

DIGITAL REVOLUTION IN FINANCE: A COMPREHENSIVE ANALYSIS OF CENTRAL BANK DIGITAL CURRENCY IMPLEMENTATION

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Abstract

In recent years, central bank digital currency (CBDC) has garnered significant attention, raising the prospect of widespread adoption in payment transactions. Global public authorities and central banks are closely monitoring these developments, analyzing their potential impacts on the economy, financial systems, and central banking. This study delves into the overview of CBDC and discusses the opportunities and challenges associated with its implementation. It sheds light on strategies for facilitating the issuance of CBDC, aiming to offer valuable insights for researchers, policymakers, and practitioners seeking a deeper understanding of CBDC.

Keywords: Digital Currency, Reserve bank of India, literature review, CBDC, Financial services

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1. INTRODUCTION

Advancement of science and technology signifies notable shift in societal dynamics. From inception of Bitcoin, blockchain has witnessed swift progress. Essentially, blockchain operates as a collaborative database, ensuring that the information or data saved within it is resistant to forgery, transparent, traceable, open, and collectively maintained (Priyadarshini and Kar, 2021; Garg and Kumar, 2023). These distinctive characteristics establish a robust foundation of trust and facilitate the creation of a reliable cooperative mechanism. Furthermore, blockchain technology presents extensive prospects for development. It forms the basis for the gradual research and development of CBDC, especially against backdrop of dynamic changes in global political and economic landscapes (Torre and Xu, 2023). The intensifying competition in international monetary arenas, coupled with the rapid evolution of Fintech and the increasing adoption of digital currencies

like Bitcoin, has led to the growing maturity of distributed ledger technology (Padhi, 2022). In numerous nations, the use of physical currency is diminishing, giving way to the rising popularity of non-cash payments. Consequently, to address developmental requirements of certain countries that are still developing or navigate international economic sanctions, issuance of CBDCs has become a prominent agenda or implementation for many nations (Ozili, 2023).

Around the globe, individual countries are actively exploring proposals and evaluating the potential consequences of introducing CBDC. CBDC portray digital counterparts to fiat currencies issued by central banks in contemporary economies, serving as a mechanism of digital payment denominated in the national unit of account and constituting central bank's direct liability (Fung, B. S. and Halaburda, 2016). Despite the established reputation of novel technologies such as Distributed Ledger Technology (DLT) and the existence of issued currencies such as stablecoins and cryptocurrencies, there is a growing interest in central bank-issued and backed digital currencies designed for day to day transactions (Lee et al., 2021). This surge in interest is driven by considerations regarding the safety and decentralized nature of these currencies, contributing to a notably volatile environment for cryptocurrencies. However, the increased adoption of such forms of digital currency has prompted central banks worldwide to address this demand, particularly given the growing preference for the methods of electronic payment and escalating costs associated with traditional money printing. In light of these developments, this paper aims to contribute to the ongoing discourse on CBDCs globally. It includes an analysis of considerations related to CBDCs and explores the challenges associated with the Indian context.

Thus, this study strives to achieve the following research objectives:

1. To present an overview of Central Bank Digital Currency
2. To understand the opportunities and challenges associated with its implementation in the Indian context.
3. To discuss the strategies for facilitating the issuance of CBDC

2. CBDC: AN OVERVIEW

2.1 Concept of CBDC

CBDC denotes legal tender issued and backed by the Central Bank and represents electronic form of central bank's monetary system, akin to paper money. Backed by the national credit and constituting a debt of the Central Bank, CBDC possesses unlimited legal countervail (Carapella and Flemming. This implies that there are no restrictions on the amount for each transaction, and it must be universally accepted (Engert et al., 2017). The operational framework of CBDC typically follows a two-tier system. Utiliser engage with digital currency system of the bank via terminal equipment. Subsequently, the digital currency system of the central bank generates and issues digital currency while simultaneously recording details of ownership. An authentication system is employed to facilitate secure interactions among central government, commercial banks and users' terminals.

2.2 Types of CBDC

CBDC is categorized into retail CBDC and wholesale CBDC.

2.2.1. Retail CBDC

Retail CBDC, leveraging distributed ledger technology, is notable for being easily accessible, anonymous, and available 24X7. It holds potential for various applications, including interest rate functionalities. Designed to cater to public, retail CBDC not only aids in reducing the costs associated with cash printing but also actively stimulates financial inclusion. This type of CBDC operates as digital counterpart of fiat currency, specifically intended for use by ordinary consumers in their day-to-day financial transactions (Bindseil, 2019). Essentially, retail CBDC relies on distributed ledger technology, functioning as a secure and confidential blockchain network managed by the government. This setup enables transaction tracking while maintaining user anonymity. Furthermore, it serves as a mechanism to regulate the involvement of private entities, thereby mitigating the risk of illicit activities such as money laundering and fraud.

