

Evaluating The Impact Of India’s Cbdc On Banking Sector Efficiency And Stability

Dr .J .Bamini ¹, Dr Alok singh ², Dr. Ashish Gupta³, Arijith Banarjee⁴, Dr. Rajib Bhattacharya⁵, Saleha Jameel⁶, Mohit Kumar⁷

¹Cluster Head, PSGR Krishnammal College for women, Peelamedu, Coimbatore.

²Professor/ Director, Dr Om Prakash group of institutions, Farrukhabad.

³Maharishi University of Information Technology, Lucknow, UP, India.

⁴, SACT (Grade 1), Shibpur Dinobundhoo Institution (College), Department of Commerce.

⁵Associate Professor, NSHM Business School - Kolkata, 60 B L Saha Road, Kolkata 700053, India.

⁶Research scholar, Babasaheb Bhimrao Ambedkar University Lucknow.

⁷Assistant Professor, Teerthanker Mahaveer College of Pharmacy, Teerthanker Mahaveer University, Moradabad , Uttar Pradesh

ABSTRACT

This increasing digitalization of financial systems has prompted central banks all over the world to consider the Central Bank Digital Currencies (CBDCs) as the method of helping the efficiency of payments and protecting the financial stability. The pilot projects implemented by the Reserve Bank of India (RBI) in India about the Digital Rupee (e₹) are very important, and bring up significant concerns about its effects on the banking industry. This paper assesses the possible outcome of the introduction of the CBDC in India on the efficiency and stability of the banking sector based on its impacts on the payment system, operational cost, the intermediation role, and systemic risk. Pauline Anne Thibault, the author, concludes the paper using a qualitative analytical method based on the literature available, policy documents, and the initial results of the CBDC pilots in India that the Digital Rupee is capable of optimization of the efficiency of settlements in the banking system, decreases the transaction costs, and enhances the transparency of the banking system. Nevertheless, it also notes some primary challenges, such as risks of bank disintermediation, liquidity strains in the times of financial stress, and increased cybersecurity risks. The paper states that the risks could be reduced with proper designing of CBDC; i.e. two-level model of division, limit on transactions, and strict regulation. Generally, the results indicate that CBDC in India can be used in strengthening the efficiency in the banking sector without disrupting the financial stability so long as its implementation is gradual, adaptive, and in tandem with the current banking structure..

Keywords: Central Bank Digital Currency; Digital Rupee; Banking Efficiency; Financial Stability; Monetary Policy; India

INTRODUCTION:

The high rate of digital technologies development is one of the factors that have drastically changed the financial systems of today, altering the very nature of funds issuance, transferring, and storage mechanisms. The rise of electronic payments and fintech services as well as personal digital currencies in the last decade have grown and undermined the established role of cash and bank payment systems. To address these changes, central banks all over the world have started considering the issue of Central Bank Digital Currencies (CBDCs) as the new type of sovereign money that will be able to supplement the current monetary and financial systems.

India is one of the most appropriate settings in the discussion of the consequences of CBDCs as it is a large and diverse economy, and its use of digital payment systems is accelerating. Plans like the Unified Payments Interface (UPI) have already placed India ahead of the clock in digital transactions, making it much easier and efficient in paying and being paid in India. On this digital

basis, the reserve bank of India (RBI) launched the Digital rupee (e₹) via pilot projects, both on retail and wholesale. The main end goals of this effort are to minimize the cost of currency management systems, improve the efficiency of payment and settlement systems, and maintain monetary sovereignty in more digital financial space.

Although the issue about the introduction of a CBDC has its number of prospective benefits, there are also significant issues that concern the banking industry. Commercial banks are the main the focal point in relation to purposes of financial intermediation, provision of liquidity and credit creation. A risk-free electronic form of currency between the central bank could change the dynamics of deposits, alter the funding structure of banks, and have an impact on the profitability of the banks. In addition, the liquidity strain and financial stability challenges can be increased due to the ability to exchange bank deposits into the holdings of CBDC during times of financial strain.

It is against this backdrop that the effect on the Indian banking sector brought about by the India CBDC is a

policy relevant issue. Literature is inconclusive in a way that the effects of CBDCs are highly dependent on the design characteristics, the regulatory environment, and the situation of the domestic financial system. But emerging economies such as India still have very little empirical evidence.

