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With the US Fed's recent interest – early stage and more tentative than the Bank of England, ECB or Bank of Japan's – the concept of Central Bank Digital Currencies (CBDCs) is gaining further traction. And with it, the concern that by launching CBDCs central banks could create serious challenges to the banking industry. These perceived challenges range from an existential threat (a rather extreme view embraced mostly by the financial media) to more realistic warnings regarding banks' business models and profitability.

The Wide Angle introduced some initial thoughts and facts about CBDC and banks back in May 2021[1]. I am convinced the topic will grow in importance this year – not only for central banks but for the banking sector as well. Consequently, it should also matter increasingly for investors and analysts. Discussing CBDC challenges is not yet active part of the dialogue between banks and the market. It should be.

Seven thoughts about CBDC and banks

1 Launching CBDC is a 'when', not an 'if' scenario. And the 'when' needs to be more urgent.

2 Europe and America can no longer afford to kick CBDC into the long grass, because of:

(i) fast advances in digital private finance;

(ii) the rise of private money (stablecoins);

(iii) the irreversible decline in cash-based financial and commercial transactions;

(iv) the possibility that China (which is well advanced in launching a digital yuan) will set new CBDC standards for cross-border payments and commerce, gradually bypassing existing structures.

3 I fear that the glacial pace of CBDC progress, notably the Fed's and to a lesser extent the ECB's, is too slow in relation to fast-changing digital and geopolitical dynamics.

4 CBDCs are not a direct threat to the banking industry in developed economies. Potential challenges yes but they may also

[1] https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=d02a5e45-a36d-4f3e-b388-c1475d0b75c6

offer an additional customer-footprint anchor to digitally advanced larger banking groups.

The central banks of the major economies (primarily focused on retail CBDC), as well as the Bank for International Settlements (which is very active especially for wholesale CBDC) make the crucial point that the introduction of digital currencies should be structured in a way not to destabilise banks and their role in financing economic growth.

Indeed, replacing cheap and stable retail deposits with more expensive market funding could affect banks' credit creation by increasing the borrowing costs of businesses and households.

Focusing on the financial stability implications of CBDC, recent research by the BIS's Innovation Hub[2] estimates that 4%-12% of bank retail deposits could in time be affected, but that the alternative to CBDC is not the status quo but the further penetration of private digital money.

Both the BIS and central banks suggest that to avoid the cannibalisation of retail bank deposits, CBDC accounts should have limits on individual holdings and avoid competitive remuneration. They should be used for transactions not as an investment. This is something that *The Wide Angle* highlighted back in May 2021.

5 The stability and profitability of smaller, undiversified branch-heavy retail banks could be threatened. The introduction of CBDCs could partially impact low-yield retail deposits, leading to higher funding costs and lost margin and fee revenues.

Even without CBDCs, banks with rigid legacy structures and business models are likely to have a problematic future in the digital age. CBDCs alone will not make or break them, but CBDCs represent one more arrow in the quiver shooting for more in-market consolidation of second-tier banks in Europe.

6 The introduction of CBDCs may in time have a positive impact on financial inclusion (a neglected component of the ESG framework), as they will reach non-banked and underbanked populations. This is less of a problem in Western Europe, where banking penetration is very high (ca. 95%). It is more relevant in the US, where according to the Fed's recent report on CBDC (see below) 5% and 20% of households are non-banked and underbanked, respectively.

Of course, financial inclusion is sorely needed in emerging and frontier markets, where nearly 1.7 billion people do not have bank accounts (although that is a lot better than the 2.4 billion a decade ago).

7 For the euro area (EA) a digital euro should be a net positive, especially if its launch is not unnecessarily delayed. For four principal reasons:

(i) It will secure monetary sovereignty in the face of advancing private digital money (such as US-pegged stablecoins).

(ii) In time it will strengthen the international role of the euro – which in turn should

[2] https://www.bis.org/publ/othp42_fin_stab.pdf

implicitly help the European banks with global reach.

(iii) If properly designed, it will protect user confidentiality – a concern which was expressed as being the highest in an ECB poll on the desirability of a digital euro. But with the necessary transparency and controls to combat money laundering.

(iv) It may in fact further strengthen the EA single market for retail financial and banking transactions. Indeed, the introduction of a CBDC would be the first major transformational adjustment for the euro since euro notes and coins were introduced in 2002; and one that would for the first time be experienced concurrently at all levels right across the entire EA. Policymakers, banks, and the market need to more visibly highlight this aspect.

