Central Bank Digital Currencies – a 'solution in search of a problem' or the future of digital money

Mark Foster, March 2022

Central Bank Digital Currencies (CBDCs) are probably as sexy as supervisory monetary policy gets. Global central bankers (ECB, US Fed, Bank of England, Swiss, Japanese and Chinese) and international standard setters (BIS and FSB) are spending significant resources evaluating potential costs and benefits.

As digital currencies, stablecoins, e-money wallets, instant and cross-border payments systems play an increasingly large part in a rapidly evolving financial services landscape, it's worth taking a step back to think more about the motivations in creating CBDCs in the first place. Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, gave a speech last summer at the American Enterprise Institute, concluding CBDCs remain a 'solution in search of a problem'.

But industry thinks otherwise. Market driven innovation is quicker, nimbler and more efficient at developing products and services for consumers than regulators, legislators and supervisors are at putting in place appropriate frameworks in which market participants operate. The digital revolution has only exacerbated and sped up this private/public sector divide.

Arguably, public sector interest in CBDCs stems more from a fear of losing control of monetary policy to private stablecoin and cryptocurrency operators rather than a real desire to digitalise monetary policy. It's no coincidence that it took the launch of Libra in 2019 for the official sector to sit up and take notice, with several, including the G7, the Council and European Commission and France and Germany, refusing to allow stablecoins to operate without a legislative framework.

Since then, the European Commission has produced draft legislation to establish a new fully harmonised EU legal framework regarding the proper functioning of crypto-asset markets (though not directly addressing CBDCs) known as MiCA, which is due to start the trilogue process in April – the Council adopted its position in November last year, the EP adopted its report recently. The European Commission is understood to be working already on a future legislative framework for CBDCs expected for early 2023.

The European Parliament's Policy Department published an interesting study recently entitled 'The digital euro: policy implications and perspectives', analysing the challenge as 'a solution of continuity, where the digital euro would be issued as a digital version of cash and conceived to preserve, rather than disrupt, current monetary arrangements'. Understandably perhaps, given the authorship, the study concluded that ‘for the digital euro to produce all its expected benefits, it must develop in an appropriate regulatory environment, sufficiently conducive to the uniformity of the currency’.

Another recent parliamentary report from the House of Lords’ economic affairs committee offers an interesting political take on CBDCs. Echoing Waller’s conclusion, the report argues there is ‘no convincing case’ for a UK CBDC and that ‘while a CBDC may provide some advantages, it could present significant challenges for financial stability and the protection of privacy’. Whilst the key findings do concede ‘some benefits from the introduction of a ‘wholesale’ CBDC’ (and it’s worth citing here a recent successful wholesale Swiss project as further evidence of this) the majority of recommendations focus on potential downside risks, particularly to retail consumers, such as cyber-security and public concern over the risk of state surveillance.

Speaking at a recent launch webinar of the City of London’s 2022 benchmarking study several industry representatives expressed disappointment in the Lords’ report, with one speaker asserting that downside risks had been over-emphasised to the detriment of benefits such as reduced fraud and increased cross-border payments. Another panelist inferred that lawmakers were lagging industry and was convinced that, driven by developments in Asia in particular, CBDCs would be a reality in the next decade.

One aspect of the Lords’ report confirms my assertion that legislators follow where industry leads. The report suggests the UK’s interests would be better served by ‘taking action to shape global standards’ rather than developing a digital pound. That position sits pretty uneasily with the UK government’s stated objective of being a global leader in digital finance. It also assumes influence at international level on a subject over which domestic politicians seem reticent to overtly support – a challenging mandate for UK officials in the dialogues with their international counterparts.

Similarly, the US Fed appears inclined to pass the buck to politicians, launching a paper earlier this year expressly stating it ‘does not intend to proceed with issuance of a CBDC without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law’. In the meantime, President Biden has issued an Executive order on crypto (factsheet here) directing agencies to accelerate research into a CBDC and to speed up the decision on whether to launch a digital dollar.

One thing seems clear: the need for appropriate legislative frameworks for CDBCs. In developing domestic CBDCs, governments and lawmakers should develop a collaborative international dialogue, creating an interoperable system. Maybe then the solution will become self-evident, enabling digital money to thrive.

Strategic Advisory Management
E: info@samadvisory.eu