Central Bank Digital Currency: An Idea Whose Time Has Come, or a Dangerous Misstep?

by Howard Davies[31]

Florida Governor Ron de Santis, not a regular commentator on technological developments in the payments system, has a clear view on the notion of a Federal Reserve sponsored digital dollar. In March 2023 he announced legislation 'to protect Floridians from a Federally-controlled Central Bank Digital Currency (CBDC) and Surveillance State'[32] The CBDC, he proclaimed, is 'the most recent way the Davos elites are attempting to backdoor woke ideology into the US financial system.'

The source of his concern is that once the Fed can oversee all consumer spending, it will be a short step to banning some transactions: 'You go and use too much gas, they're gonna stop it… you wanna go buy a rifle they're gonna say no.'[33] Others on the right of US politics have made rather more sophisticated points with a similar import. The Cato Institute have argued that a CBDC would 'threaten financial privacy and financial freedom, and undermine the banking and cryptocurrency industries.' According to a survey they conducted, only 16 per cent of Americans support its introduction.[34]

At the other end of the political spectrum, the oversight powers a CBDC could give the central bank is seen as one of its key attractions. The head of

31. Chair of the Natwest Group. Professor at Sciences Po, Paris.
32. Governor Ron de Santis announces legislation to protect Floridians from a Federally-controlled Central Bank Digital Currency and Surveillance State. 20 March 2023 www.flgov.com.
33. De Santis on fed digital currency. www.tampabay.com 16 April 2023.
34. 'Only 16% of Americans support the government issuing a CBDC.' 31 May 2023 www.cato.org.

the People Bank of China's digital currency research institute, Mu Chang Chun, has emphasised the attraction of a digital currency for combatting financial crime, arguing that the authorities can 'use big data and data mining technology and conduct identity comparisons, we will be able to find the culprits[35].' Civil liberties concerns do not loom large in their thinking.

In pressing ahead with plans for digital currencies central banks have stirred up a hornet's nest, and not only at the extremities of the political marketplace. The UK House of Lords Economic Affairs Committee has taken an interest in the Bank of England's plans. Their report concluded that they had 'yet to hear a convincing case' for a retail CBDC.[36] They concluded that the idea was 'a solution in search of a problem.' An analysis prepared for the Econ committee of the European Parliament reached a similar conclusion. Its authors were 'doubtful on the wisdom of eventually launching a digital euro (Angeloni, 2023).'

So why are central bankers around the world, with varying degrees of enthusiasm, embarking on this hazardous journey, at a time when their credibility is low after a period when inflation soared well above their targets. Perhaps a single-minded focus on rebuilding a reputation for sound financial management would have been a preferable strategy?

The most obvious answer is that cash usage is in decline, and in some places paper currency may disappear before too long. Try buying a beer in Stockholm with a 100 kroner bill. Though your money may be good, you will go thirsty: almost no retail outlets in Sweden accept cash of any kind. The volume of cash in circulation is falling fast, indeed has almost halved in the last decade. Switch, a mobile payment system introduced in 2012 by a consortium of banks, dominates the market. It has 8 million users: the Swedish population is little over 10 million.

But Sweden is an outlier. In the UK there is £80 billion of sterling cash in circulation, and the quantum has continued to rise, albeit more slowly than before. In the Eurozone the volume of cash outstanding has only just begun to drop back, albeit very slowly. In the US there is $2.25 trillion in issue, though

35. Quoted in 'China's proposed digital currency more about policing than progress.' Brenda Goh and Samuel Shen. 1 November 2019 www.reuters.com.

36. Central bank digital currencies: House of Lords Economic Affairs Committee report. 30 January 2023 www.lordslibrary.parliament.uk.

much of it is held outside the States, especially in higher denomination notes. There is no sign of a decline, though spending a $100 bill in New York is close to impossible unless – or so I am told – you are buying recreational drugs. So in most countries reports of the death of cash as a store of value are exaggerated, though it is true that the proportion of transactions carried out in physical form is declining almost everywhere. In the UK, as an example, over the last decade cash-based transactions have fallen from 21 billion a day to 7 billion, while debit card transactions have risen from 2.3 billion to 7.5 billion.