This paper will assess the possible repercussion of CBDC in India in terms of efficiency and financial stability in the banking industry. Offering a combination of theoretical knowledge, the existing empirical studies and the initial findings of the CBDC pilots in India, the paper is aimed to become a part of the increasing body of research about the subject of digital currencies and the financial intermediation. The results will provide useful information to policymakers and regulating bodies as well as banking organizations as India advances to a more digital and resilient monetary system.

LITERATURE REVIEW

The increase in the interest in Central Bank Digital Currencies (CBDCs) has created a growing literature in academic and policy oriented literature looking at the possible economic, financial and institutional consequences of the new intervention. The bodies of extant literature can be divided into three strands: (i) theoretical discussions of CBDC design and monetary policy, (ii) empirical and conceptual research of the efficiency of banking sector, and (iii) research work devoted to the financial stability and systemic risk.

CBDCs and Monetary System Transformation

According to early theoretical work, central bank money is being further extended by the role of CBDCs. Barrdear and Kumhof (2016) believe that by implementing CBDCs, central banks can complement the ability to implement a monetary policy more precisely as liquidity conditions become the greater factor of control. Equally vital, Kumhof and Noone (2018) emphasize that CBDCs can enhance the effectiveness of payment systems and their resilience, as well as strengthen the monetary sovereignty of countries in support of the digital currencies offered by private providers.

These have been reflected in the opinions of policy institutions, which argue that CBDCs can act as a safe and trusted store of value in more digital economies. According to the Bank for international settlements (BIS, 2021), the strong reasons why CBDC should be adopted include payment efficiency, financial inclusion, and the resilience of the system. The BIS, however, also emphasizes that CBDC depends on its design options to a considerable extent, especially in terms of its access, remuneration, and distributions systems.

CBDCs and Banking Sector Efficiency

Most of the literature has focused on the effects of digital innovations in improving the effectiveness of banks. As shown by Berger (2003), advancements in technology within the banking industry lower the operation costs in addition to enhancing service delivery through automating the processes as well as lowering the physical infrastructure needs. Based on this argument, Andolfatto (2018) argues that properly-designed CBDC may raise the

level of efficiency, as it would then make settlement processes streamlined and minimize counterparty and reconciliation risks.

Conversely, there are studies that warn that in countries that have fully-developed digital payment systems, efficiency benefits of CBDCs can be small. According to Auer and Boehme (2020), in this scenario, the value creation of CBDCs might be to promote the resilience of the payment system at the expense of reducing costs. This point of view is especially applicable to India where such systems as UPI already offer cheap and quick digital payments.

Financial Stability and Disintermediation Risks

The most controversial feature in the use of the CBDC is connected to the effects on the financial stability. As Gorton and Metrick (2012) point out, access to the money in central banks is easy, which raises the chances of bank runs through deposits withdrawals. Using the same reasoning to CBDCs, Fernandez-Villaverde et al. (2021) caution that retail CBDCs would further amplify the process of deposit displacement of commercial banks, undermining their funding foundation.

On the other hand, some other researchers claim that the risk associated with disintermediation may be effectively controlled with the proper design of CBDC. The article by Bindseil (2020) suggests that a tiered remuneration and holding limit can be used to reduce the migration of bank deposits to CBDCs on a mass scale. Such design characteristics would attempt to maintain the intermediation role of the banks, although they will still enjoy the advantages of a digital central bank money.

Evidence from Emerging Economies and India

There is a lack of empirical research on CBDCs, especially in the settings of emerging markets. The available literature concentrates on the developed economies, and thus it still lacks the information on how the CBDCs interrelate with the banking systems which feature high financial inclusion objectives and various institutional frameworks. In India, the Reserve Bank of India (RBI, 2022) defines a slow and gradual strategy of CBDC implementation that focuses more on consistency with current banking systems.

According to recent policy-oriented studies, the two-tier CBDC distribution model in India can serve to ensure stability risks in the country and leave commercial banks with the responsibility to onboard customers and manage liquidity (Shah and Prasad, 2023). Nonetheless, there is limited evidence on how these claims may be objectively assessed based on academic sources which makes it essential to conduct additional studies.

Research Gap

Although the existing body of literature on CBDCs is growing, there still exists little agreement regarding its overall effect on the efficiency of the banking sector and financial stability especially in the vast emerging markets like India. The majority of studies are yet to be conducted in a theoretical or policy matter, and the little pilot evidence has not been sufficiently integrated. This paper aims to fill this gap, as it offers a specific analysis of the

CBDC project in India and its synthesis of insights on countries with an international outlook and institutional characteristics.

