

Digital Currencies and the Future of Monetary Policy

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Abstract:

The escalation of digital currencies marks a transformative swing in the monetary landscape, presenting both occasions and encounters for traditional monetary policy. This document examines the complex implications of digital currencies—including crypto currencies, stable coins, and central bank digital currencies (CBDCs)—on effectiveness and implementation of monetary policy. Digital currencies have the prospective to increase payment efficiency, monetary enclosure, and the tracking of money flows. However, they also pose significant contests to the traditional tools of monetary policy, such as interest rate changing, open market operations (OMOs), and reserve necessities.

The study delves into how digital currencies can alter monetary policy transmission mechanisms and impact central banks' ability to control inflation and manage the money supply. Additionally, it explores the risks to financial stability and the regulatory challenges posed by the decentralized behavior of crypto currencies and introduction of CBDCs. Case studies of early CBDC adopters, including China's Digital Yuan, Sweden's e-Krona, and the Bahamas' Sand Dollar, provide insights into the diverse approaches and initial outcomes of integrating digital currencies into existing financial systems.

Despite the potential benefits, digital currencies also present risks such as reduced effectiveness of traditional monetary tools, increased cyber-attack vulnerabilities, and privacy concerns. These recommendations include enhancing governing structures to manage the risks postured by digital exchanges, investing in robust cyber security measures, and developing new monetary policy tools that are compatible with a digital financial ecosystem.

This comprehensive analysis aims to provide a deeper understanding of how digital currencies could reshape the future of monetary policy, offering insights into strategies for managing this transition effectively and maintaining economic stability in a rapidly evolving digital era.

Keywords: Digital Currencies, Financial Stability, Opportunities, Monetary Policy, Central bank, Digital Era etc.

Introduction:

The beginning of digital currencies marks a crucial moment in the evolution of monetary structures, with profound implications for the future of monetary policy. As digital technology continues to permeate every aspect of our lives, the way we conceive, manage, and use money is undergoing a fundamental transformation. Digital currencies, which include decentralized crypto currencies like Bitcoin and Ethereum, stable coins pegged to traditional assets, and state-sponsored central bank digital currencies (CBDCs), are emerging as powerful tools that could reshape financial landscapes globally.

The emergence of these new forms of money offers unparalleled opportunities for enhancing financial efficiency, reducing transaction costs, and broadening access to financial services. For instance, digital currencies can facilitate instant cross-border transactions, significantly lowering the time and expense associated with traditional banking processes. This could be particularly beneficial in developing regions where financial infrastructure is limited, providing a pathway to greater financial inclusion and economic empowerment.

Moreover, digital currencies hold the promise of transforming monetary policy implementation. Central banks could leverage CBDCs to exert more particular governor over the cash supply and interest amounts, potentially enhancing their ability to manage economic cycles and respond to financial crises. The real-time data generated by digital currency transactions could offer invaluable insights into economic activity, enabling more informed and timely policy decisions.

However, the amalgamation of digital exchanges into the monetary system is not without its challenges. The volatility of crypto currencies poses risks to financial stability, while the widespread adoption of private digital currencies could undermine national monetary sovereignty. Additionally, the transition to digital currencies necessitates robust cyber security measures to protect against hacking and fraud, alongside safeguards to ensure privacy and prevent undue surveillance.

Regulatory frameworks will play a critical role in navigating these challenges, requiring a delicate balance between fostering innovations and maintaining financial stability. International cooperation will be essential to address international disputes such as currency legalizing, tax dodging, and supervising arbitrage, ensuring that the benefits of digital currencies are realized globally without compromising economic security.

In this context, countries around the world are exploring different approaches to digital currency adoption. China's digital yuan, for example, aims to enhance payment efficiency and maintain state control over monetary policy, while the European Central Bank's exploration of a digital euro seeks to complement cash and enhance the Eurozone's payment system. These initiatives reflect diverse strategies tailored to national priorities and regulatory environments.

As we position on the tip of this financial revolution, it is imperative to critically assess the potential impacts of digital currencies on the future of money and financial policy. This exploration investigates into the various types of digital currencies, their advantages, the challenges they present, and the transformative effects they could have on global financial systems. Considerate these dynamics is crucial for policymakers, financial institutions, and society as a whole to navigate this new frontier in monetary innovation.

