Will Central Bank Digital Currencies flow into unchartered territories?

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*A year after their 2019 paper "Understanding Central Bank Digital Currencies", the Cashless Society Working Party is revisiting the topic with a blog series. This time, Sabrina Rochemont wonders if a retail CBDC should be kept for domestic transactions.*

There seems to be a paradox in the global conversation about the potential launch of retail (general purpose) Central Bank Digital Currencies (CBDC). The threat of private cryptocurrencies to build their market from inefficient cross-border transactions partially motivated Central Banks to research retail CBDCs in depth and kick off pilots. Yet none have been openly discussing international access to such CBDCs.

Central Banks widely acknowledge that cross-border transactions have high latency and costs (around 7%, according to the Bank for International Settlements). Credit cards and digital wallets have become the main enablers of international payments, in addition to remittance services. A few large companies actually facilitate these transactions, suggesting an oligopoly. Central banks are also aware that budding cryptocurrencies are building on this inefficiency as part of their unique selling proposition.

The Bank for International Settlements (BIS) recently confirmed that none of the 17 countries studying retail CBDCs focus on cross-border payments, whereas many initiatives are under way to improve the payments' infrastructures. We have noted that a BIS paper calls out the opportunity, but Bank of England's recent discussion paper stops at suggesting that a CBDC design may offer building blocks for future cross-border transactions. So, why such silence on the matter? A recent private-sector led initiative may now change that void, through the release of a white paper for a Digital US Dollar, with a clear objective to protect the US Dollar as the world's reserve currency.

A first possible explanation is structural: amongst central banking researchers, there is intense debate on the fundamental choice between an account-based vs a token-based CBDC. Token-based money, such as cash, is a form of money in which value is stored in some kind of medium, and payments are made by transferring the monetary value stored in that medium. Whereas account-based money is transferred through debiting and crediting the value to and from accounts such as bank deposits on instruction from the payer.

Of those choices, only token-based money can be anonymous, a key characteristic of cash that is valued in international holdings of paper currencies such as the Dollar. An anonymous CBDC may be attractive to non-residents and amplify the economic and political power of a national currency. Would a central bank issue such an anonymous CBDC, risking compliance to Know Your Customer (KYC), Anti-Money Laundering (AML) and Terrorism Financing (TF) regulations? If it chose to do so, then the central bank would not be able to control access to that money. Conversely, the prospect of an account-based CBDC would be a better fit to design around the diverse territorial motivations for a Central Bank to issue a CBDC, as we explored in the paper "Understanding Central Bank Digital Currencies". Advanced economies may elect to offer a domestic CBDC to replace cash as a fundamental public service. Would an account-based CBDC be accessible to non-residents? If allowed, who would wish to hold non-anonymous currency with a Central Bank outside their resident country, apart from expatriates? Demand for cash increases in times of uncertainty, especially with financial stress, as observed at the start of the COVID-19 pandemic. However, the perceived risk of infection through handling cash then led consumers and businesses to prefer using contactless payments. Would such an account-based CBDC appeal to international holders in these uncertain times?

What else could explain that Central Banks aren't discussing international access to their future CBDC? Decisions on the international footing of a currency and the size of the Central Bank balance sheet would be political. Central Banks may be independent from governments for the conduct of monetary policy, yet the international standing of a currency is a political decision over its competitiveness for international trade. So, are Central Banks able and allowed to discuss such strategic decisions? A CBDC could launch as reserve currency, which could have meaningful global impact, such as in current trade wars: this may be a trigger for the launch of a Digital Dollar, to protect the US Dollar's unique international position. It may be also an opportunity for the Eurozone to boost the Euro's international role.

What would happen if CBDCs competed with each other internationally? Would a country break out for geopolitical advantage with a worldwide currency? The impact might be highest on developing economies and countries with weak currencies, where it might well lead to currency substitution. It would therefore be a threat to financial stability associated with loss of control over domestic economic and monetary policies. According to some studies, a worldwide currency would also lead to monetary policy synchronisation, and a race towards the zero lower bound, the lowest level that interest rates can fall to. Some currencies may also lose their domestic role in the process.

What would be the consequences of a reserve CBDC on capital flows? IMF Deputy Managing Director Tao Zhang stresses that "… *a CBDC used across borders could also have an impact on capital flow movements, the effectiveness of capital flow management measures, and the international monetary system*."

Given these levels of complexity, it may no longer surprise us that Central Banks are not openly discussing CBDCs for cross-border payments. Furthermore, this question may lead to an international agreement amongst leading economies to keep retail CBDC implementations domestic. But while Central Banks dither, cryptocurrencies and stablecoins are free to fill in the gap in cross-border transactions, as private entities no longer need a Central Bank to create a worldwide currency.