2.2.2. Wholesale CBDC

Wholesale CBDC significantly enhances the efficiency of payment and security resolution processes, addressing challenges related to liquidity and counterparty risks. It serves as a robust solution for financial institutions who maintain reserves with central bank. Given its potential to accelerate momentum and safety of wholesale financial systems, the central banks increasingly view wholesale CBDC as a preferred substitute to existing systems. Typically designed for transactions between central bank and private or public banks within a country, this form of CBDC plays a crucial role in reducing risks associated with liquidity and counterparty credit (Bordo, M. D. and Levin, 2017). In the context of India, the implementation of wholesale CBDC holds the promise of enabling the Reserve Bank of India (RBI) to interface more efficiently with its intermediaries. This, in turn, can contribute to enhancing the current Real-Time Gross Settlement (RTGS) system employed in existing financial infrastructure.

3. OPPORTUNITIES BOUGHT BY CBDC

(i) Possibility of Enhanced Financial Inclusion

The exploration of CBDC is often driven by a key motivation in developing countries – the potential for improved financial inclusion. CBDCs have the capacity to facilitate financial inclusion by extending access to currency among segments of society that are underbanked or unbanked. However, the effectiveness of CBDCs in achieving this goal may be influenced by barriers to financial inclusion, such as the geographical remoteness of certain areas. The impact of these barriers needs thorough evaluation. It's crucial to note that the success of CBDCs in fostering financial inclusion may be constrained in regions with limited access to technology. In such cases, another substitute approaches, such as promoting alternative payment solutions or subsidizing bank branches may provide more effective solutions. The assessment of these factors is essential to determine the feasibility and impact of CBDCs in addressing financial inclusion challenges.

(ii) Enhancing Banks' Efficiency and Capability

The introduction of CBDC has played a pivotal role in elevating the processing efficiency and credit evaluation capabilities of banks. In the current landscape, commercial banks have established a comprehensive customer credit evaluation system and business processing system both centered around big data and transaction-oriented, customer-centric approaches. CBDC issuance contributes to the further coordination of foundational technical architecture of these systems. This, in turn, improves the smooth operation of currency circulation and enhances precision of user credit assessments. Consequently, issuance of CBDC fosters normalization, intensification and standardization of operational management systems within banks, significantly enhancing their business processing efficiency. Moreover, a verification system based on CBDC proves instrumental for government departments. It boosts their capacity to tackle issues such as money laundering, tax evasion, and other illicit activities, underscoring multifaceted benefits of CBDC implementation in the banking sector.

(iii) Facilitating the Comprehensive Execution of Monetary Policies

The CBDC system serves as a crucial tool for achieving automatic and real-time execution of monetary policies. Monetary policies encompass a spectrum of policies, guidelines and steps taken by the central bank to regulate credit quantity and supply of money, with the aim of achieving specific economic goals. These policies, ranging from tight to loose, are tailored to economic development of various periods, ensuring macroeconomic stability. CBDC enables precise tracking of currency movements aligned with monetary policies. This precision allows for accurate regulation at the individual level, ensuring that policy funds are straightaway channeled to target subjects in the market. This approach helps to avoid delays and slowdowns in the effectiveness of monetary policy. Regulators, equipped with real-time, accurate, and direct insights, can better understand the implementation effects and transmission of policies. This ensures comprehensive and timely execution of monetary policies for macroeconomic stability.

(iv) Cross-Border Remittances with CBDC

CBDC offer the potential for expeditious cross-border remittance payments. Collaborative efforts on an international scale involving major economies, including India, could pave the way for establishing the required infrastructure for seamless CBDC transfer and conversion. The critical element of this infrastructure is ensuring CBDC's interoperability across different jurisdictions and facilitating the swift transfer of CBDC for successful transactions. In such a favorable setting, transfers of Central Bank Digital Currency (CBDC) can take place instantly, markedly diminishing the time needed for the payment to reach the designated recipient. The ability to conduct cross-border remittances rapidly with CBDCs holds the promise of enhancing the efficiency and speed of international financial transactions, ultimately benefiting individuals and businesses engaged in cross-border financial activities.

4. CHALLENGES IN ISSUANCE OF CBDC

(i) Requirement for Robust Digital Infrastructure

The issuance of CBDCs necessitates a conducive environment with efficient internet connectivity and speed, secure and affordable electronic devices, and a population with technological literacy and ease of use. This prerequisite poses a potential challenge, particularly in developing countries where digital infrastructure may be relatively underdeveloped. However, it also presents an opportunity contingent on factors such as access to capital and private sector participation to bolster the development of these essential capabilities. In essence, ensuring the success of CBDC implementation requires addressing the existing gaps in digital infrastructure. This not only involves the expansion of internet connectivity but also focuses on creating a secure and affordable ecosystem for electronic devices. Additionally, efforts towards enhancing technological literacy and usability are imperative for the widespread adoption and effective utilization of CBDC, with potential benefits for economic and financial inclusivity.