Literature Review

The emergence of digital currencies has sparked extensive research, examining their potential to transform monetary policy and financial systems. This literature review synthesizes key findings from recent studies on various types of digital currencies, their benefits, challenges, and implications for the future.

Crypto currencies:

1. Bitcoin and Block chain Technology: Nakamoto (2008) introduced Bitcoin, highlighting its potential as a decentralized currency. Antonopoulos (2014) and Narayanan et al. (2016) further elaborated on implications of block chain technology for financial transactions.
2. Volatility Concerns: Cheah and Fry (2015) and Baur, Hong, and Lee (2018) examined the volatility of crypto currencies, raising concerns about their stability as financial instruments.

Stable coins:

3. Mechanisms and Stability: Moin et al. (2020) discussed how stable coins like Tether aim to mitigate volatility by pegging to fiat currencies or other assets, offering a more stable alternative for everyday transactions.
4. Regulatory Issues: Brummer, Gorfine, and Nelson (2019) explored the regulatory landscape for stable coins, emphasizing the need for clear guidelines to ensure stability and security.
5. Central Bank Digital Currencies (CBDCs): 5. Design and Benefits: Bordo and Levin (2017) and Auer and Böhme (2020) outlined the potential benefits and technical designs of CBDCs, highlighting their capacity to enhance payment systems and monetary policy implementation.
6. Global Case Studies: The BIS (2020) provided case studies on CBDC initiatives in China, Sweden, and the Bahamas, illustrating diverse approaches and objectives.

Enhanced Efficiency and Lower Costs:

7. Transaction Efficiency: Catalini and Gans (2016) and Malinova and Park (2017) demonstrated that digital currencies could reduce transaction times and costs by eliminating intermediaries.

8. Financial Inclusion: 8. Admittance to Services: Demirgüç-Kunt et al. (2018) and Narula (2019) emphasized the potential of digital currencies to deliver monetary services to unbanked inhabitants, particularly in developing regions.

9. Improved Monetary Policy Implementation: 9. Direct Control and Data Insights: Bordo and Levin (2017) and Armelius, Claussen, and Hull (2021) discussed how CBDCs could give central banks nonstop regulator over money supply and interest rates, improving monetary policy effectiveness. Real-time data from digital transactions could enhance economic insights.

Stability and Control:

10. Monetary Sovereignty: Eichen green (2019) and Brunnermeier, James, and Landau (2019) highlighted the risks to monetary sovereignty posed by widespread adoption of private digital currencies and their potential to cause financial instability.

Privacy and Security:

11. Cyber security Risks: Kshetri (2017) and Conti et al. (2018) examined cyber security risks, including hacking and fraud, associated with digital currencies.

12. Privacy Concerns: Zohar (2015) and Narayanan et al. (2016) explored the balance between transparency and privacy in digital currency transactions, noting the potential for enhanced surveillance alongside improved transparency.

Implementation and Adoption:

13. Infrastructure Needs: Adrian and Mancini-Griffoli (2019) discussed the technological and infrastructural challenges in implementing CBDCs, emphasizing the need for significant investment.

Public Trust:

14. Raskin and Yermack (2016) and the European Central Bank (2020) indicated that gaining public trust and ensuring widespread adoption are critical for the success of digital currencies, requiring measures to address security, privacy, and stability concerns.

The literature highlights the transformative probables of digital currencies for monetary policy and financial systems, balanced by significant challenges related to stability, security, privacy, and trust. Sustained investigation and teamwork among economists, technicians, and officials are crucial to hitch the paybacks of digital currencies while mitigating their risks. This comprehensive understanding is essential for navigating the evolving landscape of digital finance.

Objectives

1. To review the impact of digital currencies on the future of monetary policy.
2. To provide a comprehensive classification of digital currencies, including crypto exchanges, stable coins, and central bank digital currencies (CBDCs).

