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India's UPI is an exemplar for the world: Eswar Prasad

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Digital currencies are a reality and we are close to the end of the era of physical currency (or cash) says Eswar Prasad, Tolani Professor of Economics, Cornell University, and Senior Fellow, Brookings Institution, Washington DC, and author of The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance. But a lot of design and conceptual issues need to be carefully sorted out to mitigate concerns about privacy, disintermediation of banks, and other risks.

Here in India for a recent G20 meeting on financial globalisation, Prasad, a 1985 batch economics graduate of RKM Vivekananda College, Chennai, spoke to businessline on issues ranging from global growth to CBDCs. Excerpts from the interview:

What is the agenda for the G20 meetings you are here for?

The main purpose of the meeting is to try move forward the discussion on financial globalisation. There's been a lot of concern about whether financial integration really helps emerging markets and developing economies or simply creates a lot of risks for them. And some of the discussion has been about how to improve the international rules of the game by which capital flows are managed, including about whether advanced countries have any responsibility for managing the spillover effects of their policies through capital flows, and issues related to restructuring of debt of highly indebted low-income economies.

On all of these, there is a bit of a rift between the advanced economies on the one hand and the emerging market and developing economies on the other. The Indian presidency really wants to shift this conversation in a more constructive direction, because emerging market countries do need foreign capital. So the idea of this meeting was to try see if there is a way to structure those capital flows in a way that is much better for the recipient countries, that doesn't create as much volatility or risks for them.

The World Bank came up with a fairly positive outlook; it wasn't as gloomy as the IMF prediction in January. So where does the world economy stand; is the worst over?

It's a pretty mixed picture. Certainly, things look a lot less bleak than they did a few months ago, or even a few weeks ago. But the signals have been quite mixed, coming from different economies.

In the US, there was a concern that the Federal Reserve's aggressive rate hikes would inevitably lead to a recession. Now, the probability seems a lot more balanced, that perhaps the US will get away with maybe a very weak recession, or perhaps even the ultimate goal of a soft landing, which means a slowdown in growth and a reduction in inflation at the same time but without a recession.

Inflation in the US has been coming down, but it is still showing a lot of persistence. The labour market has remained remarkably strong, generating a lot of job growth. But consumer and investor confidence don't seem to be very high at the moment, and that's a concern in terms of longer-term growth.

China is in a similar situation; the removal of the zero-Covid policy created a surge of optimism but also created some disruptions in the short term. But in the early part of this year, there was a sense that industrial activity, consumer demand were all picking up and that the economy might do well this year, potentially easily attaining or perhaps even crossing the 5 per cent growth target that the government had set.

But in the last few weeks, many indicators of industrial activity have come in less strong than expected: employment growth seems to be quite weak, the unemployment rate, especially among youth, is quite high. And again, consumer confidence, as reflected in retail sales, for instance, and also private sector investment have been very weak. So now in China, the picture looks a lot better than it did six months ago, but a little less good than it did maybe two months ago.

Europe is technically in a recession right now, because Germany and a couple of other core economies are having negative growth in the last two quarters. There are some parts of the Eurozone that are actually doing moderately well, but the Eurozone as a whole is not doing well.

And then if you look at the emerging market economies, India seems to be doing quite well but many other emerging markets are under fairly significant stress. So one gets the sense that again this year might be somewhat benign in terms of the growth outcomes, but the prospect that it might be a sort of breakout post-Covid year looks much less likely now.

There is lot of talk about de-dollarisation of the world economy and the use of an alternative reserve currency especially after the Russia-Ukraine conflict. Is the world relying too much on the dollar?

I think the world, including US geopolitical rivals, as well as allies, really chafe at the dollar's dominance. But the reality is that the dollar remains dominant in practically every dimension as a financing, payment, and especially as a reserve currency.

But I think it's worth emphasising the distinction I just alluded to, and the different roles of an international currency. If you think about the Russian invasion of Ukraine and sanctions that followed, the major concern for Russia really was the fact that in terms of international payments, it was going to be very constrained if it didn't have access to a dollar-based financial system. China and many other US rivals see this problem as well. Now, it turns out that there are technological developments already underway that will reduce the reliance on the dollar as a payment currency.

China has set up its own payment system called the cross-border, interbank payment system or CIPS that can more directly communicate with the payment systems of other countries.

