



राष्ट्रीय अकादमी सीमा शुल्क, अप्रत्यक्ष कर एवं नारकोटिक्स

आंचलिक परिसर, कानपुर

NATIONAL ACADEMY

OF

CUSTOMS, INDIRECT TAXES & NARCOTICS.

ZONAL CAMPUS, KANPUR



Release Date : 03.02.2022

Dispatch : 02/2022

DIGITAL CURRENCY- Concept Paper

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- Hon'ble Finance Minister, Government of India in her Budget Speech for FY 2022-23, announced the introduction of 'Digital Rupee'. She announced that:

"Introduction of Central Bank Digital Currency (CBDC) will give a big boost to digital economy. Digital currency will also lead to a more efficient and cheaper currency management system. It is, therefore, proposed to introduce Digital Rupee, using blockchain and other technologies, to be issued by the Reserve Bank of India starting 2022-23."

- Generally, we come across two forms of central bank money, namely physical cash and reserve/settlement accounts. The physical Cash is the cash we withdraw from ATMs. The Reserve/Settlement accounts are digital in form but are accessible only to select financial institutions like banks. There is also another form of money which is digital money created by the banking system, but this is however not central bank money. Distinct to these money forms, the CBDC has been defined as 'a digital form of central bank money that is different from balances in traditional reserve or settlement accounts' by The Bank for International Settlements (BIS). The RBI defines CBDCs as 'a legal tender and a central bank liability in digital form denominated in sovereign currency and appearing on central bank balance sheet'; CBDCs are a form of electronic currency that are exchangeable at par with similarly denominated cash and traditional central bank deposits. There may different types of CBDCs viz., a token based 'general purpose' CBDC that is available primarily for retail transactions but may also be available for broader use, a token based 'wholesale' CBDC whose availability is restricted and used for wholesale payment and settlement transactions and/or an account based 'general purpose' CBDC that is widely accessible. The current two-tier architecture of monetary and payments system allows private sector entities to issue the currency or payment instruments like coins which represent their liabilities and then, back the same with central bank reserves. This system of two tier architecture may be replicated by introduction of the synthetic CBDC, or sCBDC. However, European and Federal Bank define CBDCs strictly as a digital payment instrument, denominated in the national unit of account, that is a direct liability of the central bank and reject the sCBDCs.
- Central Bank Digital Currencies (CBDCs), have become an important part of the discussion on digitalisation of economies around the world. In past few years, there has been massive change in system of payments made during a transaction. The world is at juncture where the evolution of money from cowries to precious metals to paper currency has to take next turn and the digital representations of fiat currencies is on anvil. Central Banks across the world are examining the feasibility of introducing CBDCs. In October 2020, The Bahamas became the first country in the world to

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issue a central bank digital currency – the “Sand Dollar” - for retail use. In April 2021, the Eastern Caribbean Currency Union issued the block-chain based digital version of the Eastern Caribbean Dollar DCash. Sweden and China are undertaking pilots of digital versions of their sovereign currency. India has been examining the issue as well; the Interministerial Committee in its report submitted to Central Government had recommended to keep an open mind towards introduction of Indian CBDC.

- Theoretically, the Digital Rupee may be designed as a ‘Direct CBDC’, where the central bank is entirely in charge, from issuance to maintenance of ledger and compliance with laws, a ‘Hybrid CBDC’, where the CBDC represents a direct claim on the central bank, like cash, and the private sector would continue to focus on offering customer facing services such as on-boarding, KYC, execution of payments etc. The central bank would retain a copy of all retail CBDC holdings and also have both the technical and legal ability to transfer customers from one payment service provider (PSP) to another in cases of insolvency or other failures or an ‘Intermediated CBDC’, which is a nuanced version of the hybrid model where the central bank would not have any access to the retail ledger, which would be fully retained by the private sector.
- As the issue of CBDC is little international precedence and finality in terms of structure and technology is ever evolving and more in domain of theory rather than practice, India will have to design de novo and depend on the technological prowess of the country.
- Following positive outcomes may be expected from the use of CBDC:
 - ✓ Cryptocurrencies and stable coins, have become much more pervasive than ever but lack the backing of sovereign agency and thus remain vulnerable to risks. RBI could retain monetary sovereignty against the rise of private digital currencies by introducing risk-free CBDCs backed by them as legal tender.
 - ✓ National CBDC ie ‘Digital Rupee’ is expected to prevent Digital Dollarization by other country CBDCs. If Indian CBDC is not introduced and Indian citizen transact with foreign Interest bearing CBDCs which function both as cash and as financial assets like bonds and securities may pose risk of significant international spill-over effects if permitted. This may not only restrict the ability of India to independently set its domestic monetary policy, but given the data embedded in CBDCs, could also be a data security risk. Having a national CBDC as an alternative to these other currencies is therefore a necessary strategy.
 - ✓ Many private players specially mobile payment systems are offering alternate payment services and they have become dominant among the public because passing of incentives to public by these players.

