currency settlements.
- **Reduce dependency on cash**- India's high currency to GDP ratio holds out another benefit of CBDCs. To the extent large cash usage can be replaced by CBDCs, the cost of printing, transporting, storing and distributing currency can be reduced.
- **Higher seigniorage due to lower transaction costs -** Seigniorage is the return generated by a Central Bank for printing cash money (coins and notes) at cost of the physical bank note, precious metal and printing press and the sale at face value of such cash money to commercial banks. Removing the cash printing component to the benefit of digital currency would neutralize that return.
- **Protect public from private virtual currencies (VC)** -Developing CBDC could provide the public with uses that any private VC can provide and to that extent might retain public preference for the Rupee.
    - It could also protect the public from the abnormal level of volatility some of these VCs experience.
- **Unconventional monetary policy tool** - The extremely low inflationary environment in many advanced economies has constrained their ability to reduce interest rates as negative interest rates are not effective because of the shift to cash. However, monetary transmission of negative policy rates to boost demand would be more effective if currency itself can carry a negative interest rate. Hence the argument in favour of payment of negative interest rate on CBDC as an unconventional monetary policy tool to boost spending.