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## Central banks and the digital rabbit hole

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**Central Bank Digital Currencies (CBDCs) are a reality; the timeframe for adoption is the uncertainty. Central bank involvement is not as straightforward as the currencies created by the private pioneers. The learning curve might prove bumpy. But like all evolutions the gains far outweigh the risks, although there will be winners and losers as in any transition. The losers are easy to identify – it's the commercial banks. It might also ultimately be the privacy of the individual, given the insight digital currencies allow into the flow of money. It reinforces our view that investors should be long gold. Being long Bitcoin along with some exposure to No.2 Ethereum as an alternate hedge looks interesting, even if their long-term prospects might lack the clarity offered by their precious metal counterpart.**

No one would have thought that what started off in the dimly-lit recesses of the internet, as payment for drugs and other illicit, would turn into a multi-billion dollar private currency system. But that is exactly what Bitcoin and its pretenders have done over the past decade – to the chagrin of most observers. Despite Bitcoin's speculative rush of 2012-2017, to most central bankers these cryptocurrencies remained a peripheral issue. While touted as 'digital money', their extreme price volatility meant they could not be viewed as a safe store of value, transacting in them was complex (exchanges disappeared along with clients' digital coinage, while girlfriends sent nerds' hard drives to the dump) and it never got close to being a unit of account. The good old paper currencies all looked perfectly safe.

But good ideas rarely start as finished articles. The systems and concepts underpinning digital currencies have matured and participation has broadened. Opportunity has drawn the interest of mainstream money; Facebook had its own foray with its widely-panned stablecoin project 'Libra' (stablecoins being a digital currency backed by something tangible, in this case a basket of currencies/bills). There are numerous other platforms that offer something similar, facilitating rapid digital payments – both on and offshore – with fiat currency-backed digital coinage.

For all the flaws, it started to look as if private currencies could move beyond the novel; as the technological benefits became more visible, the threat to the traditional money space began to look real. And central banks began to pay attention.

As the ECB recently noted, these digital technologies can foster innovation and improve payment systems, but they could also “*threaten European financial, economic and, ultimately, political sovereignty*”<sup>1</sup>. Basically, they recognise that the growth of private money, issued outside of the existing regulated sectors — predominantly the commercial banks — represents a threat to the existing monetary order. And no responsible central banker is going to stand idly by and let that happen.

This has pushed central banks into seeking out their own alternatives, with Central Bank Digital Currencies becoming the new buzz phrase. But the game is not all about creating ‘trustworthy’ alternatives to these innovative private payment solutions. CBDCs are potentially far more powerful than the private digital coinage that begun this revolution.

Clearly ‘official’ digital currencies bring many benefits. For starters they provide users with a fully backed digital medium of exchange, fulfilling a role fiat notes and coins have served for millennia. Most central banks’ consultation documents regale us with stories of improved payment speeds and how using these technologies could shelter those vulnerable to the broader shift towards digital payments, at the expense of cash. The unbanked — which the IMF estimate numbers 1.7bn people globally — could be brought into the financial system. The costs savings just from the remittances business, where the average fee is a staggering 7%, are enormous. It would also accelerate a private sector ‘FinTech’ innovation boom, as new and rapid payment systems, utilising digital currencies, evolved. Which all sounds fantastic, assuming the motivation for using digital currencies is solving those type of problems.

But the implications run far deeper than all of that. CBDCs will not only impact how the existing banking system operates, but they could radically alter how monetary policy itself is conducted. That looks a critical differentiator in a world where the line between monetary and fiscal policy is increasingly blurred. Furthermore, CBDCs could provide a level of visibility and insight into day-to-day, or second-to-second, financial transactions that just does not exist today. And that would apply to any entity using that digital currency, not just those subject to domestic laws and regulations. In the eyes of central bankers, this means improved oversight of the financial system, improved transparency (for both domestic and cross-border transactions) and an increased ability to manage risk within the system. For governments, this might mean improvements in tax auditing and a simplification of tax returns and payments, a reduction in fraud and/or a more direct way of making welfare, pension and other transfer payments. And of course there is an unprecedented opportunity to snoop. Potentially that all adds up to a significant efficiency gain. From the perspective of the state, there is much to love.

Equally, there is much that could go wrong, some of which is known, some of which will only be discovered through experience. So the structure that any CBDC will take is going to be very important.

A basic CBDC would see access limited to the wholesale market, namely the financial institutions that are at the core of the existing system. The benefits of that would be to improve the speed and efficiency of interbank transactions and settlements. It could reduce credit risk within the system in times of stress, serving as the very highest form of collateral; collateral that could be easily expanded by the central bank based on underlying market demand. It would give the market a digital heartbeat that could be monitored in real-time.

But those with bigger ambitions see CBDCs providing access to central bank money to a far wider audience, opening it up to the entire retail system. That would be an altogether more complex beast to manage. Although CBDCs would be designed to be fungible with existing notes and coins and digital deposits, the option of having an account directly with the central bank, rather than a commercial bank, might prove too appealing. This disintermediation risk could well create a two-tier banking system.

