Opinion **Free Lunch**

The main objection to digital currencies is misguided

Bank disintermediation could be a feature, not a bug

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Cambodia launched its official electronic currency in October © Brent Lewin/Bloomberg

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Everything is being digitised, and our monetary and payments systems are no exceptions. Regular readers will know that official ecash, or central bank digital currencies (CBDCs), is one of our favourite topics — complicated enough to require unpacking, rapidly evolving, and with the potential to radically transform how our economies work.

So let us highlight a recent flurry of developments. A new CBDC has appeared, with Cambodia following The Bahamas in issuing official electronic currency. And the imminent Winter Olympics has long been expected to be where China would showcase the digital renminbi it has been trialling.

In advanced countries, inquiries into CBDCs by official bodies are coming thick and fast. A few weeks ago, the UK House of Lords published a report. Then the Federal Reserve issued a discussion paper on the pros and cons of a digital currency. And two experts, Markus Brunnermeier and Jean-Pierre Landau, have just written a report on a digital euro for the European parliament. The Bank for International Settlements, an intellectual leader in the area, does not let it go long between each speech or article about it, most recently by its general manager Agustín Carstens on digital currencies and the "soul of money".

Anyone interested should take a look at all these reports because they illustrate very well the range of attitudes to CBDCs. The Lords report exemplifies the instinctive scepticism of many: it dismissively suggests CBDCs are a "solution in search of a problem". The Fed comes across as painfully open-minded — forced not to fall too far behind other central banks' explorations but rather wishing the challenge to go away. The BIS and the digital euro report represent the vanguard of official thinking, in that they are converging on a view that CBDCs are a necessary response to an inevitable digitisation of money.

I expect everyone to arrive there in the end. There are many possible answers to the Lords' stated inability to identify the problem CBDCs are supposed to solve. Everyone agrees cross-border transfers such as remittances are far too expensive, for example, and that CBDCs could help remedy this. Most see that innovation is happening fast in payments services, and that in the absence of an official digital currency, a private one could supplant not just official money but commercial bank deposits. It was, after all, the prospect of a "Facebook coin" that spooked central bankers into studying CBDC in earnest.

Brunnermeier and Landau put it most clearly:

> "The main rationale for developing a digital euro is therefore to preserve the role of public money in a digital economy."

This recognition has been growing in official circles — especially in emerging economies, as former Indian central bank chief Duvvuri Subbarao points out — but it comes grudgingly. It has typically been matched with an immediate presumption that private financial actors can meet the challenges at least as well as central banks. And that is quickly followed by the question of what it will do to the private financial sector if central banks come in to provide a digital currency.

That, it seems to me, is the main cause for hesitation among policymakers. The worry is that an easily accessible CBDC would be so attractive that customers would prefer it to bank deposits, whether for transaction money or as a safe store of value, and thereby destroy the business model of commercial banks: to fund of value, and thereby destroy the business model of commercial banks: to fund loans with deposits, backing our main form of transaction money with ultimately illiquid investments.

But there are problems with this argument — beyond the bizarre notion that the attractiveness of a product is a reason to ban it. One is that, as all the central bank reports acknowledge, there are ways to design CBDCs that defang them as threats to private banks. Another is that even if CBDCs are more attractive than bank deposits, the interest rate on digital cash could be set so low (even negative) to keep funding costs for banks as low as before.

But the most profound problem is the fundamental premise that our current private bank-driven monetary system is something worth preserving, and that threats against it have to be resisted or disarmed. We should at least dare to ask the question whether a disintermediation of private banks by CBDC may not be a risk to mitigate, but rather the most important answer to the Lords' haughty question of what a CBDC is supposed to achieve.

Think about it. Most of the money in circulation today is in the form of bank deposits — that is to say, private commercial banks' debts to their customers. The fact that all governments feel they have to guarantee a large portion of those private liabilities is a first hint at how strange this is actually is. Stranger still is how the total amount of such money is determined.

Deposit money is created when a (private) bank issues a loan, when it credits the borrower with a deposit in an account in return for a promise to repay. That is to say, banks do not lend out money that a customer deposits with them; they simply create new deposit money when making a new loan and cancel existing money when loans are paid back. (The Bank of England Quarterly Bulletin carried a great explainer a few years back.)

The upshot is that the total size of the broad money supply in our economies is an uncoordinated byproduct of commercial banks' decisions about how to issue and allocate credit. Now, the quantity of money in circulation, and above all how fast that quantity swells or shrinks, clearly has some impact on economic activity (otherwise why would central banks try to manage monetary conditions at all?). Yet there is absolutely no reason to think that what is individually optimal for private banks in their decisions about lending should ever coincide with the overall quantity of money that makes the economy the most productive and the safest it can be.

can be.

