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THE MERITS OF AN RBI DIGITAL CURRENCY OUTWEIGH RISKS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Our central bank has flagged the risks of data vulnerability and bank disintermediation, among others, should it launch a digital currency of its own, as many other central banks are planning

Reserve Bank of India (RBI) deputy governor T. Rabi Sankar recently spoke on the possibility of a central bank digital currency (CBDC) for India. Significantly, he suggested that a phased implementation of a general-purpose CBDC is already on the cards. He also emphasized stakeholder consultations in the roll-out of an Indian CBDC. This calls for more informed debates.

Sankar's speech, in fact, opens a window to the central bank's thinking. He listed the benefits of a CBDC, including the efficiency of issuance for countries where cash usage is high, and enabling an alternative mode of digital transactions in countries with low demand for cash. CBDCs remove risks associated with interbank settlements and provide a safer option compared to private virtual currencies. Suggesting that these benefits are also relevant for India, he added that shifting from paper currency to a digital form will also save costs.

CBDCs also come with risks and challenges. The deputy governor rightly discusses the risks of disintermediation of the banking sector and the possibility of bank runs in the event CBDCs prove to be more attractive than bank deposits. A move away from bank deposits, leaving banks with liquidity constraints, would require more interventions by the central bank by way of liquidity provisions. Finally, he opines that given the digital nature of CBDCs, cybersecurity would be another major concern.

Arguably, the adoption of a CBDC needs to be assessed in the context of a country's larger objectives. India is already a global leader in digital payment systems. Having successfully established the Universal Payments Interface (UPI), we are now moving towards a private consortium-led payments mechanism called the New Umbrella Entities (NUE). Given the vibrancy of digital payment systems in India, it is worth asking whether a CBDC is at all needed for our development goals.

Interestingly, justifications for an Indian CBDC come from outside our domestic context. First, becoming more globalized in terms of international trade and investment are critical to India's national interests. With more than 50 countries looking into the possibility of introducing their own CBDCs, the future of globalization is CBDC-based. The current international payments system based on SWIFT is costly—in terms of both time and money—and it is a matter of time before international trade, investment and even remittances look to shift to multi-country CBDC networks. In order to remain globally competitive under these circumstances, India will need to have a CBDC.

Second, the possibility of CBDCs of other countries becoming international currencies is a real concern. This may lead to substantial domestic demand for these currencies in India, resulting in possible dollarization-like scenarios. Given India's recent conflicts with China, the rise of a cross-border digital yuan could also present issues of data security, as digital currencies might provide their issuer with detailed information of transactions. The best way to deal with this is to establish global protocols on the cross-border use of CBDCs. In order to have a say in these international settlements, it will be very useful for India to have a credible and working CBDC.

An Indian CBDC can also help domestic digitalization. While the current UPI-based digitalization drive has been highly successful, it does not preclude the persistence of a digital divide. Current efforts at financial inclusion have entailed very limited participation by private-sector banks, with the bulk of the burden being placed on public sector banks at considerable loss to them. Since the for-profit NUE mechanism is also bank-account-based, it might strengthen the divide. This will make inclusive digitalization a challenging project. Here, CBDCs may provide an alternative to the NUE by working outside the banking sector, through the postal system, for example.

While the arguments for an Indian CBDC are compelling, the challenges are not trivial either. Sankar has correctly pointed out the liquidity problems that banks may face with this new institutional mechanism. This is compounded by the potential solvency problem of banks, manifested in high non-performing assets. While these are two distinct problems, it is well known that illiquidity and insolvency reinforce each other. This means that RBI and the government—particularly given the preponderance of the public sector in Indian banking—may need to provide much larger support than in other countries.

Further, while CBDCs are expected to provide a safer alternative to private virtual currencies, it is still unclear how this will be achieved. Would such private currencies be prohibited, or would the CBDC coexist as a competitor to them? A prohibition may prove difficult to enforce, especially given their decentralized and borderless structure. It may even be counterproductive, as has been argued by some commentators,if they shift transactions beyond the scope of regulatory supervision and scrutiny.

To put it in perspective, the adoption of CBDCs is the only economic development that is happening at a global scale without any historical precedent to fall back on. Clearly, it is very important that every aspect of this development is scrutinized before implementation. India’s central bank has set the ball rolling. It is up to the rest of us to take up this challenge.

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