RESEARCH METHODOLOGY

Research Design

The research design that will be used in this study is qualitative and analytical to assess the effects of the Central Bank Digital Currency (CBDC) by India on the efficiency, and financial stability of the banking sector. Since the development of CBDC in India is only at its initial pilot stages, and there is a lack of extensive empirical results, the conceptual and policy-based approach is deemed right. In the analysis, theoretical insights have been combined with evidence based on policy documents, academic literature and preliminary findings of the CBDC pilot programs in India.

Data Sources

The research paper uses secondary data that has been gathered and analyzed using several sources of authority, to guarantee rigor and credibility of the analysis. These extensions are publications and working papers of international bodies like bank of International settlement and the international monetary fund (IMF), policy reports and concept notes of the reserve bank of India (RBI), and peer reviewed academic journals in economics and finance. Moreover, reports in the industry as well as publicly available information regarding the CBDC pilot projects in India are employed to put the analysis in perspective.

Analytical Framework

In order to determine the implication of Digital Rupee, the research paper utilizes a systematic analytical framework that dwells on two fundamental areas including efficacy in the banking sector and financial stability. The efficiency of bank performance is checked according to the level of payment and settlement speed, cost implications of operation and the shift in the competitive environment. The financial stability is considered in terms of its possible impact on the bank intermediation, liquidity operational system and systemic risk which should be considered during financial stress periods.

The comparison approach is also integrated into the framework with the help of the foreign experimentation and experience of CBDCs in both developed and developing economies. This comparative approach will aid in finding the design aspects and regulatory systems that could be applicable to the Indian institutional setting.

Evaluation Criteria

The effects of the CBDC of India are measured based on the qualitative indicators based on the literature and policy goals as stipulated by the RBI. Such indicators are the rise in the efficiency in transactions, lessening in the complexity of operations, possible change in the deposit behavior as well as the stability of the banking system during stress events. Although the study does not utilize the econometric models, it entails consistency, logical coherence, and correspondence with the well-established theoretical constructs.

Limitations of the Study

The main constraint of this study lies in the fact that the implementation of CBDC in India remains at an initial level, which does not allow obtaining in-depth quantitative information. Consequently, the results can only be viewed as suggestive and not absolute. Further studies could just increase the scope of the current analysis with empirical evidence as more entities integrate CBDC, and employ methods that allow quantifying the impact of efficiency and stability outcomes more accurately.

Impact of CBDC on Banking Sector Efficiency

The implementation of a Central Bank Digital Currency (CBDC) can radically transform the efficiency of the banking industry by transforming the way payments are made, the way things work, and the competitive environment. The Digital Rupee (₹) is outlined in the Indian context to work together with the already existing banking making financial transactions more efficient. This segment reviews the most significant outlets that the CBDC of India is likely to influence the banking industry in efficiency.

Payment and Settlement Efficiency

Among the key efficiency benefits of CBDCs, rapid and more secure payment and settlement procedures can be named. Digital rupee provides instant settlement with a finality effect, which minimises delays and counterparty risks that are inherent to traditional interbank settlement systems. CBDCs in the contexts of wholesale applications can simplify interbank into a process through removing numerous layers of reconciliation, thereby enhancing liquidity management, and lowering the cost of settling.

In the case of retail payments, the Digital Rupee presents an alternative digital payment tool, which is not based on middle people to make final settlement. This attribute can help in increasing transaction reliability especially in high value or time related payments. Although the current digital system in use in India including UPI is already a highly efficient system, CBDC will be more beneficial because of the possibility of central bank money settlement, as opposed to commercial bank liabilities.

Reduction in Operational and Transaction Costs

The application of CBDCs will lower operational expenses of the banks by eliminating reliance on physical cash processing involving printing and distribution, storage and security costs. Furthermore, the digital settlement with the help of CBDCs can reduce the cost of the back-offices connected with reconciliation, compliance and records-keeping. CBDCs are also programmable which allows automation of banking operations, thereby enhancing cost-efficiency and scalability.

Nonetheless, investment in technology infrastructure, cybersecurity, and employee training can raise both short-term expenses of banks. These investments will bring in the increase of efficiency in the long run as systems become stable and penetration becomes widespread.

Enhancement of Transparency and Traceability

Transaction transparency and traceability introduced by the CBDCs can possibly increase the regulatory compliance levels and mitigate fraud. In the case of banks, enhanced transparency of transactions flows can enhance risk management as well as accuracy in reporting. This clarity can also decrease the expenses related to the regulatory compliance and the anti-money laundering (AML) procedures, which will lead to general efficiency.