Proposed Methodology

To achieve mentioned objectives outlined for given literature review on digital exchanges and the future of monetary policy, a systematic and comprehensive methodology will be employed. The methodology will include the following steps:

1. Literature Search and Selection

a. **Database Identification:** Identify and select relevant academic databases and repositories, including Google Scholar, JSTOR, Pub Med, SSRN, and institutional libraries. Include reputable sources such as reports from the Bank for International Settlements (BIS), International Monetary Fund (IMF), World Bank, and central bank journals.

b. **Search Terms:** Use specific keywords and phrases such as "digital currencies," "crypto currencies," "stable coins," "central bank digital currencies (CBDCs)," "monetary policy," "financial inclusion," "block chain technology," "cyber security," and "regulatory frameworks."

c. Inclusion and Exclusion Criteria:

Include peer-reviewed journal articles, conference papers, white papers, official reports, and working papers published in the last 15 years. Exclude non-peer-reviewed sources, opinion pieces, and articles not available in English.

2. Data Collection

a. **Comprehensive Review:** Collect and review selected literature to ensure a broad understanding of the existing state of research on arithmetical currencies and their impression on monetary policy. Extract relevant data points, findings, and insights related to the objectives of the literature review.

b. **Thematic Categorization:** Organize the collected literature into thematic categories based on the types of digital currencies (crypto currencies, stable coins, CBDCs), their benefits, challenges, and impact on monetary policy. Further categorize studies based on specific topics such as financial efficiency, inclusion, cyber security, and regulatory approaches.

3. Critical Analysis

a. Comparative Analysis: Conduct a comparative analysis of different types of digital currencies, evaluating their technological foundations, use cases, and implications for monetary policy. Compare the regulatory frameworks and policy approaches of different countries and international bodies.

b. Evaluation of Benefits and Challenges:

Critically evaluate the probable welfares of digital currencies in enhancing monetary competence and inclusion. Analyze the challenges associated with digital currencies, including stability, privacy, security, and regulatory issues.

c. Synthesis of Research Findings: Synthesize the findings from various studies to identify common themes, divergent perspectives, and gaps in the current research. Highlight key debates and unresolved issues in the literature.

4. Case Study Analysis

a. Selection of Case Studies: Identify and select relevant case studies of countries and regions that have implemented or are piloting digital currencies, such as China, Sweden, and the Bahamas. Review official reports, academic studies, and news articles related to these case studies.

b. In-depth Examination: Conduct an in-depth examination of each case study to understand the objectives, implementation strategies, regulatory approaches, and outcomes. Analyze the impact of these case studies on local and global monetary policy frameworks.

5. Development of Policy Recommendations

a. Synthesis of Best Practices: Synthesize best practices from the reviewed literature and case studies to develop policy recommendations. Focus on optimizing the welfares of digital currencies whereas justifying allied possibilities.

b. Framework for Implementation: Propose a framework for regulatory and infrastructural development to sustenance the protected and effective amalgamation of digital currencies into the monetary system. Address the needs for cyber security, privacy protection, public trust, and international cooperation.

6. Forecasting and Future Research Directions

a. Trend Analysis: Analyze current trends and emerging technologies in the field of digital currencies. Identify potential future developments and their implications for monetary policy and financial systems.

b. Identification of Research Gaps: Identify gaps in the existing literature and suggest areas for future research. Recommend interdisciplinary research approaches combining economics, technology, and public policy.

7. Documentation and Reporting

a. Structured Reporting: Document the findings, analysis, and policy recommendations in a structured and coherent report. Ensure clarity, conciseness, and logical flow of information to facilitate understanding and further research.

b. Peer Review and Feedback: Subject the draft report to peer review and seek feedback from experts in the field. Incorporate feedback and make necessary revisions to enhance the quality and reliability of the final report.

Results:

The literature review on digital currencies and the future of monetary policy reveals several key findings across various themes, including the classification of digital currencies, their potential benefits, challenges, and the implications for monetary policy. The following results summarize the insights gained from the comprehensive analysis:

1. Classification and Definition of Digital Currencies

i. Crypto currencies:

