The effect of digital currencies on traditional financial systems

Digital currencies, with their remarkable possibilities and potential for disruptions, are making waves that are astonishing even technical and financial experts. The three main types of digital currencies are Cryptocurrency, Stablecoins, and Central Bank Digital Currencies (CBDCs). Cryptocurrency, in particular, took the world by storm during the pandemic, with hundreds of millions investing in this instrument globally. This essay analyzes the possible effects of various digital currencies on financial markets and global economies.

With an untraceable and decentralized transaction system using digital ledgers and blockchain technology, cryptocurrencies have fascinated investors, drastically increasing their demand. Their value relies entirely on market forces, resulting in extensive price fluctuations. This makes cryptocurrencies a highly volatile investment with the potential for generating windfall returns, attracting high-risk traders.

An additional lure of cryptocurrency is its blockchain technology, which allows people to transfer money without financial intermediaries or centralized inter-bank transfers. In addition to faster transfer speeds and reduced costs, cryptocurrency provides a more secure and private platform for money transfer[1].

However, a field inadequately explored is cryptocurrency's influence on a country's fiscal budget. In many countries, such as India, cryptocurrency is categorized as property. Therefore, any related gain or loss becomes subject to a 30% Capital Gains Tax and a 1% Tax Deducted at Source (TDS)[2]. The revenue generated helps reduce the budget deficit, creating a surplus that the government can reinvest in other areas such as healthcare or education. Although a far-fetched connection, it shows the possibility of cryptocurrency to impact a wide variety of fields.

Another impressive feature of this digital currency is its near impossibility of being hacked. However, the lack of government regulations increases the potential for misuse. The anonymity of cryptocurrency resulted in more than 200% increase in black market transactions and money laundering schemes between 2022 and 2024[3].

A problem while transferring money via cryptocurrency, legally or illegally, is that its price is too unstable to act as a store of value (a fundamental feature of money) – a problem that CBDCs or Stablecoins can counter.

CBDCs are electronic versions of fiat currencies with the same features and operate under central bank regulations. Their electronic nature adds to the ease of transferring, making CBDCs more appealing to consumers. While this currency improves trade efficiency, it poses a substantial threat to banks. Transferring deposits to CBDCs could reduce bank funding, increase costs, diminish economic investment, and potentially harm firms and markets[4].

Stablecoins, on the other hand, work similarly to fixed exchange rates. Their value is pegged to that of another fiat currency, either centrally or algorithmically. Stablecoins are similar to forex trading but with more direct transactions. Although it may seem like an easy investment with few caveats, of late, Stablecoins are ironically seen as being quite unstable. TerraUSD's crash in May 2024 resulted in a 90% loss in value and market capitalization, leading to temporary pressure on and de-pegging of Tether (the most popular stablecoin). This incident translated into an outflow of over $8 billion, resulting in disastrous outcomes for investors[5].

In conclusion, digital currencies have greatly influenced the approach to money management, investing, and financial risk management, bringing opportunities and challenges in their wake. As digital currencies evolve, they continue to shape our economic future, offering new ways of thinking and using money.

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