However, it is important to maintain a proper balance between the transparency and user privacy. Unreasonable disclosure requirements have the potential to impose more compliance costs and impact user acceptance.

Competitive Dynamics and Innovation

CBDC introduction could upset the competition in the banking industry. The Digital Rupee can also motivate the banks to become more innovative and to offer better services by giving them a standardized and interoperable digital payment instrument. There is a potential to increase competition because banks aim to make a difference by value-added services that are to be developed based on the CBDC infrastructure.

Concurrently, apprehensions have been expressed that CBDCs may diminish the input of the banks to the service of making payments. A two-tier CBDC model in India has important roles in onboarding and distribution to customers where the banks are central to maintaining their relevance and gives an incentive to innovation that increases efficiency.

Efficiency Gains in Financial Inclusion

CBDCs can also have the minor contribution towards efficiency of banking, through financial inclusion. The Digital Rupee has the potential to improve the costs of transactions among under-served population groups because the money allows access to digital central bank money without the need to maintain complicated banking relationships. With the enhancement of financial inclusion, banks can enjoy the advantage of a wider range of customer base and the facilitation of provision of financial services.

Altogether, the Digital Rupee can make the banking sector more efficient with the help of raising the speed of the payment, decreasing the costs of operations, and promoting the innovation. The extent of these efficiency gains will however be dependent on the level of adoption, technological preparedness and success in coordinating regulations. In the Indian environment where digital payments are already highly developed, the effect of the CBDA efficiency is expected to be complementary, but not transformative.

Implications for Banking Sector Stability

As much as the efficiency gains associated with Central Bank Digital Currencies (CBDCs) are impressive to motor, their impact to the stability of the banking sector is a principle issue to policy makers and regulators. The implementation of the Digital Rupee (₹) by the Reserve Bank of India (RBI) can impact the funding environment of banks, the liquidity situation, and risk profile. In this section, I will analyze the implications of the CBDC

initiative by India as far as the concept of stability is concerned.

Bank Disintermediation and Deposit Substitution

Enhanced risks that could be affiliated with the retail CBDCs include the possibility of disintermediation of banks, which has been among the most popular topics of discussion. Since CBDCs are a direct and risk free liability of the central bank, households and firms might go for digital rupees as a way of holding their money as opposed to a commercial bank deposit particularly in times of economic uncertainty. This deposit replacement may decrease the stable source of funds of the banks making them more dependent on wholesale funding and may ultimately increase the cost of funds.

The issue could be alleviated by the RBI adopting a two-tier CBDA model of distributing money in the Indian context as they ensure that the commercial bank continues to remain as an intermediate between the central bank and the final consumers. Also, the suggested elements of the design, such as restrictions on CBDC holdings can further deter the mass exodus of deposits out of banks.

Liquidity Risk and Bank Runs

CBDCs have the potential to change the dynamics of the bank runs by facilitating the quick and frictionless flow of the bank deposits to the central bank money. This may hasten the liquidity exits of banks in periods of financial strains to increase the systemic risk. And the panic-inducing nature of digital transactions might be heightened by how quickly and simply they can be completed in comparison to cash withdrawals.

These risks however can be addressed by the proper design of CBDC and regulatory protection. The central bank can contain excess outflows by measures like transaction caps, non-interest based central bank deposits, liquidity backstops and so on. The conservative and gradual way in which the RBI implement the use of CBDC is therefore important in maintaining stability.

Impact on Credit Creation and Monetary Transmission

Alterations in the deposits made by banks can influence the ability of the banks to lend to the real economy. A long-term replacement of bank deposits with CBDCs would limit the lending process, especially when other sources of funds are either less cheap or less stable. This may have more macroeconomic effects such as lower investment and low growth of the economy.

Meanwhile, CBDCs could also work to improve the transmission of monetary policy by providing the central bank with an additional direct offer to control the liquidity situation. Sub-optimal impacts on credit supply would then be partly counterbalanced by improved transmission efficiency on those conditions that banks are capitalized and liquid enough.

Operational and Cybersecurity Risks

The online support structure of CBDCs poses new operational and cybersecurity threats to banks and the central bank. Outages in the system or any form of cyberattacks or technological breakdowns can break

payment systems and destroy the trust of the population. In the case of banks, the process of CBDC platforms integration with existing systems can make their operations more complicated and subject to technological risk.