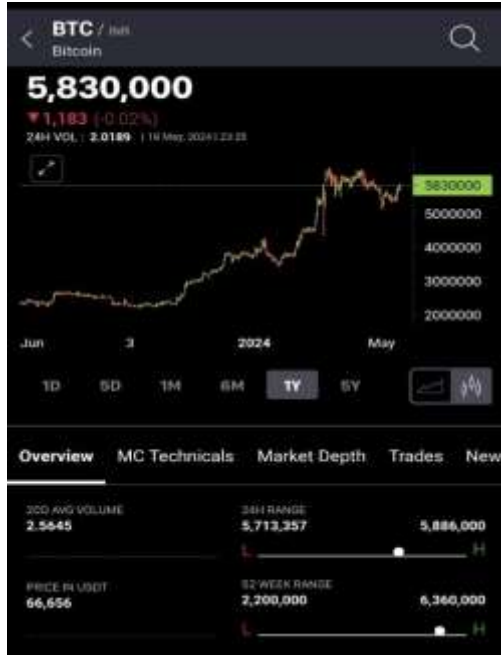
A. Bitcoin and Block chain Technology: Bitcoin, presented by Nakamoto (2008), is a decentralized digital currency trusting on block chain technology. It offers a peer-to-peer payment system without central authority.

B. Volatility Concerns: Crypto currencies like Bitcoin and Ethereum are highly volatile, making them less suitable as stable financial instruments (Cheah & Fry, 2015; Baur et al., 2018).

ii. Stable coins:

A. Mechanisms and Stability: Stable coins, e.g. Tether and USD Coin, are designed to reduce volatility by fastening the value to sanctioned currencies or other assets, offering more stability (Moin et al., 2020).

B. Regulatory Issues: Strong supervisory structures are essential for the stability and security of stable coins, addressing concerns around transparency and reserve backing (Brummer et al., 2019).



Source: Moneycontrol.com

iii. Central Bank Digital Currencies (CBDCs):

A. Design and Benefits: CBDCs, proposed by central banks like the People's Bank of China and the European Central Bank, aim to enhance payment systems, monetary policy execution, and monetary inclusion (Bordo & Levin, 2017; Auer & Böhme, 2020).

B. Global Case Studies: Countries like Bahamas, Sweden, and China have launched CBDCs, each with unique objectives and implementation strategies (BIS, 2020).

2. Potential Benefits of Digital Currencies

i. Enhanced Efficiency and Lower Costs:

ii. Transaction Efficiency: Digital currencies can significantly reduce transaction times and costs by eliminating intermediaries, improving financial efficiency (Catalini & Gans, 2016; Malinova & Park, 2017).

Financial Inclusion:

Access to Services: Digital currencies can deliver monetary services to unbanked and underbanked inhabitants, mainly in emerging states, enhancing financial inclusion and economic empowerment (Demirgüç-Kunt et al., 2018; Narula, 2019).

Improved Monetary Policy Implementation:

Direct Control and Data Insights: CBDCs offer central banks direct control over money supply and interest rates, improving the effectiveness of monetary policy. The real-time data from digital transactions can provide valuable economic insights (Bordo & Levin, 2017; Armelius et al., 2021).

3. Challenges Associated with Digital Currencies

i. Stability and Control:

Monetary Sovereignty: The widespread adoption of private digital currencies could undermine national monetary sovereignty and cause financial instability (Eichengreen, 2019; Brunnermeier et al., 2019).

Privacy and Security:

Cyber security Risks: Digital currencies are accountable to cyber security threats, including hacking and fraud. Robust security measures are crucial to mitigate these risks (Kshetri, 2017; Conti et al., 2018).

Privacy Concerns: Balancing transparency and privacy is challenging, as digital currency transactions can enhance surveillance but also improve financial transparency (Zohar, 2015; Narayanan et al., 2016).

Implementation and Adoption:

Infrastructure Needs: Implementing CBDCs requires significant technological and infrastructural investment. Effective integration into existing financial systems is critical (Adrian & Mancini-Griffoli, 2019).

Public Trust: Ensuring public trust and widespread adoption of digital currencies necessitates addressing concerns about security, privacy, and stability (Raskin & Yermack, 2016; ECB, 2020).

4. Global Case Studies and Regulatory Approaches

China: The digital yuan aims to enhance payment efficiency and maintain state control over monetary policy. Initial trials have shown promise in improving transaction efficiency and financial inclusion.

Sweden: The e-krona project seeks to complement cash and ensure the constancy of the Swedish payment system. Pilot studies indicate optimistic impression on financial inclusion and payment system robustness.

