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Digital Rupee | Will commercial banks still be needed for credit creation?

With the digital rupee, the RBI would be able to the increase the effectiveness of monetary policy by directly changing interest rates on deposits and/or lending

SASHI SIVRAMKRISHNA

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The naïve articulation of commercial banks as intermediaries that lend deposits has long been dispelled with. Instead, banks must be understood as creators of credit money. A deposit (money) is created when a bank gives a loan. In other words, loans create deposits. However, a bank must have positive balances in its reserve account at the central bank for interbank settlements. Theoretically speaking, central banks will always provide commercial banks with reserves. It is the price at which these reserves are provided, the repo rate being the benchmark, that central banks control. To further ensure prudential lending norms by commercial banks, additional requirements on capital adequacy and reserve balances are imposed on them by central banks.

The digital rupee, a central bank digital currency (CBDC), would allow individuals and perhaps businesses too to hold CBDC-accounts at the RBI. If so, as discussed in our earlier **article**, private agents may prefer to hold risk-free deposit accounts at the central bank rather than a deposit account at a commercial bank which cannot be absolutely risk-free. How could this affect the commercial bank's role in credit money creation?

Although commercial banks may still be allowed to create credit, without corresponding deposits they would have to rely predominantly on capital in order to have positive reserve balances at the central bank, which are necessary for interbank settlements or settlements between them and the central bank. CBDCs therefore have the potential to reduce commercial banks from creators of credit-money to essentially financial intermediaries that lend their own capital. Their ability to leverage capital would diminish drastically.

It must be understood that commercial banks are strictly regulated within the present monetary system. The power to create credit-money has been devolved to them so that the process is decentralized. Commercial banks can be 'closer' to borrowers, obtaining and accumulating knowledge on the borrower's risk profile. Modern banking since the 19th century has essentially relied on commercial banks to provide credit-money to the economy. Over decades, however, commercial banking itself has become more centralized given the benefits that accrue from economies of scale in larger operations. For instance, in the United States, the assets of five largest banks as a share of total commercial banking assets has increased from less than 30 percent to more than 45 percent in the last two decades. Even in Germany, which has one of the most decentralised banking systems in the world, has seen a gradual in concentration ratios.

As the major creators of money in an economy — in the UK, for instance, commercial bank money (deposits) account for almost 97 percent of M1 — commercial banks effectively control the quantum of credit creation as well as who gets it. To put it tersely, commercial banks significantly influence if not control the nature of growth and development of an economy. Greater concentration further consigns this power in the hands of just a few banks and their leaders. At the same time, concentration at the extreme would mean just one bank — a monopoly — which could essentially be the central bank itself.

A centralized system could mean an impersonalized credit evaluation system. This may well be possible given the growth of fintech wherein risk-profiling of borrowers is available cost-effectively, on a real-time basis. Moreover, if settlements are carried out with digital rupees, the RBI would have granular data on customer spending habits. While this may raise concerns over privacy, the advantage in terms of financial inclusion and access to formal credit by presently underserviced sectors and entities also becomes feasible.

Monetary policy through the setting of interest rates (benchmark repo rate) by the RBI essentially influences the price of credit available from commercial banks. However, the transmission of interest rates to final borrowers and depositors is weak given that commercial banks are driven by profitability rather than the overall condition of the economy. With the digital rupee, the RBI would be able to the increase the effectiveness of monetary policy by directly changing interest rates on deposits and/or lending.

Moreover, if the digital rupee also hastens the transition to a cashless economy, it will give the RBI an additional degree of freedom in implementing negative interest rate policy (NIRP) if and when required.

While it is necessary to wait and see the design and scope of the digital rupee, it is imperative to ponder over the remarks of Mark Carney, former Governor of the Bank of England:

"There will be a change, measured over decades. It is very hard to predict. That which is unsustainable tends to go on for longer than you think and then happen more quickly than you expect, to paraphrase Rudi Dornbusch, but these structural flaws, in the end, in the system will ultimately result in a change."

Sashi Sivramkrishna studies macroeconomics from a Modern Money Theory (MMT) perspective.

Views are personal and do not represent the stand of this publication.

SASHI SIVRAMKRISHNA *is an economist, economic and environmental historian, and documentary filmmaker. Twitter: @Sashi31363.*