Digital Currency – Understanding the Risks

Expert opinion

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In an interview with Ankur Malhotra, Director at Mazars in India, Mr. Rahul Singhal (CA) touches upon the importance of understanding the risks of using digital currency and how that can prevent circumstances leading to the failure of our financial services.

Interviewer:
Ankur Malhotra
Director, Mazars in India

Interviewee:
Rahul Singhal
Subject Matter Expert

What is your opinion of India's leap into a national digital currency?

India has taken yet another bold step toward making its economy stronger. The Reserve Bank of India, the country's apex bank, launched the retail version of its Central Bank Digital Currency (CBDC) called e ₹-R late last year. Starting December 1, 2022, select customers and merchants in four cities – Mumbai, New Delhi, Bengaluru and Bhubaneswar – were given access to this innovative currency solution. Available through digital wallets on mobile phones, the revolutionary step will make transactions faster, easier, and more secure than ever before.

The motives behind this leap range from broadening financial inclusion (giving even those without a bank account easy access to a free digital payment system) to increasing the efficiency and stability of payment systems by creating a public payment option as a backstop (the role now played by cash).

While the implementation will continue to test the fundamentals of our digital prowess across the underserved population of the country, it is a measure that has broadened the scope of financial evolution. The move will bring in transparency, efficiency and convenience to financial transactions in India. However, the success report on the implementation is yet to come.

What are some of the core benefits of having a digital currency?

A CBDC has potential benefits. It would check illegal activities that rely on anonymous cash transactions. It would bring more economic activity out of the shadows and into the formal economy, making it harder to evade taxes. The above is possible because of the digital trail that is present in the digital eco-system.

Due to this anonymity gap, most central banks and observers also note that it is highly unlikely that any CBDC can meet the levels of privacy currently available with physical cash. However, an intermediate degree of privacy may be thought of and can also be possible. For example, the European Central Bank (2019) has experimented with the concept of a CBDC with elements of programmable money, by which individuals could be allotted a certain amount of 'anonymity vouchers' that could be used for small transactions, with larger transactions still visible to financial intermediaries and the authorities.

Another potential benefit of CBDC would be in case of small businesses that would benefit from lower transaction costs and avoid the hassles and risks of handling cash. The above can be seen from the increased use of the UPI system. As per reports from the NPCI, in the calendar year 2022, UPI processed over 74 billion transactions worth Rs 125.94 trillion. In 2021, the platform processed over 38 billion transactions worth Rs 71.54 trillion. With the introduction of CBDC, these digital transactions can leap to newer heights.

What could be the risks?

Digital currency will replace both cash and traditional payment systems managed by regulated financial institutions, including those by public and private banks. A payment infrastructure in the hands of the private sector might be efficient and cheap, but some parts of it could freeze up in the event of a loss of confidence during a period of financial turmoil. Take the example of Punjab and Maharashtra Cooperative Bank (PMC). As a result of the scam perpetrated by PMC by presenting false financial reports and alleged collusion with the corporates, the RBI imposed withdrawal restrictions, resulting in chaos and loss of faith of depositors in the banking system.

In this case, the scenario of households deciding to move their money out of regular bank accounts and into bank digital wallets, perceiving them as safer, could have some challenging ramifications. Banks need cash to distribute credit. It also keeps the economy stable. If commercial banks are starved of deposits, a public sector bank could find itself in the undesirable position of allocating credit to various sectors.

In addition, there will always be a difference between the way a public sector bank will operate and the innovation a private sector bank will bring in. It has been observed that private sector banks are making digital payments cheaper and quicker – an area where public sector banks are progressing slowly when compared to private sector banks.

The impact of that innovation can be seen in the recent performance of smaller Indian private banks. From 2020 to 2021, the aggregate market penetration of India's "other" private sector banks (all private banks excluding HDFC Bank, Axis Bank and ICICI Bank) climbed from 3% to 5% in overall corporate banking, where firms cite a "lead" relationship—a milestone.[1]
In terms of the established players, HDFC Bank's next-gen customer-first internet banking architecture will be run and managed on the Backbase Engagement Banking Platform. The digital banking platform meets Indian money transfer regulations, via seamless integrations with Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT), Immediate Payment Service (IMPS), and UPI Payments, and encompasses enhanced, configurable local security features on par with local industry standards.[2]

Of equal concern is the potential loss of privacy. Even with protections in place to ensure confidentiality, the central bank needs to keep a verifiable record of transactions to ensure that its digital currency is used only for legitimate purposes, in order to attain the benefits of CBDC as discussed above.

A carefully designed CBDC, taking advantage of fast-developing technical innovations, can mitigate many of these risks. Still, for all its benefits, the prospect of eventually displacing cash with a CBDC ought not to be taken lightly.

In your view, can a digital payment ecosystem undermine the role of a central bank?

New technologies can make it harder for a central bank to carry out its key functions, namely, to keep unemployment and inflation low by manipulating interest rates. When a central bank changes its key interest rate, it affects interest rates on commercial bank deposits and loans in a way that is reasonably well understood. But if the creation of digital lending platforms diminishes the role of commercial banks in mediating between savers and borrowers, it's unclear how or whether this monetary policy transmission mechanism will continue to function. Regulations need to cover the fact that a majority of the population needs to have easy access to banking services. Only policy makers have all the answers -- something we should wait for.

1.https://www.greenwich.com/commercial-banking/digital-prowess-and-regulatory-tailwinds-fuel-rise-private-banks-india
2. https://www.taiwannews.com.tw/en/news/4837299

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