THEMATIC

New money and maybe new powers too: Central Bank Digital Currencies are coming

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While it is still too early to see a full launch in a large country, the CBDC (Central Bank Digital Currency) theme is likely to grow in importance in 2021. Over the recent period, central banks have accelerated their studies and tests in this domain. As an instrument for helping economies adapt to digitalisation, CBDCs are also intended to bolster a state's monetary sovereignty in the face of new challenges. However, their implementation raises complex issues, including those concerning their coexistence and interaction with bank deposits. While not yet viewed as serving a primary role as a new instrument of monetary policy, CBDC could nevertheless offer new possibilities in this area.

Recent announcements have put a spotlight on the CBDC development programmes of major central banks, although stages of advancement vary significantly.

It is very unlikely we will see a major country introduce a fully functional retail CBDC this year[1]. That said, central banks, including some of the larger ones, seem to be speeding up their preparatory work. China's PBoC, for instance, has conducted new tests in several large cities in recent weeks (others may be rolled out shortly in Beijing and Shanghai) while the ECB recently concluded a vast survey to decide whether it will launch a concrete project in the second half of the year (full deployment could happen in 2024 or 2025). While the US Federal Reserve's communication on the subject remains more cautious[2] (which does not mean it is not looking closely at the mater), certain central banks of smaller countries (Sweden notably, that is already testing its e-krona) are at a more advanced stage[3].

The goal in creating retail CBDCs is to give the public access to a digital currency that retains a certain number of the characteristics of physical currency.

Like physical currency and unlike bank deposits, retail CBDCs will constitute a direct liability for the central bank, eliminating in principle any credit risk for the holder. Depending on the selected architecture (direct or indirect account of the end-holder with the central bank, and/or a digital token that can be used online or offline, etc.), such currencies could offer (albeit not completely) similar advantages of portability and confidentiality to notes and coins. However, their immunity to different undesirable events would differ (e.g. CBDC and physical currency would not be vulnerable to the same types of criminal activity or disaster).

The motivations for CBDC projects vary quite a lot across countries

Among other roles in supporting the digitalisation of the economy, CBDCs would pursue sovereignty objectives.

CBDC projects are part of a general public policy effort around the adaptation to digitalisation and the creation of ecosystems conducive to financial innovation. By reducing the use of physical currency (although to differing degrees depending on the country) and intensifying online exchange in several domains, the Covid crisis has added to the incentives already existing in this area. The relative weight of different motivations to develop CBDCs varies a lot across countries: for instance, in a number of emerging economies, they are seen as a way to improve the financial inclusion of people who cannot easily access the financial system. However, among their various aspects, CBDCs are also perceived as a means for states to preserve (or strengthen) their monetary sovereignty in the face of new challenges. More than with highly volatile cryptocurrencies such as Bitcoin, public authorities seem to be concerned with the development of private retail "stablecoins" (centralised or decentralised digital assets that are pegged to a traditional currency[4]), as well as with the prospect that foreign CBDC could become easily accessible to their own citizens[5]. In normal times, and even more so during times of crisis, competition between such alternative

[1] *To date, only the Bahamas has already launched a functional retail CBDC, in October 2020.*

[2] *On 14 Jan 2021, J. Powell mentioned that the Federal Reserve felt no "need or urge to be first" and that it would be years, rather than months, before it had a CBDC ready. Among the justifications he provided for this patient approach was the first mover advantage given by the US dollar reserve currency status.*

[3] *In total, a Bank or International Settlements report in January 2021 indicated that 86% of the more than 60 Central Banks it surveyed (covering all of the world's major economic powers) were exploring the topic of CDBCs with central banks representing a fifth of the world's population (presumably meaning at least China) "likely to issue a general purpose CDBC in the next three years".*

[4] *Facebook, in particular, is set to launch its digital currency, Diem, in 2021.*

[5] *Christine Lagarde explicitly mentioned this risk in a communication in l'ENA hors les murs on 30 Nov 2020.*

THEMATIC

CBDCs have, among other, sovereignty objectives

New monetary policy possibilities could in theory be vast

currencies could have the effect of eroding the status of a traditional currency, and even lead to destabilising capital movements (both domestic and international)[6]. The extent and nature of this sovereignty aspect is, however, very different depending on the power of the country concerned and the international status of their currency: serving as a defensive instrument for some, the CBDC could, on the other hand, be used as a means of external influence for others.

The development of a CBDC implies taking into account its possible consequence for banking systems.

Economic agents holding domestic CBDC alongside bank deposits (which are also dematerialised but are liabilities of private sector financial institutions) raises the issue of the respective roles and interactions of these two asset categories. Central banks will, in fact, have to define the future terms of competition (a ceiling on holding of CBDC by a single person or entity is sometimes mentioned) and plan for or prevent the changes that their coexistence could bring on banks' cost of financing, risk profile, and the mechanisms by which they normally create currency. They will also have to determine the extent of the role of intermediary played by banks in giving the public access to CBDC (since central banks thus far have not been equipped to interact directly with individuals, it is generally envisaged that commercial banks would be given this role). These are complex issues that, in addition to the technical and operational aspects, warrant a cautious pace of progress by the authorities.

Although not developed for this purpose at present, CBDC could serve as a new instrument of monetary policy.

At present, no major central bank seems to view CBDC as serving a primary role as a new monetary policy instrument (beyond the strengthening of the legitimacy and use of the official national currency). Nevertheless, many observers (including the central banks themselves) are reflecting on such a possibility and its major implications. An initial aspect is that a CBDC could lower the "effective lower bound" of monetary policy if, for example, they carried negative interest rates or, by contrast, increase it to zero if they constituted zero-rate assets which are less costly to hold (in terms of storage and security) than physical currency. A second aspect is that a CBDC could, in theory, become a "programmable currency" whose possibilities of use (time-limited, restricted to certain expenditure, etc.) could be managed dynamically by the authorities. Other possibilities, such as new interactions between monetary policy and fiscal policy, are also envisageable. Visibility in this domain is as limited as the theoretical possibilities are vast.

CBDC could therefore have many consequences, some of which would be complex and difficult to figure out; considerable work and additional testing is therefore vital before they are introduced. However, with the gradual reduction in the use of physical money and the rapid development of digital rivals for traditional currencies, it is very likely that we will see CBDC introduced within a few years. This could impact on many sectors of domestic economic and financial life, as well as international financial equilibria.

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[6] *Public authorities' concern over the excessive power of large private payment systems players may also be an incentive for some Central Banks to develop CBDCs.*

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