It is therefore necessary to ensure that the financial stability is safeguarded through the establishment of sound cybersecurity systems, constant system monitoring and effective contingency planning. The cooperation between banks, regulators and technology providers will play a major role in controlling such risks.

Long-Term Stability Considerations

The stability implications of CBDCs in the long-run will be determined by their adoption rates and the interactions it has with the rest of the financial system. The smart development and utilization of CBDCs would not contradict the role of commercial banks provided they are thoughtfully developed and applied. The focus on slow implementation, minimal functionality at pilot stages, and high regulatory standards in India indicate the stability-related approach.

All in all, although the Digital Rupee brings in new problems concerning stability, there are no challenges that are impossible to solve. The CBDC in India can help increase the resilience of the financial system by optimally designed and gradual adoption alongside constant control, thus maintaining the stability of the banking market.

Results and Discussion

This part summarizes the findings based on the analysis framework and comments on their implications based on the existing literature analysis and the institutional context of India. Since the study is qualitative and at initial stages of CBDC implementation in India, the findings are descriptive and concentrate on the new trends as opposed to statistically estimated impacts.

Summary of Key Findings

The examination reveals that the Digital Rupee (₹), which is the Central Bank Digital Currency (CBDC) in India, can be utilized in the banking sphere to enhance the efficiency of its operations mainly by accelerating settlements, minimizing the operational expenses, and enhancing transparency. Wholesale CBDC applications seem to be especially effective towards better interbank settlement and liquidity management. The use of retail CBDCs, although providing marginal efficiency improvements in comparison to the current digital payment systems, enhances the finality of the settlement by facilitating transactions using central bank money.

Simultaneously, the results also underline the fact that the implementation of CBDC also presents a series of difficulties associated with stability, in particular, the threat of deposit replacement and increased liquidity drain in times of financial strains. These risks are, however, reflected with a two-tier distribution model in India and a conditioned design of the RBI which aims at maintaining the business of commercial banks of an intermediary.

Efficiency Gains in a Digitally Advanced Economy

The outcomes indicate that the effect of India on the efficiency of the Digital Rupee is most probable to be complementary as opposed to transformative. Contrary to the underdeveloped payment systems in economies, India is already enjoying the highly efficient digital environment like UPI. As a result, marginal efficiency gains of a retail CBDC are average. This observation coincides with the results of Auer and Bhoeme (2020), who point out that in digitally developed systems, the primary benefit of CBDCs as opposed to substantially lower transaction costs is resilience.

However, the Digital Rupee provides a strategic value through providing a publicly created digital form of payment, which settles in central bank money. The attribute enhances confidence and minimizes counterparty risk especially in high transaction amount and interbank dealings.

Stability Trade-offs and Design Considerations

The results of the stability discussion disclose that there exists an obvious trade-off between safety and intermediation. Although CBDCs are a safer store of value, its mass use may fracture the deposit bases of banks. The findings confirm that the risks of building the CBDC are very design-specific; this point was supported by the previous researches. The design characteristics including holding limits, non-remuneration, and a slow rollout become key instruments in decreasing the disintermediation and liquidity risks.

The phased nature and the constant control that is pointed at by the RBI seems to be on par with the best practices in the international market, in the Indian context. This method decreases the possibility of abrupt structural changes in the bank financing and enables the policy makers to vary the design parameters based on the results witnessed.

Implications for Policy and Practice

The results mean that CBDC goals should be at par with the efforts of the broader financial system. Although it is desirable to enhance efficiency, what is more important is to ensure that the stability of the banking sector is maintained. The findings indicate that CBDCs cannot be considered a substitute to commercial bank money, but a supplement to it. The central bank, commercial banks, and payment service providers should closely coordinate their work to achieve close cooperation and reduce unwanted effects.

Comparison with Existing Literature

In general, the findings are in line with the larger body of CBDC literature, pointing to the increase of efficiency and stability threats. The case of the Indians supports the argument that CBDCs do not represent a universal solution and that their effects differ greatly in different institutional contexts. At the core of the proposed research, its target is a relatively young economy with a developed implementation of digital payments, which puts forth the current literature gap by offering context-related information which is currently underrepresented in the literature.

Policy Implications

The results of the research present a number of critical policy implications in the successful design and implementation of the Central Bank Digital Currency (CBDC) in India. Although the Digital Rupee (₹) has a promising potential to ensure more efficiency and resiliency in the financial system, regulatory decisions and institutional balancing are essential to understand the effects of the adoption on the banking sector as a whole.

