Source : www.thehindu.com Date : 2020-05-23

NOTES ON A DIGITAL CURRENCY PLAN, MADE IN CHINA

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

While the world is grappling with the fallout of COVID-19 and speculating on how far China can be blamed for the pandemic, a silent digital revolution is taking place in China. On April 29, 2020, the People's Bank of China (PBoC), the country's central bank, issued a cryptic press release to the general effect: "In order to implement the FinTech Development Plan (2019-2021), the People's Bank of China has explored approaches to designing an inclusive, prudent and flexible trial-and-error mechanism. In December 2019, a pilot programme was launched in Beijing. To intensively advance the trial work of fintech innovation regulation, the PBoC supports the expansion of the pilot program to cover the cities of Shanghai, Chongqing, Shenzhen, Hangzhou, Suzhou, as well as Xiong'an New Area of Hebei, by guiding licensed financial institutions and tech companies to apply for an innovation test."

This expansion of the pilot marks the initiation of China's central bank digital currency (CBDC). Christened Digital Currency Electronic Payment (DCEP), available via a mobile wallet app, pegged 1:1 with fiat currency, and designed to replace M0 (comprising currency issued by the PBoC less the amount held by banking institutions), this is the first such serious initiative in the whole world.

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Historically, monetary authorities everywhere have been sceptical of cryptocurrencies. Wild fluctuations in the value of cryptocurrencies, the implied challenge to the monopoly of central banks in issuing fiat currencies, the looming possibility of software bugs, the tainted shadow of the dark web have all been responsible for the unwelcome reception. In contrast, authorities were far more intrigued by CBDCs. In fact, the Basel-based Bank for International Settlement (BIS) has been conducting surveys on this issue for some time. The recent survey of 2019 ("Proceeding with Caution – a Survey on Central Bank Digital Currency", BIS Papers No 101, January 2019) revealed that while in general, central banks have been proceeding cautiously towards introducing central banks digital currencies, some have been planning to issue a fiat digital currency in the short to medium term. In particular, the survey revealed that nearly 25% of central banks have the required authority to issue a CBDC, while a third do not, and 40% remain unsure.

Chinese investors, however, were always enamoured of cryptocurrencies. With the bearish turn in the Chinese stock market in 2015-16, bitcoins became increasingly popular as an alternative asset class in China. As in media reports, in the recent past, China has emerged as the capital of the crypto ecosystem, accounting for nearly 90% of trading volumes and hosting two-thirds of bitcoin mining operations. The PBoC tried hard to curtail this exuberance but achieved limited success. According to the *China Daily*, by the end of 2017, the Chinese Cabinet approved the PBoC's own digital currency development programme, conducted jointly with qualified commercial banks and institutions. The recent move to introduce the CBDC in China is a logical outcome of the efforts to curb and tackle its runaway cryptomarket practices. Or, the philosophy of the PBoC could simply have been, if you cannot beat them, join them.

At a practical level, the benefits of CBDC are manifold. First, paper money comes with high handling charges and eats up 1% to 2% of GDP. Second, by acting as a powerful antidote for tax evasion, money laundering and terror financing, CBDCs can materially boost tax revenues while also improving financial compliance and national security. Third, as a tool of financial inclusion, particularly in emergencies, direct benefit transfers can be instantly delivered by state authorities deep into rural areas, directly into the mobile wallets of citizens who need them. On this count, it is noteworthy that the U.S. Congress recently debated the merits of implementing digital dollars in the context of the COVID-19 stimulus bill. Fourth, CBDCs can provide central banks an uncluttered view and powerful insights into purchasing patterns at the citizen scale. In the long run, it is believed that CBDCs will make cross-border payments fast and frictionless. That said, all these salutary benefits come packaged with a deep and abiding concern about the relentless rise of a surveillance state and the concomitant erosion in citizen privacy and anonymity. If face-recognition technology enables states to spy on the physical movement of citizens, will CBDCs be used to spy on every movement of their money?

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What is the design of DCEP, the Chinese CBDC? An earlier research paper by PBoC Deputy Governor Fan Yifei favoured a two-tier CBDC model where instead of directly interacting with the public, the central bank would involve financial intermediaries such as commercial banks. In tier 1, the central bank would interface with financial intermediaries. In tier 2, the financial intermediaries would interface with the general public. Such a model is accretive in that it preserves the power of existing financial systems and extends their influence further. It is believed that the DCEP uses a DLT architecture (with central controls) which preserves the primacy of the monetary authority, unlike private cryptocurrencies such as Bitcoin (BTC) and Ethereum (ETH) that are truly decentralised.

What may China be signalling with the launch of DCEP? It is possible that China has decided to use DCEP as its silver bullet to slay three dragons. First, on the world economic stage, it may want DCEP to challenge the hegemony of the U.S. dollar as the default global reserve currency. Second, in its war with American BigTech, it may want to showcase DCEP as its weapon of choice to counter FB or Facebook's Libra, which is planning to offer a common cryptocurrency to 2 billion-plus FB users across the world. Third, and still in the realm of speculation, it may wish to use the DCEP to clip the wings of AliPay and WeChatPay, gigantic fintech duopolies that control 90% of the China's domestic digital payments, and whose ambitions may one day pose a threat to the aura and authority of the central bank.

From gold to silver to paper to digital, the march of currencies goes on. China has rolled the dice on central bank digital currencies, challenging other nations to follow. Welcome to the future of money.

Partha Ray is Professor of Economics at the Indian Institute of Management Calcutta. Santanu Paul is Co-founder and CEO of TalentSprint, an edtech company

To reassure Indian Muslims, the PM needs to state that the govt. will not conduct an exercise like NRC

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