But that has not deterred central bankers thinking about this. The head of the Cleveland Fed, Loretta Mester, was direct in a recent speech<sup>2</sup> that the experience with pandemic payments had brought forward ideas about CBDCs. She noted that *“each American could have an account at the Fed in which digital dollars could be deposited, liabilities of the Federal Reserve system ... central banks could support them without the need for commercial bank involvement via direct issuance into the end-users digital wallets”*. There is no hiding from those ambitions.

Certainly, in times of economic and financial stress the idea of holding your cash with the private sector is far less appealing than with the state. It is not uncommon in emerging market crises to see deposits flow from private to state-owned banks, as people look to shield themselves from the risk of default. Even in more normal times the logic is strong, as demand for national savings products already highlights. Clearly, allowing unlimited access to CBDCs could undermine the business models of the wholesale sector entirely, draining deposits and thus forcing banks to curtail lending. It would also necessitate the central bank to step into the market for credit extension — a far more complex business. That’s on top of more typical headwinds that digital currencies place on the commercial bank sector, including the erosion of margins from transactional efficiencies and the entrance of non-bank (but technically specialist) firms into the field. In a zero-rates world, which destroys many banks’ traditional profits from maturity transformation, this mix looks pretty toxic to the traditional bank business models.

So calibrating availability of CBDCs will be a significant challenge. The obvious step would be to give people limited amounts to prevent any disintermediation. Giving someone a stimulus cheque in CBDC form doesn’t immediately look like a systemic risk for the existing players. But in times of crisis it is quite possible this could still trigger a divergence between the value of that digital currency and non-central bank issued deposits. These problems are not insurmountable, most policy tools are a work in progress and CBDCs will be no exception to that. But it does underline that there are risks, known and unknown.

In all likelihood, the advantages to central banks of creating their own alternatives to traditional bank deposits would outweigh the negatives. It could empower monetary policy at a moment

when traditional tools (interest rates) are depleted and decreasingly effective (by hitting the zero lower-bound), improving policy transmission at the point its needed. It could create new ways to fine tune policy, ensuring changes are passed through – without the traditional lag or liquidity trap – to the real economy. That is particularly important during periods of market stress when risk aversion blocks monetary transmission channels. Imposing negative interest rates for example, would be as simple as coding in some value decay to the CBDC.

We have seen transmission issues emerge in many places during the Coronavirus pandemic, when central bank efforts to encourage lenders to extend credit to a cashflow starved private sector was hindered by commercial banks own (probably sensible) sense of risk. While policy interest rates fell, lending rates ticked up. Even after lowering capital buffers, central bankers' requests have been rebuffed. In such instances, CBDCs could be tailored not only to take the horse to the water, but also to make it drink.

Official digital currencies could enable CBs to inject cash directly into the economy in times of stress, sidestepping transmission problems generated by the private sector or even government. Where central banks have mandates that target maximum employment or growth, there is sound logic that they should be delivering stimulus directly, not waiting for politicians to respond. Dual rates structures could be more easily implemented or even direct cash transfers, facilitating Ben Bernanke's long theorised helicopter drop. These could be fine-tuned in an infinite number of ways to tackle points of financial/economic stress. For example, UK Chancellor Rishi Sunak's somewhat ironically titled "eat out to help out" scheme (which contributed towards people's restaurant bills) could have been executed more efficiently had he been able to issue everyone with a CBDC token. The transactions could all be tracked and verified to ensure the funds are spent (only) as targeted. Handouts could even have an in-built fuse that reduces their value to nothing if not spent in a specified way, by a given date.

The simple appeal of cutting out the middle-man must be hugely appetising for institutions that have run out of conventional policy choices and where their unorthodox follow-ups are widely blamed for exacerbating societal problems, rather than resolving them; the contribution of QE to inequality being the hottest potato. It is also helpful that the central banks have become accustomed to running large balance sheets, given the liabilities that the issuance of CBDCs will likely create over the medium-term.

In many ways, the CBDC moniker is a smokescreen for what has been underway for the past decade – the replacement of the private sector as the primary capital allocator. A supply-sider might argue that the post-GFC problems have deterred private financial institutions from lending, restricting access to capital. That has generated negative feedback loops in the real economy, such as suppressing productivity growth and wages. But this overlooks the scarring on the demand side that the financial crisis also generated.

This is where central banks appear to have completely vanished down the rabbit hole. Rather than allowing markets to determine demand and supply, they have doubled up by suppressing the cost of capital via low interest rates (in the blind pursuit of the chimera of higher inflation).

Against a backdrop of weak private demand for credit/investment the net result has been that cash has been channelled back into financial assets, both via corporate debt fuelled buybacks and via the purchase of safe-haven government debt, which has shifted money further out the risk curve.

