



## Spare a thought for the trilemma of central bank digital currencies

Mint

Paper - III  
(Economy)

❖ Central banks may find only two of these: a digital currency, transaction confidentiality and financial stability

Central banks around the world continue to contemplate issuing their own digital currencies (CBDCs). Some have already taken steps in this direction. The People's Bank of China launched a trial of its e-CNY in Shenzhen in 2020 and has extended its use to other cities. The Sveriges Riksbank is testing its e-krona for commercial and retail payments. Even the relatively staid US Federal Reserve Board has issued a paper weighing CBDC pros and cons.

### India and CBDC

One argument is that, by providing digital access to anyone with a cellphone or smart card, a CBDC will extend modern payments technology to the masses. But the experience of countries like India suggests that there are more straightforward ways of achieving this goal. India was able to address its 'unbanked' problem by requiring commercial banks to offer no-frills savings accounts with no minimum-balance requirements. 'The Prime Minister's People's Wealth Scheme' similarly tasks public banks with offering zero-balance, low-cost accounts to underbanked rural residents. As of last year, some 400 million 'people's accounts' had been opened.

### Use of UPI in India

India has also created an efficient, low-cost electronic-payments infrastructure, the United Payments Interface. UPI is a real-time payments system operated by the National Payments Corp, a government-sponsored non-profit. Banks, e-money companies, and tech firms have introduced UPI-enabled mobile-payment apps that allow users to send money between bank accounts. But, while some 300 banks participate in the

### Why is it necessary in India

- India is a leader in digital payments, but cash remains a staple for small value transactions that can be replaced to some extent by CBDCs.
- The currency-to-GDP ratio in India is quite high.
- An official digital currency will reduce the cost of currency management while enabling real-time payments without any inter-bank settlement.
- CBDC or Digital Rupee is planned to be launched in India in the financial year 2022-23.

It is planned to launch it in two versions – Retail Digital Rupee and Wholesale Digital Rupee.

system, the government remains anxious to roll out a CBDC. Perhaps it's motivated by the belief of policymakers that a CBDC will benefit the infotech sector. From the perspective of financial inclusion and ease of payment, however, the unit will be redundant.

### CBDC as International Payments

Cross-border payments are not so cheap or simple. Moreover, governments are increasingly uncomfortable with their dependence on the US dollar as the dominant vehicle for such transactions, given recourse by the US to financial sanctions. The hope is that CBDCs might provide a digital alternative. Strictly speaking, there is no obstacle to exchanging different countries' CBDCs and using them for international payments. Multiple CBDCs can run on a single blockchain. With help from the Bank for International Settlements, central banks have experimented with platforms, known as mBridges, on which CBDCs can be traded.

### The problem with CBDC adoption

Though we possess the technical knowhow, there are formidable political obstacles to widespread adoption of these arrangements. Can you imagine China and the US agreeing on how to govern a platform on which their CBDCs are exchanged? Can you imagine agreement by 120 central banks?

Yet another motivation for the stampede to CBDCs is the inchoate belief that financial and even geopolitical primacy will turn on which central banks are quickest to issue one. This view is encouraged by economic and political tensions between the US and China, and by China's rapid move toward CBDC issuance, which is seen as threatening dollar dominance. But this argument assumes that CBDCs will be used across borders and that they will supplant the international interbank market as the vehicle for international transactions. But, given the political obstacles impeding a common trading platform for different CBDCs, this is unlikely to be the case. Ultimately, central banks face a 'trilemma' when contemplating CBDC issuance. Central banks can have only two of three things: a digital currency, confidentiality of transactions and financial stability.

### Central Bank Digital Currency (CBDC)

- CBDC is a digital form of paper currency and is legal tender issued and backed by a central bank, unlike cryptocurrencies that are not governed by any regulatory body.
- It is identical to fiat currency and is exchangeable one to one with fiat currency.
- Fiat currency is a national currency that is not pegged to the value of a commodity such as gold or silver.
- Digital fiat currency or CBDC can be transacted using a blockchain-enabled wallet.
- Although the concept of CBDCs was directly inspired by bitcoin, it is different from decentralized virtual currencies and crypto assets that are not issued by the state and are not 'legal tender'.
- Its main objectives are risk mitigation and handling of real currency, phasing out of old notes, and reducing costs associated with transportation, insurance and logistics. It will also keep people away from cryptocurrencies as a means of money transfer.
- Globally, the Bahamas is the first economy to launch its nationwide CBDC Sand Dollar. On the other hand, the African country Nigeria has started the name eNaira in the year 2020. While China became the first major economy in the world to operate digital currency e-CNY in April 2020.

## European Central Bank and CBDC

European central banks, when issuing a CBDC, will have to respect the EU General Data Protection Regulation (GDPR), the strictest data privacy law in the world. If they issue digital currencies through authorized intermediaries, their users will enjoy confidentiality. But the authorities will then have limited ability to track transactions using their CBDCs.

People using currency in transactions already enjoy anonymity, of course, but one can imagine other transactions involving bank transfers being executed using CBDCs instead. Central bankers and others worry that commercial banks will be disintermediated. That transactions typically completed by bank transfers will shift to CBDCs. With confidentiality of transactions, this could allow financial risks and imbalances to build up out of sight of regulators. This is why the European Central Bank is wisely moving slowly in the direction of CBDC issuance.

## How will CBDC work in China

The People's Bank of China is not required to offer confidentiality. When downloading a digital wallet capable of unlimited transactions, it requires extensive information from the user. When downloading a limited wallet capable of small retail transactions, it requires only the user's cellphone number, and promises, for what it's worth, not to track his or her transactions.

## Now what next

We shall see. These measures should prevent individuals from using the e-CNY to evade China's capital controls, spirit large amounts of money out of the country, and otherwise act in ways that threaten financial stability. As for whether people will trust China's CBDC, given these conditions, only time will tell.

International finance, as scholars of exchange-economics know, is fraught with trilemmas. Instead of averting them, CBDCs only create another.

### Expected Question

**Que. Consider the following pairs-**

1. Bahamas - Sand Dollar
2. China - e-CNY
3. Nigeria - e-Naira

Which of the above pairs is/are correctly matched?

- (a) 1 and 3 only      (b) 2 only  
(c) 2 and 3 only      (d) 1, 2 and 3 only

**Answer : D**

### Mains Expected Question & Format

**Que.: What is Central Bank Digital Currency (CBDC)? Why is it important for India and the global economy? Explain giving examples of digital currency launched by different countries.**

**Answer Format :**

❖ **Introduction (30-40 words)**

Tell us about the CBDC.

❖ **Main Body (140-160 words)**

Explain why it is important for the global economy with India and tell its advantages and disadvantages.

❖ **Conclusion (30-50 words)**

Explain by giving the names of digital currency introduced by different countries, showing the possibility of India being introduced.

**Note:** - The question of the main examination given for practice is designed keeping in mind the upcoming UPSC mains examination. Therefore, to get an answer to this question, you can take the help of this source as well as other sources related to this topic.