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# MARKET INSIGHT

MARCH 2022



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“We expect most major central banks will issue a CBDC before the decade is out”

# THE POTENTIAL OF CENTRAL BANK DIGITAL CURRENCIES

A central bank digital currency (CBDC) is a digital form of a country's official fiat currency, that is a direct liability to the central bank. Instead of printing money, the central bank issues digital money backed by the faith and credit of the government. It is thus a different expression of the same unit of account, store of value and medium of exchange already offered by a central bank with the potential for wide use by households and corporates.

## INTEREST FOR CBDCS IS SURGING

The change in payment habits, as well as technological developments, are both contributing to the surge of interest for CBDCs. However, the key motivation for CBDCs might be for a central bank to defend itself against threats to its monetary sovereignty, as the ability to effectively deploy monetary policy could be blunted by the adoption of private digital currencies such as cryptocurrencies and stablecoins. This explains why, according to a 2021 BIS survey, 86% of central banks are exploring the risks and benefits of issuing a CBDC, 60% are experimenting with different technologies, and 14% are conducting pilot projects. Currently only two countries have officially launched a CBDC: Nigeria and the Bahamas. Many countries are running pilots such as China, Canada, South Africa, Korea, and the UAE. In the G10, Australia, Sweden, and Japan are at the proof-of-concept stage, while the ECB, SNB, BoE and the Fed are still only at the research stage.

## A QUESTION OF DESIGN

CBDCs need to be carefully designed to balance the benefits and risks. They need to add value for users, foster competition rather than crowd out innovation, and avoid the risks of financial disintermediation. We distinguish two broad CBDC operational designs: wholesale CBDCs and retail CBDCs. Wholesale CBDCs' use is limited to financial intermediaries for the settlement of interbank transfers and wholesale transactions. The difference with standard central

bank reserves is to allow for new forms of conditionality of payments, requiring that a payment meets a specific condition to settle. Retail CBDCs can be directly held by non-banks (citizens and corporates) as a form of digital cash, altering the standard two-tier monetary system by making central bank digital money available to the public. Emerging economies appear to lean more towards retail CBDCs with financial inclusion and digitalisation as the main goals, while developed countries focus on wholesale CBDCs as they have more developed banking systems and capital markets.

## CHINA AND THE E-CNY

Whilst many countries started to explore the topic recently, the Chinese PBoC has been working on a CBDC since 2014. A pilot was launched in 2020 in 10 regions and was introduced to the Beijing Olympics this year. The digital yuan (e-CNY) is a two-tier retail CBDC system, where the back-end infrastructure is provided by the PBoC, while the front-end is managed by regulated private payment providers (commercial banks and tech firms). As a result, it does not disintermediate banks. Moreover, the e-CNY applies a DCEP approach (Digital Currency Electronic Payment), which means it is not only a digital currency but also an electronic payment system. Some 260 million of the Chinese public have already downloaded the digital wallet, and 9 million merchants (including Western franchises) have signed up for the e-CNY. According to PBoC officials, e-CNY transactions as of the end of 2021 totalled the equivalent of \$14 billion.

One of the aims of the PBoC is to increase the efficiency and resilience of the digital payment ecosystem (dominated currently by Alipay and TenPay) by fostering competition and providing an alternative in case of disruption. In addition, China's DCEP will provide access to banking services for the 20% of the Chinese population that is unbanked. Currently the e-CNY is the largest live public testing for the efficacy of a CBDC. Its relatively mature stage positions China to

set standards in CBDC development. In our opinion, this will help China reach the end goal of strengthening the yuan's monetary sovereignty and internationalisation.

We expect most major central banks will issue a CBDC before the decade is out, given the powerful social and technological forces at work. While there's no single answer to the motivations and design features for CBDCs, the two-tiered model where banks still play a role in the ecosystem and are not completely disintermediated, might be favoured in practice. This approach provides the public with access to central bank money, with the least risk of financial instability. Whatever the design, the issuance of CBDCs will likely reshape interbank systems, cross-border payments, and the way monetary policy is conducted in years to come.



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