Economics

Central Bank Digital Currencies Will Fix Bad Policy

The Federal Reserve and its peers would be able to tier interest rates to better target individual sectors of the economy.

By Alberto Gallo
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Central banks want to get into the digital currency game. *Photographer: Samuel Corum/Bloomberg via Getty Images*

More than 85% of the world's central banks are working on central bank digital currencies, according to the Bank for International Settlements. The People's Bank of China has already implemented a digital yuan, and the European Central Bank wants to launch a digital euro by 2025. Federal Reserve Chair Jerome Powell said Thursday that the central bank will launch a centerpiece research paper this summer on a digital currency. The Bank of England is looking into the matter as well.

Central bank digital currencies, or CBDCs, have the potential to revolutionize monetary policy. Rather than providing an alternative to national monetary systems, so-called GovCoins would mirror each country's fiat currency, using blockchain technology to strengthen central bank oversight.

The architecture of CBDCs will determine how much information central banks will have on individual transactions. In theory, a digital dollar using the blockchain could provide the identity of each buyer and seller in a transaction, giving the Fed real-time data on individual “wallets”. This may give the Fed the ability to tier interest rates at various levels for economic sectors or regions, rather than relying on commercial banks for policy transmission. The PBOC, which sets policy with individual sectors and provinces in mind, is already doing this via its digital yuan.

Another byproduct of CBDCs is that it will result in fewer bank notes in circulation, and with fewer bank notes in circulation the effective lower bound for interest rates might disappear. In the current monetary system, there is a physical floor to interest rates, which is where it is cheaper for institutions to dig a hole in the ground and store bank notes rather than depositing them at the central bank. In 2016, German lender Commerzbank reportedly explored hoarding billions of cash in its vaults to escape the ECB's negative interest rates. This physical limit is probably around negative 1%. But if CBDCs completely replaced bank notes, then central banks could set interest rates much lower, at negative 2% or negative 3%, for example, effectively imposing a tax on depositors and savers.

One reason why central bankers are looking to add new instruments to their toolkit is that the extraordinary measures employed since the financial crisis - like quantitative easing and negative interest rates - failed to reverse disinflationary pressures. At the same time, such policies benefited owners of financial assets and increased wealth inequality, as Federal Reserve Bank of Dallas President Robert Kaplan recently noted.

After two decades of financial asset-based monetary policy, today’s shift toward investment in the real economy is much needed. Both the U.S. and European Union are trying to deploy infrastructure plans of historic size, looking to foster the recovery while avoiding stagnation and fixing inequalities. As growth and inflation recover, central banks will normalize interest rates. The process may go wrong for three reasons. First, fixing secular stagnation in a matter of months won’t be easy after decades of policies focusing on short-term growth rather than on boosting productivity.

Second, quantitative easing left companies and governments with large debt overhangs, and markets with excessively high valuations. Companies are reliant on government support now more than ever, as the ECB recently wrote in an article on zombie firms. Recent trading patterns show markets are vulnerable to a repricing of interest rates. This means policy normalization might fail again, as it did in the 2013 and 2018 taper tantrums.

Third, when the time comes to cut back on fiscal stimulus, governments might find it hard to quit. As economist Milton Friedman said, nothing is more permanent than a temporary government program. If governments struggle to restore full employment and reduce inequality, then the likelihood of new monetary experiments will rise.

In this context, GovCoins will be policy dynamite in the central bankers' toolkit. They will allow for the speeding up of electronic transactions and better track the flow of money across the economy. They may also introduce stimulus more effectively and targeted to individuals and businesses in real need. But they might add to the power to reduce government borrowing costs even further below inflation - leaving savers with low-yielding digital cash burning in their virtual pockets. As former ECB board member Benoît Cœuré said recently, this is the elephant in the room.

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