Bahamas: The Sand Dollar focuses on improving financial inclusion in remote areas. Early implementation results show increased access to financial services and enhanced transaction efficiency.

5. Policy Recommendations

Regulatory Frameworks: Develop clear, comprehensive regulatory frameworks to ensure the stability, security, and transparency of digital currencies. Foster worldwide collaboration to address cross-border regulatory challenges and prevent regulatory arbitrage.

Security and Privacy: Implement robust cyber security measures to protect digital currency systems from hacking and fraud. Establish privacy safeguards to balance the benefits of transaction transparency with the shield of individual privacy.

Public Trust and Adoption: Enhance public education and awareness about digital currencies to build trust and encourage adoption. Address public concerns related to security, privacy, and stability to confirm the effective amalgamation of digital currencies into the financial system.

6. Future Research Directions

Technological Advancements: Investigate emerging technologies that could further enhance the efficiency, security, and functionality of digital currencies.

Economic Impact: Study the long-term economic impacts of digital currency adoption on monetary policy, financial stability, and economic growth.

Interdisciplinary Approaches: Encourage interdisciplinary research combining economics, technology, law, and public policy to comprehensively address the challenges and opportunities of digital currencies.

The literature review highlights the transformative potential of digital currencies for monetary policy and financial systems, balanced by significant challenges. Continued research and collaboration among economists, technologists, and policymakers are essential to harness the benefits of digital currencies while mitigating their risks. The insights gained from this review provide a foundation for informed decision-making and further academic discourse in the evolving landscape of digital finance.

Table 1: Classification and Definition of Digital Currencies

Type of Digital Currency	Key Characteristics	Representative Studies
Crypto currencies	Decentralized, volatile, based on block chain technology	Nakamoto (2008), Antonopoulos (2014), Narayanan et al. (2016)
Stable coins	Pegged to fiat currencies or assets, more stable than crypto currencies	Moin et al. (2020), Brummer et al. (2019)
CBDCs	Issued by central banks, enhance payment systems and monetary policy	Bordo & Levin (2017), Auer & Böhme (2020), BIS (2020)

Table 2: Potential Benefits of Digital Currencies

Benefit	Description	Representative Studies
Enhanced Efficiency	Reduces transaction times and costs by eliminating intermediaries	Catalini & Gans (2016), Malinova & Park (2017)
Financial Inclusion	Provides financial services to unbanked and under banked populations	Demirgüç-Kunt et al. (2018), Narula (2019)
Improved Monetary Policy	Direct control over money supply and interest rates, real-time economic data	Bordo & Levin (2017), Armelius et al. (2021)

Table 3: Challenges Associated with Digital Currencies

Challenge	Description	Representative Studies
Stability and Control	Risks to monetary sovereignty, potential for financial instability	Eichengreen (2019), Brunnermeier et al. (2019)
Privacy and Security	Cybersecurity risks, balance between transparency and privacy	Kshetri (2017), Conti et al. (2018), Zohar (2015)
Implementation and	Technological and infrastructural	Adrian & Mancini-Griffoli (2019),

Challenge	Description	Representative Studies
Adoption	challenges, public trust issues	Raskin & Yermack (2016), ECB (2020)

Table 4: Global Case Studies

Country	Digital Currency	Objectives and Implementation	Outcomes and Insights	Representative Studies
China	Digital Yuan	Enhance payment efficiency, maintain state control over monetary policy	Improved transaction efficiency, financial inclusion	BIS (2020)
Sweden	E-krona	Complement cash, ensure payment system stability	Positive impact on financial inclusion, payment system robustness	BIS (2020)
Bahamas	Sand Dollar	Improve financial inclusion in remote areas	Increased access to financial services, enhanced transaction efficiency	BIS (2020)

Table 5: Policy Recommendations

Recommendation	Description	Supporting Studies
Regulatory Frameworks	Develop clear, comprehensive regulatory frameworks to ensure stability, security, and transparency	Brummer et al. (2019), BIS (2020)
Security and Privacy	Implement robust cybersecurity measures, establish privacy safeguards	Kshetri (2017), Conti et al. (2018)
Public Trust and Adoption	Enhance public education, address concerns about security, privacy, and stability	Raskin & Yermack (2016), ECB (2020)