The second stimulus for the central bank work on CBDCs came from the company formerly known as Facebook.

At the end of each year's IMF/World Bank autumn meetings the Group of 30 organise a private session for central bankers and bankers. It is often the most informative meeting of the week. I well recall the session in October 2019 at which Facebook were invited to present their plans for a stablecoin, then known as Libra. Their representative explained that Facebook's aim was financially to enfranchise the poor of the planet and quickly to replace the world's fiat currencies. Digitally facilitated commerce would migrate to their own platform. The underlying message was that the central banks' time as managers of the global money supply was coming to an end and that, frankly, Facebook would do a better job for us all. They would, incidentally, make a huge amount of money from what would in effect be interest-free loans from the population – which is what a dollar bill amounts to – but that advantage was not a declared part of the pitch.

The central bank Governors in the front row could see their seigneurage income, which keeps them in the style to which they have become accustomed, disappearing before their eyes. Their sinews stiffened, and they decided to fight back. Benoit Coeuré of the ECB threatened that 'the bar set for regulatory approval will be very high.' He described the Libra announcement as 'a wake-up call' and called for the ECB to 'step up its thinking on a central bank digital currency[37]'.

The subsequent demise of Libra was not a surprise. Facebook tried in a number of countries to secure regulatory approval for it and failed. After a

37. Spooked by Facebook's Libra, euro zone to step up work on public crypto currency. 13 September 2019. www.saudigazette.

time it was renamed Diem, to confuse the enemy, but the regulators were unmoved. In the end Facebook accepted defeat and in January 2022 sold the technology (which the central banks in fact regarded as intelligent and well-designed) to a Californian bank called Silvergate, which itself collapsed in March 2023. (One of its high profile clients was FTX).[38]

Diem was, therefore, never launched, and has become a footnote in the history of cryptocurrencies. But the work it triggered in the central banking community has continued: the Governors in Basel had glimpsed the future, and did not like what they saw. So they set their technologists to work.

The Bank for International Settlements has been assiduous in tracking CBDC activity around the world. Their 2022 survey, published in July 2023 (Kosse and Mattei, 2023) showed that 94 percent of all respondent central banks were working on a CBDC. Perhaps surprisingly, in view of the political sensitivities, the 2023 survey showed that 'Work on retail CBDC is more advanced than on wholesale CBDC.'

Almost a quarter of central banks were piloting a retail version and the BIS forecast that there would be 15 retail currencies circulating by 2030. So even though, in almost all cases, there have been no changes in the law to facilitate such issuance and no formal political support for it, central banks were pressing ahead, on the unstated assumption that the privacy and competition issues can easily be resolved.

That may be a heroic assumption, and even some central bankers have acknowledged that they have not so far succeeded in winning over public or political opinion. The Governor of the Austrian central bank, Robert Holtzmann, has recognised that 'what is still missing is a convincing storyline for the digital euro, something which we can put in front of the people'.[39] EU Commissioner Mairead McGuiness, who put plans to approve the e-euro to the European Parliament last year, has now backtracked, telling MPs that 'there is no pressure on parliament or council to finish this piece of legislation… I think slowing down is a very healthy thing.'

38. Facebook ditches Diem stablecoin with asset sale to Silvergate, Roman Dillet. 27 January 2022. www.techcrunch.com

39. Digital euro conspiracy theories and privacy concerns put EU central bankers in the hot seat. Jack Schikler, Coindesk. 11 September 2023. www.sg.news.yahoo.com.

Part of the reason for this growing reticence among policy-makers is that the central banks have found it challenging to defend their plans against the charge that a CBDC may threaten financial stability. It is widely accepted now that it would need to be delivered through commercial banks: central banks have balked at the prospect of opening millions of accounts for private citizens. They are simply not equipped to do so. (When I was the Deputy Governor of the Bank of England in the 1990's staff members could hold accounts there: persuading your local curry house to accept a Bank of England cheque was quite a problem, and there were only two ATMs – at head office, and the Bank's printing works - that would accept it.)

