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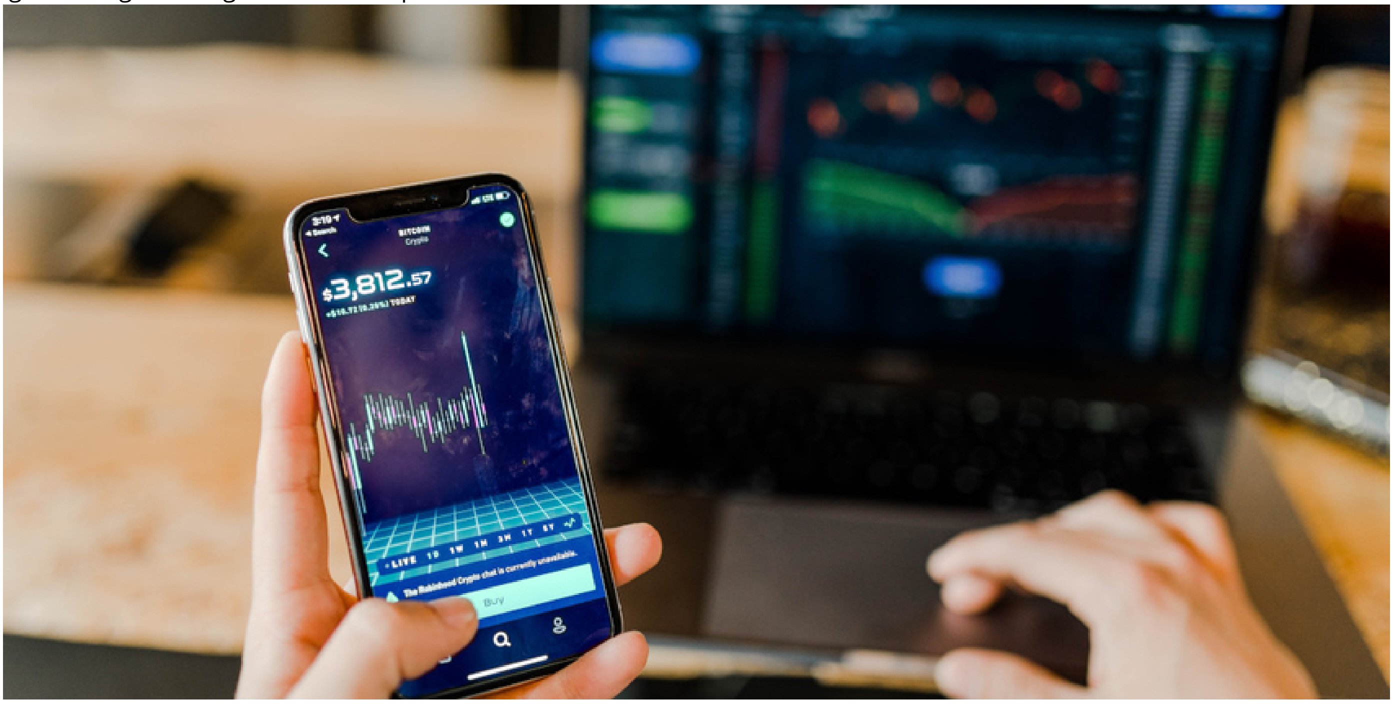
Some unwanted consequences of a digital euro

Ignazio Angeloni: Digital currencies put central banks to the test in their essential function



Digitalization is ubiquitous in today's life, so it should not be surprising that it enters the domain of central banks as well. The appearance of Bitcoin in 2008 and the announcement of Libra in 2018, which Facebook reportedly intends to launch next year in limited format, aroused the interest of central banks, creating some alarm. After all, those innovations threatened their primeval function of creators of safe means of payments opening the door to less reliable alternatives.

More recently, central banks have started contemplating a direct involvement as direct producers of digital currencies (central bank digital currency, or CBDC). The European Central Bank has recently signaled an interest in getting involved. Its communication was largely non-committal so far but there have also been signs that it may consider the issuance a "digital euro" not a remote option, but a matter of time.

CBDC paves the way for bank runs

The ECB should think twice. As well known, CBDCs have risks as well as possible advantages; both are discussed in a recent report of the Bank for International Settlement (BIS). The point, however, is that some of the dangers involved are of special relevance to the euro area due to the specific features of its monetary union and of the ECB's monetary control framework.

First, by offering a readily available and totally safe alternative to bank deposits, CBDCs facilitate runs on bank deposits. In a crisis, depositors and other short-term investors move out of unsafe banks to avoid losses. Such losses may be so great that no interest rate penalty is sufficient to discourage the flight. This risk is greater in the euro area due to incompleteness of its banking union, the absence of a common deposit insurance and the existence of bail-in provisions which allow losses on uninsured deposits and other funding sources.

The Eurozone is prone to design flaws

Since weaker banks are still concentrated in certain jurisdictions, runs may easily re-ignite the adverse bank-sovereign loops and euro-exit fears already experienced in the euro crisis in 2010/2011 and again in the Greek crisis of 2015. At its root, the problem is that CBDCs allow a riskless entity (the central bank) to compete with risky ones (private banks) in the same market segment (means of payment). This is a design flaw the euro area is particularly vulnerable to.