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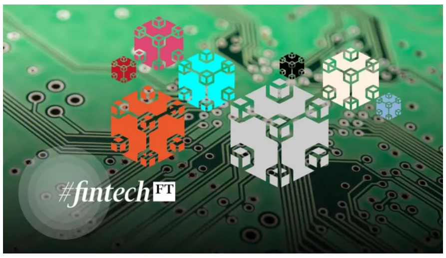

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In fact, it's even worse. The way the quantity of money is expanded or contracted by private banks is destabilising. That is because when money growth is fast, economic growth tends to be fast too, and the resulting optimism and high returns encourage banks to lend and hence create even more money. Conversely, when people default on their loans or pay them down, jobs are lost and growth slumps, giving banks fewer reasons to lend.

What CBDCs could do is to separate the processes that determine the total amount of money in circulation from the processes that allocate credit. In such a system, banks would have to do what we tend to naively think (before we read the BoE explainer linked to above) that they are already doing: bidding for customers to deposit their existing money balances with them, and putting those balances to good use by lending them on to borrowers they have identified as creditworthy. All the while, democratically controlled policymakers would directly determine the total amount of money in circulation, without getting involved in credit allocation. Put that way, disintermediation begins to sound like quite a good thing.

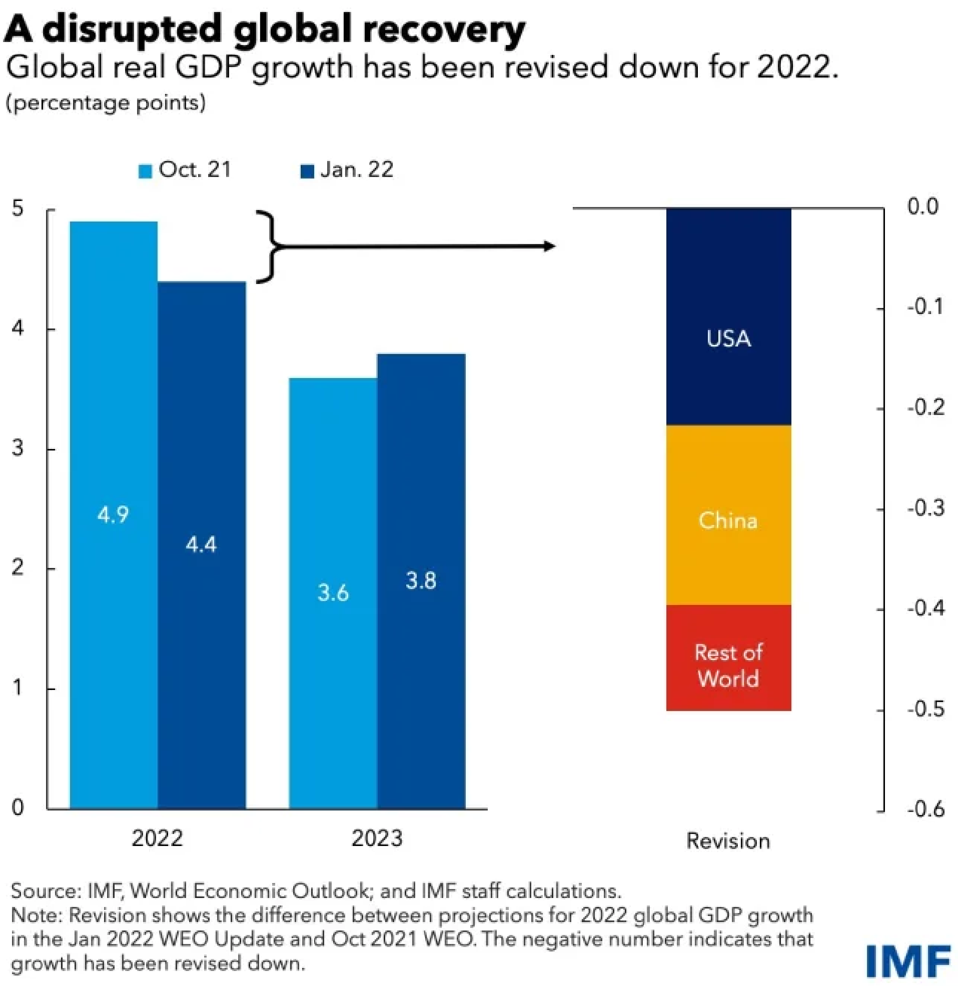
Other readables

- The Federal Reserve's press conference this week makes some market observers expect a faster tightening of US monetary policy.

- Yet new economic research offers a novel argument to keep monetary policy loose in an "unbalanced global recovery" like the one we have today. Luca Fornaro and Federica Romei point out that while central banks face the full costs of domestic inflation from stimulus, the benefits spill over across borders — by stimulating the production of goods whose short supply are driving global inflationary pressures goods whose short supply are driving global inflationary pressures.

Numbers news

- The IMF has downgraded its growth forecasts. Martin Wolf dissects the analysis.



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