CARTWRIGHT

Central Bank Digital Currencies

Deconstructing Central Bank Digital Currencies

Central bank digital currencies, or CBDCs, are set to become an integral part of the global financial architecture. Here we explore the potential pros and cons of this emerging payments system and how it could impact our clients.

But what is a CBDC?

A CBDC is digital money for businesses and households alike that is backed and issued by a central bank. Unlike cryptocurrencies such as Bitcoin, its value will be fixed by the Bank of England and equivalent to the British pound. Like Bitcoin, every transaction using the digital pound will be permanently recorded on a digital cryptographic ledger in real time, but the system will be heavily centralized and controlled rather than distributed.

Potential Benefits

What is the point of a CBDC? Here are four potential benefits often cited by central banks:

1. Preserving the relevance of public money. Just 3% of British money takes the form of physical cash created by the BoE. The remaining 97% comes in the form of electronic bank deposits created by private commercial banks, which is not public money.

   The use of cash in the UK is dwindling fast while cryptocurrencies, particularly "stable coins," gain traction. There are also fears that tech giants will begin vying for market share in the financial sector, as has already happened in China with Tencent and Alibaba. If the world's central banks fail to respond with an alternative digital means of payment, the future of money could pass them by.

2. Improving cross-border payments. Moving money across borders today involves banks, payment processors, financial clearinghouses and international communication and exchange systems. With CBDCs, moving money across borders should become cheaper, faster and more transparent.

3. More targeted government spending. CBDCs will allow governments to operate at higher resolution. For instance, they could issue targeted microfinance grants straight to the accounts of people and businesses considered especially deserving. The central bank would also have a record of every transaction, making money laundering, terrorist financing and tax evasion much more difficult.

4. Tighter control over the levers of monetary policy. Central banks would be able to control how much money is sloshing around the economy with greater precision, injecting new money into the real economy more easily in the event of, say, a recession.

Risks and Dangers

But not everyone is convinced by the merits. Former Bank of England Governor Mervyn King says it is "far from clear" that a CBDC has the answers to its potential risks, of which there are many.

One potential risk – the disintermediation of commercial banks -- could directly impact the pension fund industry. Since central bank money is perceived as 100% risk-free, many people and businesses will hold part or all of their deposits or savings in CBDCs. During an economic crisis, panicked depositors could pull their money out of private banks and transfer it into CBDC accounts, resulting in widespread bank runs.

To mitigate this risk, the BoE has proposed setting a maximum deposit limit of £20,000 for each CBDC account. But even that could imperil the financial health of many commercial banks, particularly smaller ones, in turn hampering their ability to pay their pension covenants.

Broader Risks

The introduction of a digital pound could also generate broader economic or financial risks as well as exacerbate existing ones:

1. Higher inflation. Every time a bank makes a loan, it conducts a risk assessment. This has a constraining effect on money creation. However, if central banks can create and inject as much money as they want into the economy, at little risk to themselves, this will result in increased inflationary pressures.

2. System fragility. In its report on CBDCs, the House of Lords Economic Affairs Committee warned that a CBDC would create "a centralised point of failure that would be a target for hostile nation states or criminal actors." An outage in the power grid, IT or telecommunications systems could also disrupt the CBDC network. If such a failure were to occur with a Digital Pound, it could result in a loss of confidence in the BoE, the one institution backstopping the entire banking system.

3. Effects on basic freedoms, privacy and democratic rights. A Digital Pound goes hand in hand with Digital Identity. A comprehensive national digital ID management system, already under development, will mean broader and closer scrutiny of everyone's most personal data.

Although the BoE insists it would have no access to users' personal data, so-called "payments interface providers" (PIPs), all from the private sector, will. Many believe citizens' personal data could be sold. PIPs are likely to include the UK's large commercial banks as well as tech giants such as Amazon, Alphabet (Google), Apple Facebook and Microsoft.

A CBDC, if launched, would allow money to be "programmable," thereby giving the issuer control over how it can be spent by the recipient. Combining digital currencies with digital IDs while gradually phasing out the use of cash would, in theory, give governments, central banks and PIPs the ability not only to track every purchase we make but also to determine how we can and cannot spend our money, where we can spend it, how long it stays in our account before expiring and, in an extreme case scenario, if we can spend it at all.

At the click of a mouse, individuals or organizations engaging in activities deemed to be socially undesirable could simply have their digital assets temporarily deleted or their accounts' ability to transact frozen, locking them out of the financial system. No need for emergency powers or compulsion of intermediary financial institutions.

This article is primarily intended to bring awareness to this emerging issue, and we would welcome feedback from our clients to help us shape our strategy going forward. Our present position is that many of the potential benefits cited by CBDC proponents can be achieved through other means, without causing yet further stress and disruption to an already vulnerable financial system. But what do you think?

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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