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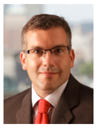
Central-Bank Digital Currencies: Debunking Five Common Myths

Insight from sub-adviser, Wellington Management



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Key Points

- In our view, central bank digital currencies (CBDCs) will coexist with both cash and existing forms of electronic money, rather than replacing them.
- We think policymakers are aware that if central banks compete with the nonsovereign financial sector, it will prove too disruptive to the existing system.
- CBDCs could enable more precise and targeted macro policy by providing stimulus and subsidies directly to specific groups of people, such as by age group, geography or occupation status.

CENTRAL-BANK DIGITAL CURRENCIES (CBDC'S) WILL, IN OUR VIEW, ALMOST CERTAINLY BE ISSUED AND WIDELY USED IN THE FUTURE. In five years, we believe there will be roughly a dozen CBDCs and, in 10 years, we think nearly every country will have them. After all, 85% of central banks currently have a CBDC project.[1]

CBDCs will likely never be a large part of the overall money supply, however, which mainly consists of financial-system deposits (rather than those at a central bank). In our view, they will coexist with both cash and existing forms of electronic money, rather than replacing them. We believe the demand for paper money will ensure that it will not be eliminated in most countries for decades or even longer.

In this short paper, we discuss how disruptive CBDCs are likely to be and dispel some commonly held CBDC myths.

CBDCs' Potential for Disruption

In theory, CBDCs could be significantly disruptive, as they could compete with bank deposits, facilitate capital flight, or have substantially different characteristics. For example, they could automatically pay negative interest rates or even have an expiration date.

In practice, however, we do not believe CBDCs will be as disruptive as commonly advertised. We think policymakers are aware that if central banks compete with the nonsovereign financial sector, it will result in disintermediation.[2] Thus, in our view, policymakers will ensure CBDCs are, in most relevant ways, a complement instead of a substitute for private-sector money and financial services.

Notably, we believe fintech[3] will thrive in a CBDC world, and CBDCs will become important inputs that can be leveraged for all sorts of financial products for individuals, firms, and governments alike. They could enable much more precise and targeted macro policy, for example, by providing stimulus and subsidies directly to specific groups of people, such as by age group, geography, or occupation status.

Debunking Common CBDC Misconceptions

As market interest in CBDCs grows, we believe they have caused some consistent misconceptions. Here, we look to dispel five of the most frequently discussed CBDC myths.

CBDCs aren't new. What's new is the fact that they can now quickly establish themselves.

Misconception #1: CBDCs Are New
In the past, it was common for central banks to accept retail deposits. For example, the Bank of Spain did so until 1962. In addition, central bank digital currency (in retail form) existed as early as the 1990s, when Finland introduced the Avant Card. However, central-bank retail deposits were abolished so that central banks would not compete with the rest of the financial system. And the Avant Card failed because its network of users was too small. So, what is new is not CBDCs, but the fact that they can now quickly establish themselves within modern digital networks, where buyers and sellers can access them effortlessly and ubiquitously.

Misconception #2: CBDCs Will Massively Disrupt the Banking System
Central banks no longer allow retail deposits because doing so disrupted the outside banking system and the overall financial system. For this reason, we believe central banks will only allow functionality to the extent that it does not disintermediate the private sector or other outside players. With that said, CBDCs will likely place significant competitive pressure on areas where governments see the industry's products as a public good, such as payments.

Misconception #3: CBDCs Will Make Private-Payment Systems Redundant
As noted above, we think policymakers will be careful not to cause too much disruption with the introduction of CBDCs. After all, their main role is to preserve stability and protect the financial sector itself. In our view, most payments in the economy, whether in China or in the West, will remain digital and electronic, but will involve private money such as bank deposits or Alipay,[4] rather than CBDCs.

Misconception #4: CBDCs Will Be Extremely Functional and Complex
It is exciting to think about the possibilities for CBDCs to transform macro policy. And it may be scary to think about the possibilities for governments to track every single transaction a person makes. But it is important to remember that with every new functionality for a CBDC, there is also a new cost. In our view, this means central banks will be very careful to make sure the public will accept the currency. We believe this means, for example, ensuring that below a certain denomination all transactions will be anonymous, just as with cash. Notably, however, in economies where most transactions are digital already, users have very little anonymity when it comes to their purchasing behavior.

Misconception #5: CBDCs Will Upend the Existing Dollar Reserve System
We believe it's unlikely that CBDCs in and of themselves will disrupt the existing international financial system. However, we do think they could be one of several factors (including economic and geopolitical fragmentation and the rise of unorthodox monetary policy in developed countries) that together could precipitate the biggest changes in international financial architecture since the end of World War II.

Recent Developments in Central Bank Digital Currencies

China's CBDC project, which started in 2014 with a 10-year implementation time frame, has been in testing phases for more than a year. It's available in increasing numbers of cities and also internationally, via agreements with the authorities of Thailand and the United Arab Emirates. The currency will

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likely remain in trial mode for at least several years, until policymakers are satisfied with the currency's functionality or if other countries' currency debuts put increased urgency on the plan.[5]

Recently, the Biden administration in the US, along with the US Federal Reserve, appear to be taking the topic more seriously.[6] Notable developments elsewhere in the world include Sweden's e-krona project and Switzerland's Project Helvetia.[7]

Bottom Line: CBDC Investment Implications

In our view, CBDCs will be positive for financial-system development and could be a very useful tool for fintech. In addition, we think the ease of transactions could push liquidity into scarce assets (e.g., gold, crypto). However, we don't believe they will be a significant threat to traditional financial institutions or systems, though they could be sources of competitive pressure in some areas, such as payments.

Critically, we think CBDCs will increase in relevance and prevalence in the years to come and the above misconceptions are likely to be dispelled along the way.

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[1] International Monetary Fund, 2020.

[2] Disintermediation is the withdrawal of funds from intermediary financial institutions, such as banks and S&Ls, for the purpose of making direct investments.

[3] Fintech refers to software and other modern technologies used to support or enable banking and financial services.

[4] Alipay is a third-party mobile and online-payment platform established in Hangzhou, China in 2004 by Alibaba Group and its founder Jack Ma. Alipay is currently based in Shanghai.

[5] Sources: SCMP, April 2021. CGTN, December 2020. Wall Street Journal, April 2021.

[6] Bloomberg, April 2021.

[7] Reuters, December 2020.

Important Risks: Investing involves risk, including the possible loss of principal.

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