The major economies are behind in the CBDC process

BIS and IMF data as of the end of last year shows that 87 countries (accounting for 90% of global GDP) already have or are considering a CBDC. The number of interested countries has grown dramatically from only 35 nine months ago.

Among those countries, nine have already fully launched their CBDC. The first was the Bahamas' Sand Dollar, followed by seven independent island states in the East Caribbean. The most recent, and the most significant to date, is Nigeria's e-Naira, which will be available for both the banked and especially the non-banked population.

CBDCs are in an advanced project stage in 14 countries, including Sweden and Ukraine (Europe's most advanced countries with respect to CBDC adoption), South Korea, Thailand, the UAE, Saudi Arabia, and China.

China is the first global economic power to launch a CBDC (digital yuan, or e-CNY) on a pilot basis in several large cities. It is possible that the People's Bank of China will roll out launch across the country this year. A more active promotion of the e-CNY during the forthcoming Olympics, which kick off this week – including to foreign athletes and visitors – may offer additional clarification in this respect.

Other countries are still lagging. Among the major Western-style economies, Japan and Canada are at more advanced stages of development. The ECB, Bank of England, and the US Fed are still taking the early steps of research and investigation, with the adoption of a CBDC remaining an option, not a certain course of action.

The Bank of England – acting together with HM Treasury – is more advanced than the ECB and Fed, assessing that in 2022 its CBDC project may move to the development stage (which then will take several more years).

As for the ECB, following a six-month consultation period after the publication of its first report on a digital euro (October 2020), last July it kickstarted a two-year investigation period to address key issues and take a decision. Following which the development stage, if it gets there, will probably also take another few years. At best, a digital euro is still several years away.

The US is the newest kid on the CBDC block. After a lengthy period of underwhelming focus, at the beginning of this year, the Fed published its first discussion paper[3] addressing the possibility and desirability of a digital dollar. The paper takes no position on the suitability of a CBDC in the US.

It nevertheless suggests that "a US CBDC, if one were created, would best serve the needs of the United States by being privacy-protected, intermediated, widely transferable, and identity-verified". Slow as it is, the Fed's no-rush approach is nonetheless better than nothing.

The stablecoin alternative pressures CBDCs

Private cryptocurrencies are gaining ground fast. Mining-based cryptocurrencies (Bitcoin, Ether, etc.) are, and will probably remain, mostly a store-of-value type of money, one in dire need of being properly regulated as such.

The story is different with stablecoins (Tether, USDCoin, TerraUSD, BinanceUSD, DAI, etc.). These cryptocurrencies are fully collateralised by reserve assets (highly-liquid and very low-risk) and with a value around parity with the US dollar. They can thus be used and accepted for financial and commercial transactions (money as means of exchange and even unit-of-account).

Stablecoins are increasingly present in the market. From ca. USD 20bn in early 2020, their global outstandings reached over USD 130bn at the end of 2021. If the trend continues, financial systems lacking CBDC alternatives could see their currencies replaced by stablecoins (largely pegged to the US dollar). Not an option that any European central bank would be happy to tolerate.

The initial hesitancy of the US regarding CBDC could have been the result of the emergence and growth – occurring mainly in the US – of stablecoins. The thinking was that, with parity with the dollar, stablecoins may not impact the US financial system in a negative way. And if stablecoins spread around the world as mainstream digital money, the dollar's reserve currency role may indirectly be enhanced.

But that was not to be. European (and other) central bankers adopted a different view, warning that digital payments were already dominated by three US providers (two card suppliers and an online-payment supplier) and that without CBDCs, private money such as stablecoins could dangerously disrupt their financial systems and monetary policies.

They will all be breathing more easily now that the Fed is taking a more positive view on a digital dollar. Which may end up pushing stablecoins away from a mainstream digital money position. Perhaps not coincidentally, following the publication of the Fed's CBDC paper, Meta (Facebook's parent company) announced last week that it is cancelling

[3] https://www.federalreserve.gov/publications/january-2022-cbdc.htm

Diem (formerly Libra), its previously planned stablecoin project.

This may in fact raise a question or two about the viability of stablecoins as the future of money in general, especially in the absence of proper regulation in the US. The latter point is key, as I believe adequate regulation in the US could stabilise or even enhance the market position of stablecoins. Which, unlike mining-based cryptocurrencies, would be viewed as a reassuringly safe investment (not dissimilar to a money-market fund).

If regulated, stablecoins could also be an alternative means of payment, although likely not to the detriment of CBDCs. Assuming of course that the major central banks manage to get their projects implemented sooner rather than later.

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