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CBDC: Central Banks Mobilize to Retain Control Over Monetary Sovereignty

The Covid crisis was just one of a number of factors that challenged traditional notions and habits around money. New technology has already transformed people's relationship with legal tender but more profound questions over "ownership" of money and payments systems are emerging. Against that background, central banks are accelerating their efforts in the area of digital currency.

Debate on the nature of money has hardly been as intense in living memory. The rise of digital currencies brings new levels of convenience and utility, but raises issues around fundamental attitudes towards money and monetary systems.

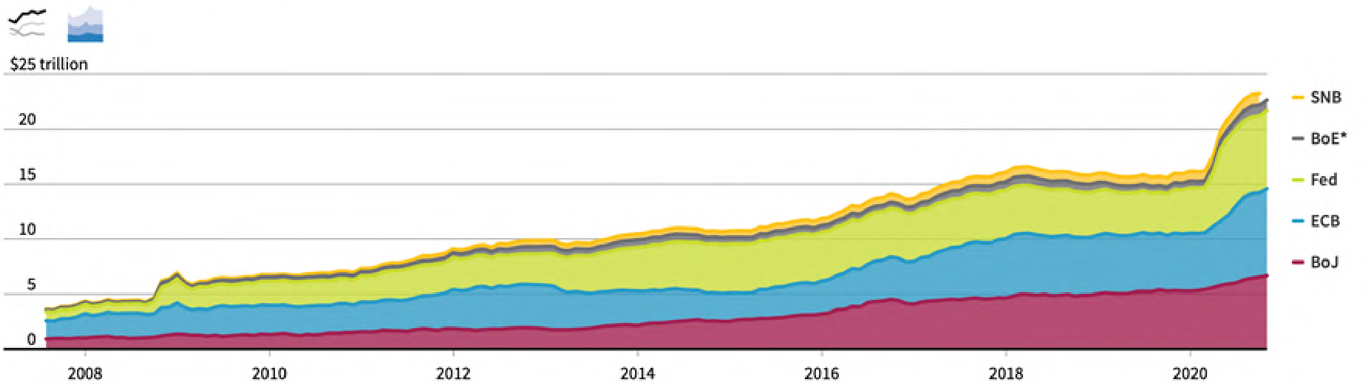
Fiat currency (money created under central bank 'fiat' or decree) has always needed the confidence engendered by central authorities for its legitimacy and adoption. But that historical confidence and legitimacy in the eyes of the public – while still relatively solid – is subject to a range of converging forces, affecting the perception of current and future manifestations of money.

First, there has been the quantitative easing policies pursued by central banks around the world since the global financial crisis of 2008, coupled with the rise of modern monetary theory (MMT) – a theory that posits that central banks who issue their own currency should issue just as much of it as they see fit in pursuit of their economic objectives.

Central bank balance sheets

Assets for the European Central Bank, Bank of Japan, Federal Reserve, Swiss National Bank, and Bank of England

Converted to U.S. dollars at current rate



*Combines the weekly series that stopped in September 2014 and, from then on, the sum of the four assets reported weekly that account for over 90% of the balance sheet by value.
Source: Thomson Reuters Datastream

In the eyes of some, it follows that the vast sums of money created by central banks – apparently out of thin air – in their efforts to stave off global recession, undermine faith and diminish the value of local currencies. Yet this massive increase of money in circulation found its way into rising asset prices rather than inflation. This, however, is no longer the case, and inflation is very much uppermost in the minds of the public as a range of factors force up prices at rates not seen this century.

Rise of cryptocurrency

One foundation of the fiat currency regime has been the lack of alternatives and another factor confronting traditional notions of money is the rise of cryptocurrency. One of the stated benefits of crypto – if not the major benefit as expounded by its promoters – is its decentralized nature. Cryptocurrency brings the prospect of a financial system operating outside the jurisdiction of governments and banks, so it is hardly surprising that central banks have opposed the idea from the outset.

This opposition ultimately led to the effective demise earlier this year of Facebook's proposed stablecoin Diem (a stablecoin is a type of digital currency intended to be less volatile than cryptocurrencies through its linkage with national currencies). The potential for cryptocurrency to serve as a haven for illicit funds is also a major concern of central authorities.

Guardians of monetary sovereignty

Above all, central banks are determined not to surrender their role as guardians of monetary sovereignty. The rise of highly volatile cryptocurrencies has led to concerns over financial stability and hence the European Central Bank, Federal Reserve, and Bank of England are all engaged in plans to launch their own digital currencies.

Nowhere are central bank digital currency (CBDC) plans more advanced than in China where the authorities are seeking to ensure that they retain control over a payments system that looked set to be taken over by the country's giant tech players. By the end of last year, the People's Bank of China's digital yuan pilot declared that its digital currency system was now being used by around 10% of its population (some 140 million people).

For some, the urgency with which China is pursuing its CBDC agenda is consistent with a wider geopolitical agenda. The prospect of a digital yuan available worldwide is potentially a threat to the global supremacy of the US dollar as the world's reserve currency.

What features of a CBDC would be most important to you? Select three.