CBDC Design and Regulatory Safeguards

A careful and flexible CBDC structure should be favored by the policymakers, inventive and yet stable. The survival of a two-level distribution scheme where commercial banks and regulated middlemen deal with customer-facing services is crucially important to the retention of the middleman role of banks. The risk of high migration of deposits in banks to CBDC wallets can also be minimized through regulatory measures that include limits on CBDC holdings, transactions, non-interest factors, etc.

Gradual and Phased Implementation

A gradual implementation plan enables the policymakers to track the adoption rates and evaluate possible risks on an ongoing basis. Expanding CBDC capabilities and access to users gradually is one way the policy can be adjusted at the right time to respond to the effects that have been observed on liquidity and payment behavior of banks and the provision of credit. Such adaptive practice is specifically significant within a big and diversified economy such as India, where possible variations in regional and institutional aspects can make an impact on the CBDC use.

Strengthening Banking Sector Resilience

In order to address the possible funding and liquidity constraints associated with the adoption of CBDC, policymakers need to strengthen the current protection measures in the banking sector. This entails the maintenance of sufficient capital and liquidity buffer, increased stress testing structures and availability of central bank liquidity facilities. Better monitoring of the activities will be required to detect the vulnerabilities that may emerge as a result of shifts in deposit patterns and online payment processes.

Cybersecurity and Operational Risk Management

Considering the digital form of CBDCs, effective cybersecurity and operational risk management systems are essential factors. The policy makers are expected to set technical specifications, data privacy systems and recovery systems in case of system failure or a cyber attack. Close coordination among the central bank, commercial banks, and technology providers will be essential in order to guarantee that the system remains stable and citizens are confident in the system.

Promoting Innovation and Financial Inclusion

The CBDC policy must also focus on both the creation of innovations and financial inclusion. The Digital Rupee will provide competition and efficiency to the banking sector by facilitating their ability to interoperate with current digital payment systems and enhance the creation of value added services. Simultaneously, specific actions

must maintain such CBDC acquisition so that the numbers of those underserved by the system can be served without introducing access issues or imposing too much compliance costs.

In sum, the policy implications are that the success of the CBDC in India can be achieved not solely on the technological potential, but on a wise regulatory form as well as coordination among the institutions. A policy framework that is well-tuned can be used to guarantee that the Digital Rupee boosts efficiency in the banking sector without jeopardizing financial stability.

CONCLUSION

This paper discussed how the efficacy of the banking sector and financial stability may be affected by the introduction of the Central Bank Digital Currency (CBDC) by the Indian authorities, namely the Digital Rupee (₹). Using the available literature, policy documents, and preliminary findings of the CBDC pilot projects in India, the article evaluated how a shift in payment systems, banking activities, and systemic risk dynamics could be achieved through introduction of a digital version of central bank money.

Based on the analysis, it is possible to outline that the Digital Rupee can facilitate the effectiveness in the banking sector by raising the processing speed, decreasing the cost of operations and transactions, and bolstering the openness in payment procedures. These advantages are mostly noted in wholesale uses, in which CBDCs have opportunities to enhance interbank settlements and enhance liquidity. Nonetheless, as a retail-centric economy progresses to a more digitally advanced economy like India, where the efficiency gains of a retail CBDC appear to be incremental, the efficiency gains of that CBDC variant are expected to be sizeable and complementary instead of revolutionary.

Meanwhile, the research points at critical issues of stability related to stability. Having a risk-free digital currency can become more dangerous as it will cause more deposit substitution and faster liquidity flows out of banks during times of financial strains. However, these risks are not caused by CBDCs per se, but they have much to do with the design and implementation. The application of India to the two tier distribution model and the suggested protective strategies like holding limit in addition to a gradual implementation goes a long way to curb the threats that this may cause to the stability of the banking sector.

In general, the results indicate that the CBDC in India may help to make the financial sector more efficient and resilient without affecting the fundamental activities of the banking industry as long as the introduction of the CBDC is not reckless, radical, and unregulated. With the ongoing development of the Digital Rupee, the future studies can be directed at the possibility to provide an empirical assessment with references to transaction-level data and stress-testing models to measure the lasting impact of the Digital Rupee on the behavior of banks, its credit supply, and financial stability. This will be crucially needed to inform the policy-making and ensure that the CBDC is part of the Indian digital financial future.

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