The shift from private money into “unlimited” CBDCs: an unviable development or a chance for reform and new opportunities?

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Overview

- CBDC – to what end?
- Limited or unlimited access to CBDC?
  - Threat of runs into CBDC
  - Financial stability concerns
  - Financial stability opportunities
  - Regulatory opportunities
  - Monetary policy implications

Reasons for introducing CBDC

- Enhancement of financial inclusion
- Facilitation of cashless payments
- Rival to the attraction of cryptocurrencies and stablecoins
- Reaction to decline of cash usage
  - Cash replacement?
- Store of value for the public
  - Reserve money equivalent for everyone

Limited access to CBDC?

- Caps on CBDC holdings
  - limited to “cash-like” volumes
- Practical role of capped CBDC?

Reasons for holding limits

- Unlimited safe store of value option rivals banks' exclusive access to cheap funding from retail depositors
- Unlimited CBDC would lead to
  - need for banks to pay interest commensurate with inherent risk during normal times;
  - dramatic loss of liquidity due to mass conversions into CBDC in crisis times

Runs increase in magnitude

- Runs on bank deposits in crisis scenarios much easier than without CBDC in place
  - Instant conversions of retail deposits into CBDC possible instead of transfers of commercial bank money to accounts with other banks
  - Moves into safe haven instead of shifts based on incomplete information and rumours about financial status of specific banks

Consequences of runs for banks

- Death spiral of liquidity outflows
  - Depletion of reserves
  - Sales of more liquid assets
    - HQLA: currently particularly problematic because of market price drops of low-yielding bonds
  - Fire sales of less liquid assets
  - Insolvency

What changes with CBDC in place?

- Optimal flight option: conversion into safe haven CBDC
- Likely consequence: magnitude and speed of runs increase
- Net liquidity drain intensifies
- Prima facie: highly problematic
- At second thought: issues as well as opportunities

Information deficit during conventional runs

- Confusion, panic, disinformation among (retail) depositors
- Resulting insecurities and movements of commercial bank money not easily resolved
- Resulting in difficulties for central banks and competent authorities
  - Liquidity flow predictions
  - Liquidity need predictions
  - Bank solvency status assessments
  - Stakeholder exposure and financial stability assessments

CBDC: swiftness across the board

- With CBDC in place, runs would be instant and massive in magnitude.
- Within a short period of time, central banks and competent authorities would know about the scale of the liquidity loss and could assess to what extent banks can counter them without risking insolvency.
- This assessment would provide the basis for fast and robust liquidity programmes, potentially Emergency Liquidity Assistance, and potentially resolution actions.

Optimal choices, adequate responsibility

- CBDC as the new benchmark: a basic infallible store of value option (for zero interest)
- Deposits: low risk (above deposit insurance [DI]caps) and interest-bearing
- Investments: moderate to high risk and adequately compensated
- Policy consequences:
  - No more need for depositor “bail-outs” above DI caps?
  - No more need for DI schemes?
  - Focus in resolution scenarios entirely on financial stability?

Interim conclusion

Unlimited/uncapped access to CBDC should not be rejected categorically. Potential benefits of its usage have not been explored which leads to the interim conclusion that the need for limits/caps has not sufficiently been justified.

Stepping stone for regulatory reform

- What if
  - the public fully embraced CBDC as their base facilitator of store of value and cashless payment services;
  - regulators referred the public to this new world of optimised store of value options and eliminated deposit insurance (let alone de facto guarantees) for commercial bank money;
  - banks' balance sheets shrank as a result of less (cheap) funding from depositors;
  - CBDC could directly be used for investments, lending and borrowing;
  - the financial landscape became more diversified because the public would no longer hold most of their monies in commercial bank money?

Financial stability implications

- Potential effects:
  - Banks would become less systemically important.
  - Depositor protection would be less of a concern in crisis/resolution scenarios.
  - Critical financial functions could be provided by a range of financial intermediaries.
  - Specific and complex resolution regimes would no longer be needed.
  - Burdensome requirements of prudential regulation such as Total Loss Absorbing Capacity (TLAC) could be eased.

Financial stability implications (cont'd)

- Downsides:
  - A more fragmented financial landscape would make financial supervision not necessarily less complex. The focus would shift from a strong concentration on SIBs to a supervision focused on build-ups of risk in less obvious segments of the financial sector.
  - Reduced efficiency?
  - Competitive disadvantages for markets with CBDC compared with markets without CBDC?
  - New and undesirable roles for central banks? Disruptions to their monetary policy implementation?

Monetary policy implications

- CBDC as a monetary policy instrument?
- Direct mechanism for monetary tightening
  - Interest paid for CBDC holdings immediately impacts banks' rates for deposits and drives them up
- In principle, direct mechanism that supports monetary easing
  - But: negative interest applied to CBDC holdings problematic insofar as it jeopardises its role as the new base store of value facility.

Conclusions

- Value of CBDC introduction depends on market conditions.
- Benefit shared in all markets: first cashless type of central bank money for everyone.
- Preference for design features that affect existing financial landscapes as little as possible?
  - Especially: should CBDC design features leave bank funding models intact? Should caps be introduced for an interim period and lifted after banks had had sufficient time to adapt to new realities?
- Potential benefits of unlimited CBDC for depositor protection and financial stability worth exploring.
- Ultimately, preference for a fullhearted approach that holds promise for change as compared with a hesitant experiment whose added value is unclear.