% of responses, by country, ■ = greatest share of responses; Source: Ipsos MORI, OMFIF analysis

	All	Germany	Indonesia	Nigeria	US
You can use a CBDC everywhere	**29.1**	13.9	**40.1**	**45.2**	17.0
Payments using a CBDC remain private	20.7	11.4	**38.3**	20.7	12.2
CBDCs are 100% secure	**33.0**	**23.1**	31.6	**51.0**	**26.2**
You can pay with a CBDC using your smartphone and at payment terminals	20.6	7.3	27.2	37.5	10.7
You can store your CBDC on a physical card	9.0	5.9	11.1	9.7	9.1
Paying with a CBDC does not require power or an internet connection	14.4	9.5	17.0	23.7	7.5
A CBDC is simple to use	22.3	13.6	35.1	27.5	13.0
You don't pay fees to use a CBDC	24.7	**23.2**	25.8	27.9	**22.1**
Payment with a CBDC takes place instantly	17.1	7.6	17.5	32.1	11.4
None of these - I would not consider using a CBDC	**23.3**	**43.9**	**7.0**	**2.7**	**39.4**
Don't know	13.1	17.5	11.8	5.5	17.6

A survey conducted in November 2021 by OMFIF and G+D showed a sharp difference in attitudes toward CBDCs between consumers in developed and developing countries. Some 90% of consumers in Nigeria and 60% in in Indonesia said they are likely to use CBDCs. The equivalent figures for the US and Germany were 24% and 14%, respectively.

A central bank-issued CBDC retains all of the features and advantages of regular fiat-issued legal tender but it exists outside existing digital payment systems in that commercial banks are excluded from the transaction chain. Under CBDC, payment transactions take place instantaneously through a single digital ledger, doing away with the present requirement to pass through multiple banks – something that results in delayed processing over several days in many cases and particularly for cross-border transactions.

Additionally, consumers using CBDC would have no need to hold a commercial bank account – something with positive implications for financial inclusion. Gone also would be the fear of a banking failure as CBDC carries a government guarantee.

Commercial banks excluded?

Given these attributes, what role commercial banks will play in future CBDC payments systems is central to debate on their design, as widely-adopted CBDC threatens to remove or diminish banks' traditional retail funding sources.

Retail payments, and in particular cross-border remittances, have been at the heart of the FinTech wave, as new entrants correctly identified the obvious inefficiencies and expense in existing cross-border arrangements.

For emerging markets, the attractions of CBDC are many. It promises to be a major boost for financial inclusion, yet affordable communications technology is still just a dream for vast numbers of people, so central banks are considering how to include offline functionality in CBDC systems.

Development in wholesale CBDC is less marked than retail with some concern that technologies advanced may not possess the security features that capital markets demand. Nonetheless, progression in the CBDC arena is certain to transform wholesale markets.

The next 12 months will see significant progress in retail CBDC development among the major financial blocs. The challenge for central banks in their efforts to retain control of monetary systems and preserve stability is to achieve this while not stifling innovation in the private sector. Technological considerations may be among the least of the issues of concern. Instead, the challenge is to drive acceptance and to convince the public of the benefits of CBDC while securing political support, establishing standards and cross-border interoperability, and drafting international regulatory commitments.

Intuition Know-How has a number of tutorials that are relevant to this article:

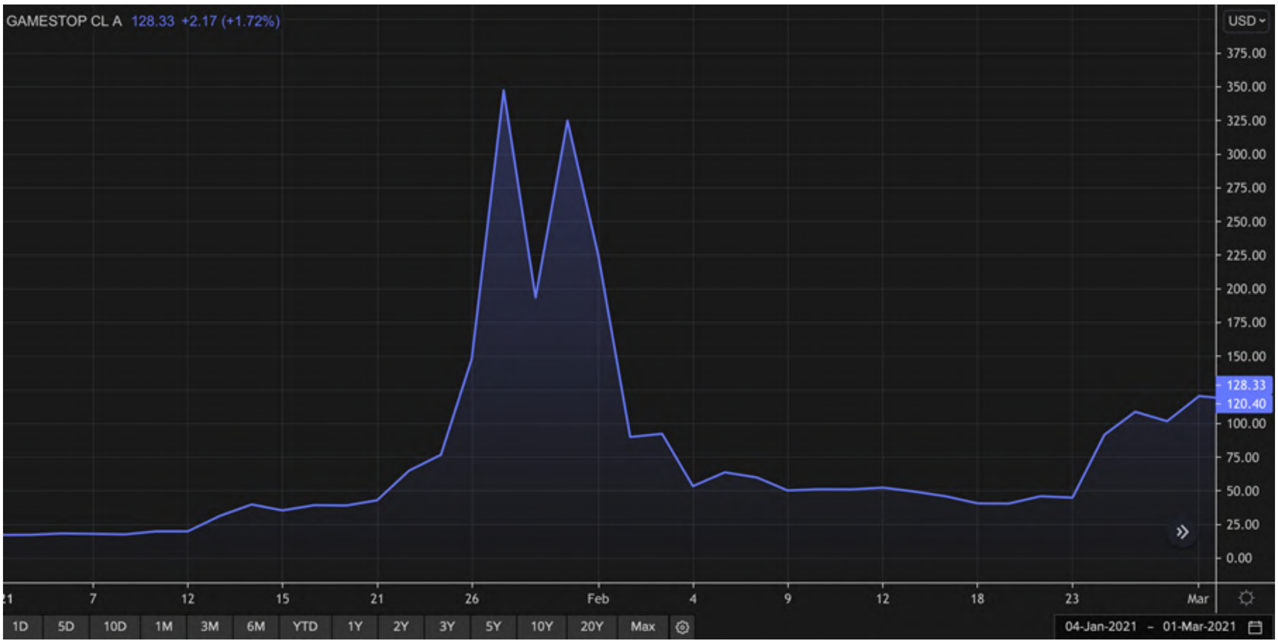
- Payments – An Introduction
- Payments Systems
- Digital Money & Mobile Payments
- FinTech – An Introduction
- Crypto Assets
- Monetary Policy Analysis
- Inflation – An Introduction
- Inflation Indicators

