Economic Insight

Be cautious with a digital ECB euro

Like other central banks, the ECB is discussing the pros and cons of issuing a digital alternative to its physical coins and notes. But digital central bank money entails risks and should be implemented only under strict conditions. In case of doubt Germany should oppose such proposals.

Representatives of the ECB are discussing the pros and cons of issuing a digital alternative to their physical coins and banknotes. [1] This could be digital ECB euros stored locally, e.g. on a card or in a mobile phone app which take over the function of a wallet. Digital euros could also be held in an account at the ECB. With such digital versions of the euro, the ECB could react to the fact that physical cash is increasingly perceived as uncomfortable and is replaced by electronic payments via bank accounts.

Central bank money is the basis for ...

Most people should not see this as a problem. But many overlook that cash issued by the ECB is different from the money in their bank accounts. Coins and notes of the ECB – whether physical or perhaps soon digital – are the only legal tender and must be accepted by all creditors. The ECB can never run out of this money because it has the sole right to issue it. In this respect, central bank money is safe, it is the real money.

... the credibility of commercial bank money

By contrast, if someone pays with his debit card, he is transferring money from his bank account to the bank account of the seller. The balance in this checking account is commercial bank money and not central bank money. [2] Ultimately, commercial bank money can only be compared to central bank money because bank customers can demand that their deposits be paid out completely in cash, i.e. in the form of central bank money. This is the basis for the credibility of commercial bank money.

Digital central bank money only under strict conditions

But if at some point cash disappeared from business life – as feared by the Swedish central bank – commercial bank money would lack this anchor of trust. [3] Therefore, the ECB should consider a digital alternative to cash. But if wrongly designed, a digital euro could lead to new risks. It should only be introduced if the following five conditions are met:

- First, digital central bank money should not completely replace the physical one, but only supplement it. The citizens, not the central banks, should decide what they prefer to pay with.

- Secondly, digital central bank money, like cash, should not bear interest: At present, cash prevents central banks from massively pushing market interest rates into negative territory. For example, if they set the policy rate at minus two percent, it would be more favorable for investors to switch to interest-free cash – despite storage and insurance costs. Cash thus prevents the central bank from pushing through low negative interest rates in the real economy. This would change if digital central bank money completely replaced the physical money and paid a negative interest rate – with all the negative consequences such as pushing up property prices. I am therefore opposed to the proposal by many Anglo-Saxon economists that digital central bank money should pay (possibly negative) interest.

- Thirdly, the central bank must not distort the allocation of credit: if a citizen wants to exchange his bank balance for digital central bank money, his bank must transfer the corresponding amount of central bank money to his account at the central bank. [4] However, the decline of bank balance hardly frees up central bank money, because bank deposits are backed by only a small amount of central bank money – the minimum reserve. The central bank would have to close this financing gap. However, it should only do this by lending the banks the additional central bank money they need against collateral. In contrast, it should not provide central bank money by buying corporate or government bonds from the banks. The central bank would then indirectly finance individual companies or the state, thus distorting the allocation of savings.
Fourthly, precautions against bank runs are needed because, in real or perceived crises, investors could exchange their bank deposits for safe central bank money at a mouse click, thus destabilizing the banking system much more quickly than in the case of more inertial cash. It is true that the central bank is in principle prepared to make sufficient central bank money available to solvent banks. But the speed and scope of a digital bank run could overburden the central bank operationally. To counter these risks, citizens should only be allowed to exchange money into digital euros free of charge up to a certain limit. Amounts above this limit (probably held for investment purposes only) should be charged with a certain fee. The fees should be based on the costs of transporting, storing and insuring large amounts of cash.

Fifth, the introduction of digital central bank money may require changes in the EU treaty. However, the less stability-oriented member states should not take this as an opportunity to make the ECB even more involved in the indirect financing of states.

In case of doubt, Germany should dig in the heels

If the five demands mentioned above were politically unenforceable, the risks would outweigh the chances of a digital ECB euro. The Federal Government and the Bundesbank should then oppose such plans. After all, there is no time pressure with the digital euro. Cash is still popular in most countries.

[1] see for example Benoît Coeure, "The future of central bank money", speech given on 14th May 2018
[2] In accounting terms, central bank money is a liability of the central bank, while commercial bank money (also called fiat money) is a liability of the commercial bank.
[3] The Swedish central bank has made good progress in preparations for the possible introduction of a digital krona, see "E-krona project, report 2".
[4] The exchange of bank deposits into digital central bank money is comparable to a situation when a bank customer wants his bank balance to be paid out in cash. If the bank has not enough cash, it has to ask the central bank to pay out cash, the bank's central bank accounts is then debited with this amount. Its balance at the central bank therefore decreases in proportion to the amount of cash paid out to the bank customer.
[5] Unlike Markus Brunnermeier and Dirk Niepelt ("On the Equivalence of Private and Public Money"), I do not believe that the risk of a bank run can only be controlled by the central bank’s role as “lender of last resort.”
[6] Like Ulrich Bindseil in his most recent paper "Tiered CBDC and the financial system", I distinguish between the transaction and investment motive, but I am against interest on digital central bank money.
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