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ISSUES OF CURRENCY POLICY AND EFFICIENCY OF BANKS

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Abstract

Digitalization is reshaping economic activity, shrinking the role of cash, and spurring new digital forms of money. Central banks have been pondering whether and how to adapt. One possibility is central bank digital currency (CBDC)—a widely accessible digital form of fiat money that could be legal tender. While several central banks have studied the adoption of CBDC and have undertaken pilots, many have not actively explored it and remain skeptical.

Keywords: digital currency, central bank, currency, technology, transaction, tool, method, investment.

INTRODUCTION

This discussion note proposes a conceptual framework to assess the case for CBDC adoption from the perspective of users and central banks. It abstracts from cross-border considerations by assuming that CBDC is for domestic use only. This note discusses possible CBDC designs, and explores potential benefits and costs, with a focus on the impact on monetary policy, financial stability, and integrity. This note also surveys research and pilot studies on CBDC by central banks around the world. The main takeaways are as follows:

- The impact of CBDC introduction will hinge on its design and country-specific characteristics. Critical features will be anonymity (the traceability of transactions), security, transaction limits, and interest earned. The role of cash and commercial bank deposits in payments will also matter.
- CBDC could strengthen the benefits and reduce some of the costs and risks to the payment system and could help encourage financial inclusion. However, demand will not necessarily be very high and will depend on the attractiveness of alternative forms of money. Moreover, there are other payment solutions to help central banks more fully achieve their goals relative to money. CBDC will have to contend with



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operational risks arising from disruptions and cyberattacks.

- Token-based CBDC—with payments that involve the transfer of an object (namely, a digital token)—could extend some of the attributes of cash to the digital world. CBDC could provide varying degrees of anonymity and immediate settlement. It could thus curtail the development of private forms of anonymous payment but could increase risks to financial integrity. Design features such as size limits on payments in, and holdings of, CBDC would reduce but not eliminate these concerns.

MATERIALS AND METHODS

1. **The impact of digitalization is widespread and profound.** It is changing the nature of jobs, education, commerce, innovation, and product life cycles. Demographics are accelerating these developments. Millennials now outnumber baby boomers (Tilford 2018) and are steering the economy toward their world—one in which digital platforms are central, and nearly second nature.

2. **Payments, and more fundamentally money, are also undergoing tremendous change [2].** Technology, new employment arrangements, and the growing decentralized service economy, as well as evolving social attitudes, are driving efforts to build new and more decentralized forms of money. These offer peer-to-peer transactions, micropayments, and easy-to-use interfaces integrated with social networks. Payments are increasingly being diverted toward privately run solutions. Even cryptocurrencies such as Bitcoin, Ethereum, and Ripple—still early in their development cycle—offer competing forms of money.

3. **Deep and pressing questions arise.** Is there a role for cash, or a cash-like form of money, in the digital world? Should central banks offer new forms of money? If so, what are the implications for monetary policy and financial intermediation, stability, and integrity?

4. **Central banks are taking these questions seriously.** Several are actively investigating the possibility of a central bank digital currency (CBDC). This new central bank liability would be a widely accessible digital form of fiat money, intended as legal tender. One day, it could fully replace physical cash. CBDC seems to be a natural next step in the evolution of official coinage (from metal-based money, to metal-backed banknotes, to physical fiat money).



RESULTS AND DISCUSSION

CBDC could be account- or token-based, the former involving the transfer of a claim on an account and the latter of a token between wallets. A transaction in account-based CBDC would resemble today's transactions between commercial bank depositors, except accounts would be held with the central bank. A payer would log in to an account at the central bank—for example, through a web page or an app on a handheld device—and request a transfer of funds to a recipient's account, also at the central bank (Figure 1). The central bank would ensure settlement by updating a master ledger, but only after verification of the payer's authority to use the account, sufficient funds, and authenticity of the payee's account. The exchange of information would therefore be substantial [3].

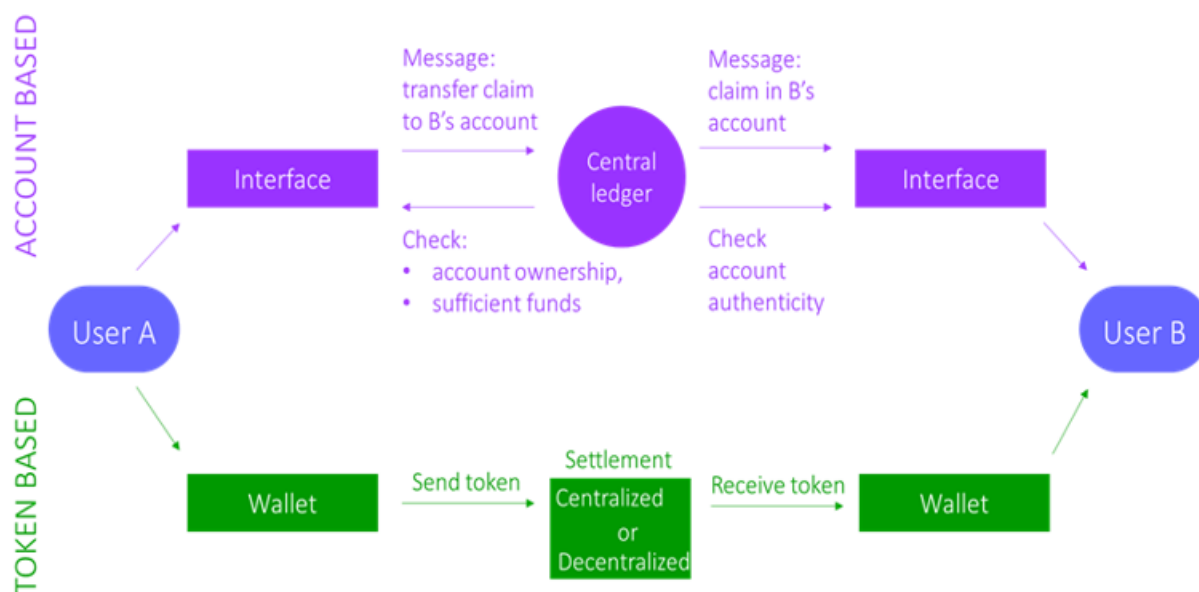


Figure 1. Account- and Token-Based CBDC, Basic Mechanics

Transacting in token-based CBDC would involve more steps than exchanging cash but would offer the convenience of not having to meet in person. Unlike cash—the prime example of a traditional token-based form of money—CBDC tokens would be too complex to be distinguished from counterfeits by parties to the transaction. Settling a transaction using token-based CBDC would require external verification of the tokens. As a result, transactions might not be entirely anonymous, like cash. The extent of anonymity would depend on whether wallets are registered and transaction information is recorded.

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CONCLUSION

The trend is already evident in some countries and is expected to become more widespread. Sweden is probably the most striking example. In other countries, cash in circulation as a share of GDP has actually increased in the past decade, as documented in Bech and others. In addition, the demand for cash is likely to diminish as older generations give way to more technology-adept generations. Merchants and banks in both advanced and developing economies are also trying to discourage cash transactions, given the related costs.

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