Table 6: Future Research Directions

Research Direction	Description	Representative Studies
Technological Advancements	Investigate emerging technologies to enhance digital currencies	Narayanan et al. (2016), Catalini & Gans (2016)
Economic Impact	Study long-term impacts on monetary policy, financial stability, and economic growth	Bordo & Levin (2017), Armelius et al. (2021)
Interdisciplinary Approaches	Encourage interdisciplinary research combining economics, technology, law, and public policy	Eichen green (2019), Brunnermeier et al. (2019)

These tabular representations provides a concise and structured overview of the findings from the literature review, facilitating easy reference and comparison of key insights, benefits, challenges, and recommendations related to digital currencies and their impact on monetary policy.

Conclusion:

The literature review on digital currencies and the future of monetary policy highlights the transformative potential of digital currencies, encompassing crypto currencies, stable coins, and central bank digital currencies (CBDCs). Each type of digital currency offers unique benefits and presents distinct challenges, impacting financial systems and monetary policy in various ways.

Key Findings:

Classification and Characteristics:

- i. Crypto currencies like Bitcoin are decentralized and volatile, primarily serving as speculative assets rather than stable financial instruments.
- ii. Stable coins aim to reduce volatility by pegging their value to fiat currencies or assets, offering more stability for everyday transactions.
- iii. CBDCs, issued by central banks, are designed to enhance payment systems, improve monetary policy implementation, and promote financial inclusion.

Potential Benefits:

- i. **Enhanced Efficiency and Lower Costs:** Digital currencies can streamline transactions by eliminating intermediaries, thus reducing transaction times and costs.
- ii. **Financial Inclusion:** They have the potential to provide financial services to unbanked and under banked populations, particularly in developing regions, thereby promoting economic empowerment.
- iii. **Improved Monetary Policy:** CBDCs enable central banks to have more direct control over money supply and interest rates, which can improve the effectiveness of monetary policy. Real-time data from digital transactions provide valuable economic insights.

Challenges:

- i. **Stability and Control:** The widespread adoption of private digital currencies could undermine national monetary sovereignty and lead to financial instability.
- ii. **Privacy and Security:** Digital currencies face significant cyber security threats, including hacking and fraud. Balancing transparency with privacy is crucial to prevent misuse of data and ensure user trust.
- iii. **Implementation and Adoption:** Successful implementation of digital currencies requires substantial technological and infrastructural investment. Public trust is essential for widespread adoption, necessitating measures to address security, privacy, and stability concerns.

Global Case Studies:

China's digital yuan, Sweden's e-krona, and the Bahamas' Sand Dollar provide practical insights into the diverse objectives and implementation strategies of CBDCs. These case studies demonstrate improvements in transaction efficiency, financial inclusion, and payment system stability.

Policy Recommendations:

- i. **Regulatory Frameworks:** Developing clear and comprehensive regulatory frameworks is essential to ensure the stability, security, and transparency of digital currencies.
- i. **Security and Privacy:** Robust cyber security measures and privacy safeguards must be implemented to protect digital currency systems and user data.
- iii. **Public Trust and Adoption:** Enhancing public education and addressing concerns related to security, privacy, and stability are crucial for the successful integration of digital currencies into the financial system.

Future Directions:

- i. **Technological Advancements:** Future research should explore emerging technologies that could further enhance the efficiency, security, and functionality of digital currencies.
- ii. **Economic Impact:** Long-term studies are needed to understand the full economic impact of digital currency adoption on monetary policy, financial stability, and economic growth.
- iii. **Interdisciplinary Research:** Combining insights from economics, technology, law, and public policy can provide a holistic approach to addressing the challenges and opportunities of digital currencies.

The review underscores that digital currencies hold significant promise for transforming monetary policy and financial systems. However, realizing their full potential requires overcoming considerable challenges related to stability, security, privacy, and public trust. Ongoing research, interdisciplinary collaboration, and thoughtful policymaking are essential to navigate the evolving landscape of digital finance. By leveraging the benefits and mitigating the risks, digital currencies can contribute to more efficient, inclusive, and resilient financial systems worldwide.

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