Second, a digital euro would interfere with the ECB operational framework. In the euro monetary control framework, money market rates move within a range defined above by the penalty rate of the marginal lending facility and below by the rate on free overnight bank deposits at the central bank. This "corridor" has moved down in recent years and QE has forced market rates adhere to the lower end of it (the "effective lower bound") – the deposit rate, which is now negative. The rate set by the central bank on the digital euro could hardly diverge from that of the deposit facility.If it did, it would give rise to arbitrage operations, involving banks possibly with treasuries of large non-financial corporations. As a result, the deposit rate, a critical monetary policy variable under QE, would become hostage of the rate on the digital euro, which the central bank may wish to adjust based on considerations other than monetary policy.

An unwanted tax in form and substance

Thirdly, a digital euro available to all, bearing negative interest rates, would be a direct taxation imposed on citizens by the central bank. All central bank seigniorage is in essence a form of taxation; the difference here would be that with a CBDC the veil of appearance would fall resulting in a taxation in form, as well as in substance. While it is hard to foresee the political and legal consequences of this, one may well imagine circumstances in which the independence of the central bank – at least in setting the interest rate – would be challenged. Again, the risk is especially grave in the euro area, because the power of taxation is a national prerogative in force of the EU Treaty.

If the digital euro were made accessible to all subjects without limits, the above risks would be most evident. These risks would be mitigated if limits were imposed, for example, by excluding certain categories of holders or segmenting the remuneration by adopting a tiering system. However, in that case the advantages would be reduced as well. And, again, segmenting the population of eligible holders of digital currencies would give rise to multiple arbitrage channels, creating distortions and possibly frustrating those very limits over time. However, risks and drawbacks would be lower if holdings of CBDC were restricted to official institutions, like foreign central banks and sovereign wealth funds. A CBDC scheme targeted to this type of holders would limit the risks while retaining the double advantage of allowing the ECB to be at the cutting edge of digital money technology and encourage the international use of the euro.

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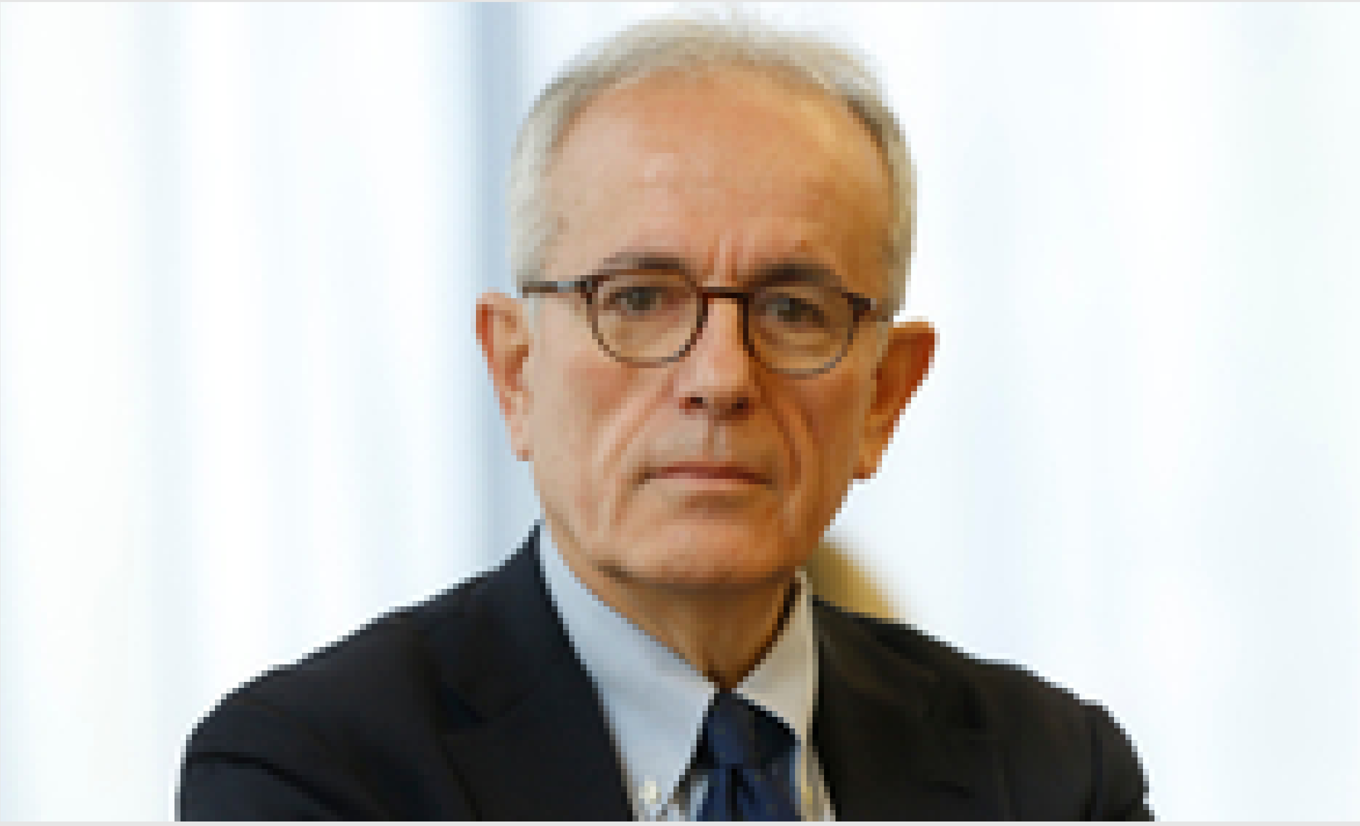

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