But if every account-holder at a private sector bank has a central bank wallet on their mobile phone in addition to their current account, a bank run is just a click away. A speculative social media rumour about the health of a bank could trigger an instant reaction. The failure of Silicon Valley Bank last year showed how quickly a bank run can now develop. And the second order consequences could be very significant. If a commercial bank lost customer deposits rapidly the central bank, as regulator, would need very quickly to decide whether the problem was one of liquidity or solvency. If the bank is insolvent, the central bank would need to put it into resolution very quickly. But if the central bank concluded that the bank affected by the run was fundamentally viable, it would need to redeposit those transferred funds with the illiquid bank, quickly becoming its largest source of funds: an uncomfortable position for a regulator to be in. And it might take a long time for that position to be unwound.

In its own analysis of the potential impact of a CBDC, the Federal Reserve has acknowledged these concerns (Carapella *et al.*, 2024). The Fed recognises that banks 'might suffer larger or more frequent runs in the presence of a CBDC', and furthermore that 'a CBDC may weaken financial stability by reducing the ability of banks to extend credit at times of stress.' Their conclusion is that in stress times the rates charged to borrowers 'may increase by 50 to 250 basis points,' and that lending to corporates may reduce by between 1 and 5%. The percentage is not huge, but would be material. They recommend that central banks should attempt to reduce the attractiveness of a CBDC, by adopting a model in which CBDC holdings do not attract interest, and by imposing holding limits. The ECB has proposed that there should be a

€3,000 euro limit on any individual holding a digital euro account backed by the central bank.

Controls of that kind would certainly help to mitigate the financial stability risks. The prohibition on internet payments on CBDC is uncontroversial, as cash does not generate a return (except perhaps in the unusual case where deposit rates at the central bank turn negative). But a holding limit would make a CBDC fundamentally different from the cash it purports to replace. There are no holding limits on bank notes – through putting a large volume of cash back into the banking system may be a challenge for anti-money laundering reasons. So solving the financial stability problems may come at the expense of one of the principles on which the case for a CBDC is founded. The more you offset the financial stability risks the less perfect a substitute for cash the CBDC becomes.

With a low holding limit, as proposed by the ECB, the CBDC looks like a safety valve which would close, rather than open, when the system is under pressure - an odd concept. So why are some central banks still keen to press ahead?

The Bank of England has tried harder than most to construct an intellectually coherent argument. It presents the primary case for a digital pound as being to ensure 'the role of UK central bank money as an anchor for confidence and safety in our monetary system' (H.M Treasury and the Bank of England, 2023), with a secondary argument that it will promote 'innovation, choice and efficiency in payments.' Note that the case advanced by Facebook, that a global stablecoin was needed to reduce the cost of cross-border payments, has now been relegated to a list of 'other motivations'.

By no means all central banks are persuaded of the merits of these arguments. Randy Quarles, the former Deputy Chairman of the Fed, is a prominent opponent. 'CBDCs, he argues, are driven by FOMO (Fear of Missing Out) and vulnerability to mass suspension of our critical thinking and to impetuous deluded crazes and fads'.[40] Stephen Cecchetti, the former Chief Economist of the BIS, argues that a rash of CBDCs will not improve the global payments system, and could result in a 'bad equilibrium' where 'a world of multiple CBDCs in advanced economies threaten financial stability

40. Fed's Quarles compares CBDC rush to parachute pants and FOMO. 28 June 202. www.pymnts.com.

domestically.' He argues, furthermore, that a CBDC cannot be anonymous, to avoid facilitating criminal activity, and that a tight holding limit makes no sense as, if one were imposed 'there would be circumstances when bank liabilities will not be convertible into CBDC at par' (Schoenholtz and Cecchetti, 2021). In attempting to respond to financial stability and privacy concerns, the central banks have produced a camel: a horse designed by a committee.