All this has achieved is to increase leverage in the system at the expense of any real investment – from traditional capex to government spending on infrastructure and education. It could well be that CBDCs allow this cycle to extend even further. But they could also help alleviate some of the pressures that cash, inefficiently allocated by QE, has created, in addition to transactional efficiency gains.

Despite digital currencies' private sector origins, we don't see CBDCs as a response to central bank concerns about disintermediation risks from cryptocurrencies themselves. The romantic appeal of having a safe asset outside the control of global central banks, which can't be replicated ad infinitum, is genuine of course. It's something that gold does effectively; this is in a handier digital form though. But as we've seen in the past, the private sector can only function efficiently and in the open with the support of the state – even holding gold has been determined a punishable offence in the not so distant past. The maturity and long-term success of things like Bitcoin depend largely on maintaining their niche. That's probably not an immediate problem with Bitcoin's market cap hovering around \$200bn, barely more than the net worth of a couple of tech oligarchs. That compares to gold at \$10trn, give or take. So Bitcoin can remain an untroubled niche player for a while yet, before it attains true *persona non grata* status.

What are the investment implications of all of this?

First, CBDCs can generate further transactional efficiencies. This is something that the private sector was already doing, as anyone transferring cash using an App instead of a bank would have noticed. But secure and trackable real-time payment transfers, both domestic and cross-border, will generate significant economic gains, particularly in emerging markets where the non-banked, but digitally-connected are concentrated.

Second, even a more limited wholesale CBDC would bring financial stability benefits, giving CBs another lever to pull in a crisis. But a CBDC accessible to everyone would democratise access to safe assets and provide a direct connection between central banks and all the arms of the real economy. This could be used (in limited form) exclusively for the purpose of executing a monetary policy programme, or could be the conduit for targeted fiscal policy, if you can distinguish the blur by then. This would be a significant improvement on the trickle-down expected from QE.

Third, commercial banks' business models were already suffering in a world of zero rates and high regulatory and compliance burdens. New FinTech entrants innovating in digital payments and the improvements in transactional efficiencies (i.e. lower costs), are a further nail in the coffin. And CBDCs risk unsettling the private sector's deposit base. If calibrated effectively these risks could be mitigated and it could even open up new business opportunities with more manageable

risk taking. But competition will be fierce and legacy businesses always tend to do poorly as they struggle to break from defending the old regime.

Fourth, there is no end game for central bank balance sheets, they will continue to grow and become more diverse. They will also become more closely entwined with fiscal policy, not only facilitating the financing of budget deficits but then sending the proceeds out to be spent. We'd better hope they can operate more effectively than their old communist colleagues, who lacked the technology (and hopefully understanding and insight) of their modern day peers.

Fifth, which we haven't touched on yet, are the benefits a CBDC would offer as an internationalised means of exchange. They will be used for cross-border payments. But their credibility might provide the pioneer state with an asset that could be viewed in a similar way to a reserve currency. So expect this to become a global central bank (and a politicised) financial arms race. Those with most to gain will lead — China. Those with most to lose — the US — will approach the problem more gingerly. But perhaps it is outside of these two where the real innovation will be. There will be an opportunity for economies to exit the US dollar-dominated reserve currency system entirely with easily configurable international digital currency baskets. These digital currencies would reflect trade risk far more efficiently, squeezing transactional costs and counterparty risk in the process. Even the option of exiting the Swift payment system must be highly appealing given the politicisation that has seen in recent years.

In many ways it is the absence of an achievable policy goal that leaves central banks in this place. Monetary policy was effective at defeating inflation, but structurally economies have changed. Demographics now burden them with weak demand while technology remains a disinflationary force across an ever-widening suite of goods and services. Central bankers are discovering (belatedly) that the monetary guillotine is great at taking the hydra's head off, but not much good at sticking it back on, i.e. actually generating inflation (outside of financial assets). CBDCs provide new tools with which to try and tackle these challenges, in addition to the overall benefits and efficiencies they could generate. So we must hope central bankers are brave enough to take the leap, but careful enough to manage the potential risks, so that CBDCs don't put them on the path to Cold Lazarus<sup>3</sup>.

The risks reinforce the logic of owning gold and the case for adding long Bitcoin (and to a lesser extent Ethereum) positions — for all their pitfalls — as a core hedge against catastrophe. It is certainly an attractive way of hedging against the abuse of the oversight that CBDCs will provide to our financial overlords, not to mention a way of participating in the broader digital currencies/technology boom. These are also assets that, despite extreme volatility, have delivered significant price returns throughout history, where broader participation is still very low and is fundamentally supply constrained.

1. ECB — Report on a digital euro, October 2020 (Link)

2. Payments and the Pandemic, Loretta Mester, September 2020 (Link)

3. Cold Lazarus was a Dennis Potter play in which a preserved head was brought back to life ~400 years later, an experience that proved miserable for everyone, particularly the head. (Link)

# INDEPENDENT STRATEGY

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