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Digital Rupee | Will people still deposit money in commercial banks?

While the consequences of CBDCs on cryptocurrencies like Bitcoin and Ethereum are attracting widespread attention, it is the possible repercussions of CBDCs on the commercial banking system that could be far more disruptive

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In Budget 2022, the Union government introduced Central Bank Digital Currency (CBDC) which will give a big boost to digital economy. It is proposed to introduce Digital Rupee based on blockchain and other technologies, and will be issue by the Reserve Bank of India starting this year.

FM **Nirmala Sitharaman** in her Budget speech on February 1 announced the launch of a digital rupee in 2022-23. The digital rupee — more generally referred to as Central Bank Digital Currency (CBDC) — will be issued by the Reserve Bank of India (RBI).

China was the first country to launch its own CBDC called the Digital Currency Electronic Payment (DCEP). The soft launch of the digital yuan, eCNY, took place in August 2020. By the end of October 2021, some 140 million people had opened eCNY accounts at the People's Bank of China and transactions amounting to $ 5.4 billion had been settled using digital currency.

More recently, in October 2021, the Central Bank of Nigeria launched the eNAIRA, complemented by an official mobile wallet app. While many other countries are expected to announce their CBDCs soon, India is all set for its own launch this financial year.

In any modern economy, obligations that arise in market exchanges between entities are settled using either the financial liabilities of the state (currency or cash issued by a country's central bank) and/or the financial liabilities of commercial banks (deposit accounts – current or savings). The general acceptability of cash and deposit accounts in settlement of claims arises from their being legal tender or in other words, financial liabilities that are accepted (and nothing else) as final settlement owed to the state including taxes, fines and penalties.

Settlements between private agents and to the state must be effected across space, quickly, at minimal costs and for transactions ranging from very small to very large values. This has become possible with digital payments like UPI, IMPS, NEFT and RTGS wherein deposits at commercial banks can be transferred between economic agents instantaneously. However, interbank settlements using reserve accounts at (that are financial liabilities of) the central bank are still required.

CBDCs could potentially disrupt the commercial banking system as we know it by making it possible for settlements to take place using digital currency (cash in an electronic form), which are the financial liabilities of the state, i.e., the central bank itself.

The impact on commercial banks as the main intermediaries in payments settlement depends on the proposed design of digital rupee system. Will individuals and businesses be allowed to open accounts directly at the RBI?

Presently, the monetary system allows only commercial banks but not individuals and businesses to have accounts at the RBI. Deposits at commercial banks are not risk-free. A commercial bank's net worth can turn negative with increasing non-performing assets (NPAs), or in other words, a bank can go bankrupt. Deposit insurance provides cover only up to Rs. 5 lakh. In contrast, a deposit account at the central bank would be risk-free.

Could the opportunity to open accounts at the RBI then potentially cause bank runs when people move their deposits from commercial banks to their CBDC-accounts at the RBI?

This will depend on whether the RBI enforces a cap on the amount that can be held in or other restrictions on CBDC accounts.

There are strong advocates of CBDCs who argue that commercial banks and associated card companies extract large rents given that private agents are almost entirely dependent on them at present for settlements. Payments settlement using CBDCs also raises issues related to data privacy and concerns over the state monitoring transactions of its citizens. Once again, proponents of CBDCs argue that even currently, surveillance is possible: state agencies can access data from banks upon request. At the same time, it is important to realize that CBDCs could actually ensure higher standards of data protection given that information is currently being exploited for profits by private players.

Nonetheless, there are calls by these proponents for some form of anonymous CBDCs, at least for small value transactions that would replicate the anonymity afforded by physical cash.

While the consequences of CBDCs on cryptocurrencies like Bitcoin and Ethereum is attracting widespread attention, it is the possible repercussions of CBDCs on the commercial banking system that could be far more disruptive.

Moreover, as we discuss in part two of this article (due tomorrow), CBDCs could not only unsettle the deposit-taking of commercial banks but also dissipate their role in credit-creation.

What seems like the introduction of a simple service by the central bank may well transform the deposit and payments settlement system and the role of commercial banks as we know it.

In response to a query on this issue, Mark Carney, former Governor of the Bank of England, said, "Banks are a means to an end, not ends in themselves, and they will have to adapt to a much more competitive environment."

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

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