Regulator Concern at Online Investor Vulnerability

Both the European Commission and the SEC have expressed concern over the rise of “gamification” of retail investing and indications are that enhanced investor protection regulation is inevitable.

It was just over a year ago that the global stock markets witnessed one of the most unusual phenomena of recent decades.

With so many in the developed world locked down at that time due to covid restrictions, appetites for stock market speculation through online platforms spiked dramatically. Among that population of amateur retail investors were a determined group who, organized through social media, attempted (and succeeded) in frustrating the “shorting” of the GameStop stock by a number of hedge funds (“short selling” is an investment strategy that speculates that a stock will fall in value).



The rise and fall of Gamestop. Source: Refinitiv

The activities of the GameStop cohort may have been driven as much by political considerations as profit motivations, but the incident served to concentrate minds on the role of a number of innovative and aggressive online trading platforms, notably Robinhood. Concerns over inexperienced investors have been compounded by the massive growth in cryptocurrency trading with all of its extreme volatility.

The surge of retail interest in the stock market has abated somewhat, but questions over investor protection remain. Hence, in the United States the Securities and Exchange Commission (SEC) last August requested from the public *"Information and Comment on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology."*

The "digital engagement practices" (DEP) referred to by the SEC include tools such as *"behavioral prompts, differential marketing, game-like features (commonly referred to as gamification), and other design elements or features designed to engage with retail investors on digital platforms."* The overall objective of the SEC's request is to *"facilitate the Commission's assessment of existing regulations and consideration of whether regulatory action may be needed to further the Commission's mission."*

The impact of 'gamification' of investment has not been lost on European authorities either.

Similar concerns prompted the European Securities and Markets Authority (ESMA) to issue a statement that warned against making investment decisions based on information shared on social media. This drew even greater attention to the increasing role of digital platforms in the investment sphere – something recognized by the European Commission when it published its digital finance strategy in September 2020.

Capital markets and investor risks

Ironically, the role of technology is considered by the EU as fundamental to increased retail investor participation in financial markets. This deficiency is reflected in (although not the direct cause of) serious underperformance of European stocks relative to their US counterparts.

S&P 500 v Eurostoxx 600 - Rebased 20yrs. Source: Refinitiv

In support, the European Commission cites easier access to investment products and capital markets, easier comparability, and lower costs. At the same time, it also recognizes that new technology "can also carry risks for consumers (e.g. easier access to potentially riskier products)" and render investment protection rules "no longer fit for purpose".

In its attempts to develop its notoriously thin capital markets, the EU is adopting an integrated approach from the ground up. In January, it announced its Financial Competence Framework for Adults in the European Union, hailing it as a "key milestone" in its 2020 Capital Markets Union (CMU) Action Plan. Last August, it engaged in a public consultation in its efforts to "build retail investors' trust in capital markets" and a comprehensive study based on its findings is expected later this year.

A new retail investment culture?

GameStop and crypto are just the most visible evidence of the impact a new wave of digital investment platforms is having on the retail investment market, with a host of new entrants looking to bring a US-style retail investment culture to Europe.

While in principle the arrival of these new entrants would seem to be aligned with the goal to broaden and deepen EU capital markets, their offerings and delivery are likely to come under keen scrutiny at regulatory level. This is on the grounds that very many would-be investors possess inadequate knowledge or understanding of investment principles. Online investment discussion groups - as identified by ESMA in their warning - overwhelmingly center on speculative, short term stock tips rather than considered, long term investment principles.

The EU and the SEC's intervention comes at a time of nervousness over perceived elevated levels of the major indexes. Stock markets are dealing also with a low level of IPOs, the rise of private equity, and heavy concentration, particularly in the technology sector.

Intuition Know-How has a number of tutorials that are relevant to this article:

- Equity Markets – An Introduction
- Equity Markets – Issuing
- Equity Trading – An Introduction
- Equity Indices
- US Equity Market
- European Equity Market
- Hedge Funds – An Introduction
- Hedge Funds – Strategies
- Crypto Assets