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The digital euro – a different route to banking union?

Tom Huertas: The introduction of the digital euro would de facto bring about banking union. But this would be on the books of the ECB. If banks are to participate in banking union, there must be a Single Euro Deposit Guarantee Scheme

The European Central Bank decided in July 2021 to progress toward the implementation of a digital euro. This would potentially enable everyone to have an account directly at the central bank. More recently, EU officials once again called for the completion of the European banking union and the introduction of a European deposit guarantee scheme. Enthusiasm for the digital euro is mounting; that for banking union remains – to put it mildly – restrained.

Does this matter? Yes, it does. The digital euro is effectively a collective obligation of the euro-area member states. Holders will prospectively be able to use the digital euro to store value as well as to transfer and receive value. The digital euro is an asset that will retain its value in euro, even if a credit institution fails or a member state defaults on its debt. As ECB executive board member Fabio Panetta recently stated at the ECON Committee of the European Parliament, the digital euro will be risk free.

That cannot currently be said of bank deposits, even covered deposits. Although covered deposits are insured, this insurance is only as credible as the backstop behind it. Although member states may backstop national deposit guarantee schemes, such a backstop cannot guarantee that a euro in covered deposits shall remain a euro, particularly if it is the default (or even the decline in creditworthiness) of the member state that causes the bank issuing the deposits to fail.

Preferring a digital euro over a bank deposit

A digital euro would expose this fundamental flaw in the current euro area crisis management and deposit insurance framework. If individuals and institutions have the choice of holding either a digital euro or a bank deposit, they are likely to opt for the former, particularly if the bank concerned is weak and/or headquartered in a poorly rated member state. In such an environment, funds would flow to the ECB, and it would be up to the ECB to allocate credit, either directly or indirectly. That would produce banking union, but on the books of the ECB.

The ECB is well aware of the adverse impact that the digital euro could have on financial stability. Partially for this reason, policymakers have suggested that there should be a limit on the amount of digital euros that an individual or institution may hold, or that the digital euro should carry significantly negative rates. Over the coming year the ECB plans to narrow down the design options and to introduce a prototype in 2023.

But history suggests that there is nothing so temporary as a permanent limit, and economics suggests that it will be difficult to find an interest rate that makes the digital euro attractive relative to cash (physical currency) and crypto whilst remaining unattractive relative to deposits. Indeed, it is practically impossible to devise an interest rate that would make the digital euro unattractive relative to a deposit in a bank that is about to fail.

The need for euro deposit insurance with a European backstop

Consequently, to keep their deposits from flowing into the digital euro banks will need euro deposit insurance with a European backstop. This would protect covered deposits not only from the risk that the bank could fail, but perhaps more importantly from the inability or unwillingness of the authorities to put banks into resolution as soon as they reach the point of non-viability.

As SAFE White Paper 85 points out, a euro deposit insurance can be had for little additional economic cost, thanks to the super seniority of covered deposits under the Bank Recovery and Resolution Directive (BRRD), the progress banks have made toward meeting Minimum Requirement for Own Funds and Eligible Liabilities (MREL) subordination requirements, the contributions that banks have already made to the Single Resolution Fund (SRF) and the guarantee that the European Stability Mechanism provides to the SRF.

All that needs to be done is to make the SRF the Single Deposit Guarantee Scheme, make the use of resolution via bail-in to facilitate orderly liquidation under a solvent wind-down strategy the single presumptive path for dealing with failing banks, and to make sure (by making the ECB the single lender of last resort) that authorities do not exercise forbearance and let banks operate past the point of non-viability. It is not necessary to touch the funds amassed by national deposit guarantee schemes. Such schemes can and should function solely as institutional protection schemes.

Taken together these steps would strengthen the safety of deposits, minimise recourse to taxpayers, and promote financial stability. Last but not least, they would increase the likelihood that the digital euro will not end banking as we know it, but usher in a banking union that would involve banks as well as the ECB.

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This blog post is based on the SAFE White Paper No. 85 "Reset required: The euro area crisis management and deposit insurance framework", which was submitted to the targeted consultation on CMDI framework by the European Commission.

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