

NEWSLETTER

CORPORATE FINANCE MANAGEMENT FACULTY

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Central Bank Digital Currencies & Monetary System

INTRODUCTION

In the last decade, there has been a series of discussions around the concept of Central Bank Digital Currency (CBDC) by Economists, Governments and Central Banks. Over a hundred countries are exploring CBDCs at one level or another. Some research, some testing, and a few are already distributing CBDC to the public. In the Bahamas, the Sand Dollar, the world's most advanced official digital currency, has been in circulation for more than a year. Sweden's Riksbank has piloted the first and second phases of the e-Krona, which tested the technological basis of the currency, its integration with existing point-of-sale terminals with the internal systems of commercial banks and explored legal as well as ethical issues. In China, the people's Bank of China has been working on the digital renminbi (called e-CNY) since 2014 and is ramping up efforts to roll it out. The Federal Reserve has also recently issued a report on CBDC. In Africa, Nigeria became the first country to launch its own digital currency: e-Naira with Ghana following suit with e-Cedis. This article intends to look at what the CBDC is, the reasons why countries are keying into it and its likely effect on the monetary system.

WHAT IS CENTRAL BANK DIGITAL CURRENCY?

A CBDC is a country's fiat currency available exclusively in electronic form, which has the endorsement of the Federal government and serves as a legal tender. Though the CBDC share some similarities with cryptocurrency like Bitcoin, which is digital money in token format, supported by blockchain technology, the CBDC is not Bitcoin. Unlike other cryptocurrencies, the CBDC enjoys the support and backing of the Central Bank of the issuing country. The dynamics of the CBDC are centralized and controlled by the government, while other cryptocurrencies are fully decentralized and rely on adoption dynamics by users. CBDC will enable people and businesses to have bank accounts directly with the Central Bank through digital wallets. This is unlike the existing system where only banks can open accounts directly with the Central Bank.



TYPES OF CENTRAL BANK DIGITAL CURRENCY



CBDC CAN EITHER BE WHOLESALE OR RETAIL

Wholesale CBDCs are for use by regulated financial institutions that hold reserve deposits with a central bank. They build on the current two-tier structure, which places the central bank at the foundation of the payment system while assigning customer-facing activities to Payment Service Providers (PSPs). The central bank grants account to commercial banks and other PSPs, and domestic payments are settled on the central bank's balance sheet. Wholesale CBDCs are intended for the settlement of interbank transfers and related wholesale transactions, for example, to settle payments between financial institutions. The wholesale CBDC is seen as the most popular proposal among central banks because of the potential to make existing wholesale financial systems faster, inexpensive, and safer.

Retail CBDCs modify the conventional two-tier monetary system in that they make central bank digital money available to the general public, just as cash is available to the general public as a direct claim on the central bank. One attribute of retail CBDCs is that they do not entail any credit risk for payment system participants, as they are a direct claim on the central bank. Retail CBDCs come in two variants. One option makes for a cash-like design, allowing for so-called token-based access and anonymity in payments. This option would give individual users access to the CBDC based on a password-like digital signature using private-public key cryptography, without requiring personal identification. The other approach is built on verifying users' identity ("account-based access") and would be rooted in a digital identity scheme.

WHY ARE CENTRAL BANKS GOING FOR DIGITAL CURRENCIES?



The increasing pressure on the Central Banks at the fast-growing trend

of other digital currencies particularly bitcoin and the kind of disruptive effect they may have on the financial system is one major reason why most Central Banks are developing their virtual currencies. The need to facilitate financial inclusion is also a key driver of CBDC programmes which helps to bridge the gap with the unbanked. The declining trend of using physical cash to transact business, especially with the emergence of the COVID pandemic, has resulted in many Central Banks rolling their sleeves and familiarizing themselves with the nitty-gritty of the digital currency. This is to enable them to tap into the benefits of virtual currency as well as promote electronic transactions.

THE CENTRAL BANK DIGITAL CURRENCY AND THE MONETARY SYSTEM

A Monetary System is defined as a set of policies, frameworks, and institutions by which the government creates money and control the exchange of money in an economy. The National Treasury, the Central Banks and commercial banks are part of the institutions that make up the monetary system. The three types of monetary systems are the commodity, commodity-backed monetary system and Fiat money.

Money and its institutional foundations have evolved alongside the technology available. Many recent payment innovations have built on improvements to underlying infrastructures that have been many years in the making. From Real Time Gross Settlement (RTGS) to retail Fast Payment Systems (FPS) which allow instant settlement of payments between households and businesses around the clock, the financial system has evolved and still evolving. Presently, the CBDC will play a very important role in further shaping the monetary system by promoting efficiency, convenience and safety of the payment system.

A well designed CBDC can address the issues around financial inclusion by offering the unbanked alternative pathways to open transactional accounts and participate in the digital economy, particularly those who might otherwise fail to meet banking requirements. This financial access can in turn help drive down poverty and increase economic growth.

Cross border payments which are usually time-consuming and costly are likely to be enhanced with well thought out CBDCs strategies. This should take into cognisance interoperability between separate CBDC systems, where central banks work together to link domestic CBDCs to ensure fast, secure and efficient cross-border payments.

CBDCs can help deliver public goods and improve government service delivery, including, for instance, government-to-citizen payments, such as social welfare disbursements and loan and subsidy programs for smallholder farmers or small-medium sized enterprises.

An interest-bearing CBDC as a store of value can have a rate of return in line with risk-free assets such as short-term government securities. The CBDC interest rate would serve as the main tool for conducting monetary policy.

The introduction and widespread use of CBDC can discourage tax evasion, money laundering, and other illegal activities that are made easier by paper currency, especially, large-denomination bills.

CONCLUSION

There is no doubt that a well-designed CBDC aside from improving settlement finality, liquidity, and integrity in financial services, will also improve the monetary system by providing new tools for controlling money supply, financial inclusion, and regulatory compliance. To this end, in order not to lose monetary control, it is very expedient for stakeholders especially the Central banks to ensure that the implementation and use of the CBDC are built on trust like any other monetary system tool.

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