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These entities have also combined several other financial services with their social media apps. However, they pose risks – of monopolies, high entry barriers, potential misuse of data, safety and security of technology and may not offer interoperable services, leading to fragmentation of markets, increased costs and complexities, ultimately impacting the consumer. CBDC may address these concerns by ensuring continued retail access to central bank money. It may replace cash as a competitor to these private payments systems.

- ✓ CBDCs may potentially lower transaction costs for cross border payments which at present suffer from several market failures viz., of lack of speed, costs and opacity.
 - ✓ CBDCs provide the option of ascribing interest rates to the currency itself which is not possible for cash. Interest-bearing retail CBDCs issued directly to households potentially raises central bank's ability to improve and control monetary policy transmission.
 - ✓ CBDCs may facilitate more efficient and safe payment systems, financial inclusion, foster innovation and competition, and improve financial integrity by enhancing visibility and tracking of transactions, and reduce illegal activities such as money laundering. It may enable direct, timely and targeted transfers of aid or stimulus packages to the public or firms in times of crisis.
- The Digital Rupee is set to be launched in FY 2022-23. Following challenges may be overcome during this new journey of money in India:
 - ✓ Direct access to central bank liabilities for households and businesses may lead to enlarged role of central bank. Central banks would need to rapidly build newer capabilities even in a with 'Hybrid/Intermediated/Synthetic CBDC' model.
 - ✓ Design features of CBDC would need to take into account various demographics including levels of technological literacy and ease of use to avoid 'digital divide'. A supportive environment in terms of efficient internet connectivity and speed; safe, secure and affordable electronic devices; and technological literacy and ease of use would be required for optimum penetration of Digital Rupee.
 - ✓ Significant considerations would have to be given towards citizen's preference of Privacy along with Accessibility. Cash is still significantly popular because it provides for anonymity. However, if the Digital Rupee is designed to be fully anonymous like cash, concerns of money laundering, tax evasion or financing illegal activities may not be addressed. Policy responses could include maintaining privacy of data and transactions, even from the central bank, except when required for law enforcement. Although falling short of full anonymity offered by cash,

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CBDC can be designed to offer anonymity, or pseudonymity, in varying degrees, relative to alternative payment methods.

- India in recent past has done massive digitisation of processes, most significantly in financial transactions. The RBI has been actively encouraging the development of the digital payments space. National Payments Corporation of India (NPCI), a not-for-profit company, promoted by a large number of private and public sector banks, in 2007 understood the diverse needs of the economy and came up with a number of products that help in making retail payment for different types of transactions. The game-changer in this space has been the Universal Payment Interface (UPI), which acts as a real-time payments system that can enable the instantaneous transfer of funds between two banks, using a mobile device. Using this platform, apps like Google Pay, PayTm and PhonePe have popularized digital payments tremendously. However, while the private sector-based payments system may work well enough within India, it is only a sovereign-backed digital currency that will be trusted in a global system.
- A decision is yet to be taken on the private currencies. Prohibiting such monies may prove to be difficult to enforce, given the difficulty of tracing them, and their decentralised and borderless framework. The Inter Ministerial Committee in its report recommended banning of private cryptocurrencies but notes that there may be ways to circumvent the prohibitions through use of unauthorised VPNs or leveraging the fragmented regulatory landscape to shift to friendlier jurisdictions. It has also been argued that banning would move the activities underground, making them difficult to monitor, particularly for use in illegal activities. Hon'ble FM has stated that a decision on legal status of private digital currencies will be taken by Government, tax @ 30% has been introduced on profit earned on transfer of private digital currencies falling under digital asset.