Intelligence MEMOS

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To: Canadian Financial Regulators

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Re: **Central Banks and the Future of Money**

Central banks around the world are now giving serious consideration to the pros and cons of making central bank digital currencies (CBDCs) available to the general public.

While the consensus view in earlier periods seemed to be that any such move would be unwarranted, or at a minimum premature, sentiment seems to be shifting rapidly, a landscape I outlined in a C.D. Howe Institute Commentary.

The Bank of Canada, the European Central Bank, the Bank of Japan, the Nederlandse Bank, the Riksbank and the Bank of International Settlements announced last week that they would "share experiences" as they assess whether issuing a CBDC in each of their respective economies would be desirable.

The main driver for this sudden change in view is technology, coupled with the powerful competitive pressures emerging from fintech and new forms of electronic payment.

While earlier concerns centred largely on the declining use of banknotes and what this might imply for government seigniorage, central bank worries are now more existential and focused on the future role of central banks themselves. Facebook's developing Libra cyptocurrency no doubt served as a powerful catalyst for a timely reconsideration of the risks posed by private-sector competition.

One of the most important aspects of the investigation will be what form the currency might take. The simplest form would be a digital token that could be used to transact anonymously, exactly like paper banknotes except it would be virtual, an option dubbed stablecoins. Its main selling point would be increased convenience. At the other extreme, the CBDC might take the form of an account-based digital currency in which members of the general public would be allowed to set up accounts at the central bank and use them for transaction purposes. While the transactions would no longer be anonymous, one of the attractions, aside from greater security, would be the possibility of earning interest on account balances. For this and a number of other reasons, the account-based version of CBDCs might prove to be the more attractive option.

Proponents see account-based CBDCs as more than a purely defensive reaction. They believe these CBDCs would materially improve the role of central banks' money by providing a more stable unit of account, a more efficient medium of exchange and a more secure store of value. And the potential benefits could go well beyond these traditional money functions.

CBDCs could promote financial stability, improve the implementation and transmission of monetary policy, raise productivity, reduce tax evasion and discourage a number of other costly and illegal activities by facilitating the elimination of paper currency, say supporters.

These positive claims have not gone unchallenged. The most common concern is the destabilizing effect that account-based CBDCs might have on the economy in times of financial stress. As a safe and convenient alternative to commercial bank deposits and other types of financial assets, CBDCs might act as a dangerous accelerant in the context of a bank run, transforming an isolated concern about one bank's solvency into a systemic crisis. Another source of concern is the disruptive effect that account-based CBDCs could have on the competitive position of commercial banks, other financial institutions and key financial market infrastructure.

It is not obvious that the position of commercial banks should be protected if a better business model exists and an account-based CBDC would significantly enhance economic welfare. But if the introduction of an account-based CBDC was deemed too disruptive, many of the same benefits might be realized by introducing a hybrid form of the token CBDC. This would involve creating a digital token that was traceable and could also pay interest, replicating many of the features of the account-based CBDC, but without the account. It would make life for those who use paper bills to pursue various illegal activities more difficult and offer effective, though more limited, competition to banks among other benefits.

In the end, policymakers may decide that the best way forward for Canada and other countries does not involve the introduction of a CBDC – though this looks increasingly unlikely.

Independent of the final outcome, some active government engagement would nevertheless seem advisable to ensure the most promising way forward is not precluded. Moving swiftly would avoid the dislocation of potentially insurmountable policy reversals at a later stage, which could leave us in a place we would rather not be. The question is no longer whether central banks will need to react, but how they should react to these inevitable tectonic technological shocks.

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