(ii) Heightened Risk in Payment System

Value of a prospective digital currency is contingent on traders' expectations and recognition, leading to greater volatility and risk compared to traditional currencies. In a "point-to-point" payment and settlement trading mode, where customers engage as the direct traders, they assume associated risks with trading. Differing expectations of public and central bank's recognition of digital currency can have adverse effects on its widespread adoption. This variability may hinder the popularization of the digital currency, particularly among individuals with lower levels of education. Some users may struggle to adapt to operational and literacy skills needed for effective utilization of CBDC, accentuating the challenges associated with its implementation.

(iii) Constructing the Circulation Environment

The establishment of a conducive circulation environment for CBDC poses significant challenges. Commercial banks, responsible for dispensing cash withdrawals via electronic wallets, face the intricate task of integrating dual cores of the digital currency system and the existing accounting system. This undertaking demands sophisticated management and operational systems, entailing substantial time and costs and investments to ameliorate the hardware and software across all the nodes. In addition, commercial banks must establish connections and conduct audits between these dual cores. They are also required to reform or retrofit systems related to deposits, loans, foreign exchange, payment settlement, and intermediary business to align with the evolving demands of digital currency. Simultaneously, to foster CBDC adoption, banks must expand their workforce substantially and invest in specialized equipment. This includes the establishment of a dedicated department for access of digital currency for the public. Business and enterprises, intending to engage with CBDC, must configure corresponding digital currency infrastructure. They need to undertake skills training for employees, offering detailed explanations of digital currency fundamentals to ensure familiarity with currency-related operations. This multifaceted challenge underscores the complexity and resource-intensive nature of transitioning to a digital currency system.

5. STRATEGIES TO FACILITATE THE ISSUANCE OF CBDC

(i) Enhance Governance Mechanisms and Establish Standards, Laws, and Regulations for CBDC

To propel the issuance and circulation of CBDC, the central bank must adopt a multifaceted approach, consolidating resources and leveraging synergies. In the planning stages of CBDC issuance and circulation, the central bank should institute a user-friendly operational framework, ensuring accessibility and convenience. To ensure effective implementation, it is essential for central bank to institute and refine a robust monetary risk monitoring system while delineating regulatory responsibilities comprehensively. This guarantees standardized application of CBDC from its origin. Central bank should meticulously craft contingency plans for potential risks associated with CBDC, enhancing awareness and proficiency in risk prevention. Furthermore, close coordination between commercial banks and central bank, utilizing the two-tier delivery systems, is essential for judiciously allocating market resources.

(ii) Reinforce Data Governance and Establish Transaction and Privacy Protection Mechanisms

Central banks play a crucial role in establishing data trading mechanisms centered around the Conditional Trigger Mechanism for interest payments within CBDC. The CBDC's Conditional Trigger Interest Payment Mechanism, built on a blockchain network, serves as a favourable motivation for the efficient supply of personal sensitive data. This occurs while concurrently reinforcing protection of privacy and rectifying negative externalities associated with supply of data. By doing so, the central bank addresses the two-way uncertainty problem inherent in data pricing and efficiency optimization. To augment anonymity and safeguard private data, the central bank should consider the adoption of currency-denominated accounts. This strategy not only enables the careful use of big data generated by CBDC transactions without jeopardizing personal privacy but also empowers individuals with control over their data governance rights. Adopting account-binding currency CBDC empowers users to select the tokens linked to their accounts, thus establishing the criteria for relevant authorities to access specific data. This approach actively involves the market in governing the microscopic aspects of personal privacy data, offering individuals the autonomy to make informed choices regarding data linkage to their accounts.

(iii) Enhance Global Collaboration and Innovate Regulatory Approaches to Address Future Challenges

It is imperative for government to deepen its commitment to international cooperation, fostering a heightened awareness of active engagement in exploration of digital currencies' international regulatory standards. Government must actively participate in collaborative endeavors to study and formulate international regulatory standards, thereby contributing to the development of a cohesive global framework. Strengthening communication with countries worldwide is paramount, facilitating joint discussions on the technical standards of digital currency. Through proactive participation, government can not only contribute to shaping these standards but also amplify its international influence and voice in the realm of digital currencies.

6. CONCLUSION

The introduction of the CBDC carries significant and insightful implications. In practical implementation of digital currency issuance, central bank must strategically leverage advancements in science and technology. To realize these objectives, the adoption of not only blockchain technology but also insights from, account systems, big data analysis systems, and security authentication and cloud computing is essential. As legal tender, digital currency issuance necessitates adherence to principles that integrate traditional and digital currencies, ensuring consistency in management throughout issuance, circulation, and transactions. Crucially, it must align with the principles of macroeconomic control set by the central bank. The widespread use of CBDC by public as a form of currency will exert a profound influence on various facets, including financial infrastructure, monetary policy and financial markets. This adoption is poised to instigate transformations in areas such as monetary policy formulation, cash management, Financial Technology (Fintech) and financial regulations, ushering in a new era of evolution and adaptation in the financial landscape.

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