In addition, you have financial market development in many emerging markets. So now, it's easier to trade directly between currency pairs such as the rouble and renminbi, the renminbi and the rupee, or the rupee and the Brazilian real without necessarily having to go through an intermediating currency such as the dollar.

So these changes are underway. Now, are we going to see a fundamental shift in the dollar's role as a payment or perhaps even invoicing currency? At the margin possibly. We've heard about Saudi Arabia invoicing some of its oil exports in renminbi rather than dollars and accepting payments in renminbi. But the reality is that the renminbi is not a convertible currency because there are still capital controls in China. So it's hard to see this gaining a huge amount of momentum.

And then as the reserve currency there is another complication for potential rivals to the dollar. A reserve currency is one that is held by central banks for a rainy day, because they want to protect their balance of payments when they need hard currencies to pay for imports or to pay off their debt. And for that, you need a currency that is backed up by deep financial markets, a country of large economic size, and, most importantly, the institutional framework that generates trust among foreign investors.

So if you think about a country that can provide a currency, in large amounts, with a trusted central bank and has an institutional framework that is still reasonably good, it's very hard to rival the US.

My sense is that in the future, we are going to see some erosion in the dollar's prominence. As a payment currency, it will still remain the most important one, but maybe it will lose some of its share. As a reserve currency, its role seems more secure and I really don't see much of a shift away from the dollar. The dominance of the dollar is going to be reinforced by the fact that it has no serious rival.

What is the future of currency and how far are we from using digital currencies in a big way?

Clearly the future of money is digital. If you think about many large, advanced economies, they are shifting towards digital forms of payment. Many emerging market economies and even low income economies are shifting towards digital forms of payment as well.

There are some advanced economies like the US, Japan, Switzerland, which, curiously, still use cash a lot for retail transactions. But the future of money really is digital. And I think central banks, recognising this, are issuing, or experimenting with retail central bank digital currencies, in order to make sure that there is a public payment option available once the use of physical currency that is cash disappears.

But one paradoxical thing that is happening in many countries, China being an example, and I think India is going to become an example like that as well, is that even as we start moving towards CBDCs, the user case for a CBDC is becoming somewhat weaker.

In China, for instance, Alipay and wechat pay are two of the largest payment providers, and they blanketed the economy with very low cost, easily accessible digital payments. So the question is, why is there a need for a digital renminbi. China's far ahead of most other countries in terms of its digital currency experiments and a lot of CBDC digital renminbi wallets have been opened. But the transaction volume there has been minimal, because people don't see the point of CBDC. As for Sweden, another early experimenter with CBDC, a Swedish parliament committee recently concluded that right now, they don't really need a CBDC because the private payment infrastructure works very well.

In India, the way the UPI is working is an exemplar for the rest of the world, because it's giving a lot of people very easy access; it's forcing payment providers operating on the platform to provide interoperability across different payment providers, which is one of the big selling points of CBDC.

So, I think CBDCs are coming, but how widely they will be used remains open to question. Digital forms of payment can perhaps control corruption, at least at the margin, although it hasn't really changed incentives that really fuel corruption. Getting more economic activity into the formal economy is certainly an advantage of a CBDC. Of course, CBDCs have risks as well. One risk of digital wallets is that you might disintermediate the banking system if people shift their money away from bank deposits towards a CBDC digital wallet.

Now, the presumption is that CBDCs won't pay a positive rate of interest, so why would people prefer a CBDC?

That concern in normal times may not be a problem. But if there is panic about the banking system, you could have a large scale shift of deposits out of commercial banks, which could precipitate a banking crisis.

In the US, there was recently a flight of deposits from Silicon Valley Bank and First Republic Bank. If CBDC wallets had been easily available, despite part of deposits being covered by deposit insurance, people might have moved their funds to CBDC digital wallets, and then you have exactly the event you're trying to prevent, which is a banking problem.

So these design choices, both conceptual and technical, will need to be very carefully thought through to make sure that we can mitigate some of these risks related to privacy, disintermediation, and so on, before moving forward.

But I see this as inevitable, because very soon, we're going to stop using cash altogether. For households, merchants, small-scale, corner stores, large retailers and for governance, digital payments are just much more efficient and convenient.

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