Others point out that there is no shortage of innovative private sector developments in the payments system. Facebook's world-conquering model may have been a bridge too far, but stablecoins are developing rapidly and the cost of cross-border payments is falling. India provides an example of how a Unified Payments Interface, stimulated by the government through the creation of nationwide digital identifiers, can bring digital payments to a huge proportion of the population, with no need for a CBDC.[41]

But perhaps, in the deepest recesses of the central banks' vaults, there are other arguments in play. In particular, there is a difficult question of monetary sovereignty in a world in which cash disappears – though that day is a long way off in most countries, as we have seen. The Fed hints at some concerns in its own discussion paper on a digital dollar, which is in other respects less forthcoming and enthusiastic than similar papers from the ECB. They note that a potential benefit of a CBDC 'could be to preserve the dominant international role of the US dollar,' raising the spectre of a world in which other CBDCs might be 'more attractive than existing forms of the US dollar', so that 'global use of the dollar could decrease'.[42]

The ECB's concerns are slightly different. They have become anxious about the US tendency to 'weaponise' the dollar payments system, by excluding countries from it through their sanctions regime. In the case of Russia, in the light of the war in Ukraine, US and EU interests have been aligned, so far, but that has not always been the case in relation to Iran, for example. There could well be other examples of non-aligned foreign policies in the future. Perhaps a digital euro would create a way round that potential problem? That may be behind the ECB's claim that a digital euro would 'safeguard monetary sovereignty' (Panetta, 2022).

41. A digital payment revolution in India. 15 May 2023. The Economist www.economist.com.
42. Money and Payments: the US in the age of digital transformation. January 2022. Board of Governors of the Federal Reserve System. www.federalreserve.org.

Conclusion

The world's central banks have, in the last five years, devoted considerable resources to projects designed to produce a proof of concept for a CBDC. Some have gone so far as to pilot a live version. The Peoples Bank of China has done so in 4 cities, and has announced a partnership with the Singaporean authorities to allow the e-CNY to be used there. Three Caribbean countries have launched CBDCs, though a recent review by the Kansas City Fed concluded that 'a few years after launching, none of the Caribbean CBDCs had yet achieved widespread adoption'.[43]

And so far none of the major Western central banks have made a firm commitment to go ahead. The Fed's declared position is that they will not move forward without specific legislative approval, which seems unlikely to be forthcoming in the near future. Most Republican elected officials are instinctively hostile, even if they are not all as vocal as Governor De Santis. And the EU Commission and Parliament, who were moving towards legislation last year, have applied the brakes, at least temporarily.

In these circumstances it may be wise for the central banks themselves to act cautiously. After the last two years when their credibility has taken a hit while inflation soared, they do not need another failure, or to enter the highly controversial territory of civil liberties and privacy. There is a far stronger case today for a wholesale CBDC, which raises fewer concerns among politicians and the public. Indeed there are signs that the market for a wholesale CBDC is beginning to open up. In June 2024 the World Bank issued its first Swiss Franc digital bond. It uses distributed ledger technology and settles using a Swiss Franc wholesale central bank digital currency from the Swiss National Bank.[44]

Bruegel, the Brussels think tank, have set out the advantages of beginning with a wholesale euro. They argue that consumers in the eurozone benefit already from a very efficient retail payment system, and that 'creating a CBDC for retail purposes in the euro area offers little obvious added value, at least for the foreseeable future' (Demertzis and Martins, 2023), whereas they see a strong case for building a digital currency that can be used for wholesale

43. Observations form the Retail CBDCs of the Caribbean. Franklin Noll. Kansas City Fed. 10 April 2024. www.kansascityfed.org.
44. World Bank to issue CHF Digital Bond settled using Swiss Franc CBDC. 19 May 2024. www.newsbitcoin.com.

cross-country payments. Central banks could then settle directly with each other, rather than via the US dollar, which is often the case today. As they point out, since banks already have accounts at the central bank, a wholesale CBDC 'does not need to be created from scratch'.

The most recent BIS survey shows that at least some central banks are coming round to that view (Di Iorio *et al*., 2024), in June 2024 they noted that over the last year, the emphasis has changed, and the BIS conclude that 'the likelihood that central banks will issue a wholesale CBDC within the next six years now exceeds the likelihood that they will issue a retail CBDC.'

Starting with a wholesale euro would be a practical, useful step the ECB could take. It would not be front page news, perhaps, but central banking is not a popularity contest, and a retail CBDC raises many issues which have yet to be addressed. Wholesale discretion may be the better part of valour in today's political climate.

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