

Chapter 15

Thinking Fast and Slow About Central Bank Digital Currencies

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ABSTRACT

Central banks are considering the issuance of a central bank digital currency to serve as a payment tool to support economic activities. A central bank digital currency can also serve secondary purposes that are related to the statutory objectives of a central bank. A central bank digital currency is digital fiat money and an important central bank innovation. It presents potential benefits and some risks which calls for cautious optimism about issuing central bank digital currencies and a need for central banks to think fast and slow about central bank digital currencies.

1. INTRODUCTION

Money is constantly evolving and the agents responsible for producing and managing money must evolve with the times. Money and payments have evolved from trade by barter to coins, from coins to banknotes, and from banknotes to private digital currencies which are commonly used for digital payments. The growing addiction to digital payments is raising the question of whether central banks should issue its own digital currency for retail and wholesale use, also known as a central bank digital currency (Wong and Maniff, 2020; Bofinger and Haas, 2020; Fatas, 2021).

But first, what is a central bank digital currency? A central bank digital currency is a new type of digital money issued by a central bank for everyone to use for in-store or online payments (Piazzesi and Schneider, 2020; Wang and Gao, 2024). A central bank digital currency is essentially a digital banknote which individuals may use to make payments (i.e., a retail CBDC), while financial institutions may use it to settle transactions in financial markets (i.e., a “wholesale CBDC”). A central bank digital currency is dominated in the local currency unit and its value is stable at 1:1 with physical cash, meaning that a digital five dollar would be equivalent to a \$5 physical currency note. A central bank digital currency is

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not a private cryptocurrency or crypto asset which is privately issued by unknown non-state actors, rather, a central bank digital currency is issued by the central bank and is backed by the central government.

Having defined what a central bank digital currency is, it is important to point out some frictions and problems inherent in the current monetary system that require a lasting solution, and, who knows, central bank digital currency might be a solution! Moving on to the problems. The first problem is that some payments are expensive and slow. Also, many people lack full access to the financial system due to high transaction costs. Thirdly, private financial institutions wield significant power in the current monetary system due to the financialization of the economy. This arises from the fact that private financial institutions, including banks, are the largest lenders and the largest payment processors in most economies, and commercial bank deposits constitute the most abundant form of money available today because banks create money from their credit or lending operations. Furthermore, banks have a huge influence over the transmission of monetary policy because changes in central bank interest rate takes effect in the economy through changes in the size of bank lending to households, firms, and government. Therefore, central banks can only steer the economy in collaboration with commercial banks and other financial institutions. This makes financial institutions very powerful. Central banks are contemplating the issuance of a central bank digital currency to reduce the power of private financial institutions in the current monetary system. These problems, together with other central bank motivations for issuing a central bank digital currency, are steering central banks to issue a central bank digital currency to address these problems and upgrade the monetary system to become the monetary system of the future.

There is significant evidence that central banks around the world are preparing for a CBDC-led monetary system. For instance, a 2020 and 2021 BIS survey show that over 85 percent of central banks around the world are researching, developing, and piloting central bank digital currencies. Very few central banks, such as Australia and Kenya, have indicated that they will not issue digital currency now because there is no compelling case to issue a central bank digital currency. As of 2024, only few central banks have issued a central bank digital currency, namely the Bahamas (Sand Dollar), Nigeria (eNaira), Jamaica (Jam-Dex) and the Eastern Caribbean Currency Union (DCash), while countries like the US, UK, Canada, New Zealand and Australia have no intention of issuing CBDC now.

In the academic literature, many scholars have argued that central banks are hastily developing a central bank digital currency to counteract the sudden rise of private cryptocurrencies and their growing dominance in the domestic payment system (Laboure et al., 2021; Cong and Mayer, 2022; Blakstad et al., 2018; Yang et al, 2024), while other scholars argue that the issuance of a central bank digital currency may bring an end to the anonymity of money and reduce user privacy even though they accept that a central bank digital currency would deliver a safer financial and monetary system (Rennie and Steele, 2021; Gross et al., 2021). This suggests that the idea of issuing a central bank digital currency is not really bad as long as some safeguards are put in place to preserve privacy and the anonymity of digital money.

It is also common knowledge that developing a central bank digital currency is a complex task. Despite been a complex project, some central banks are thinking too fast about central bank digital currencies. By this, I mean they are very optimistic about the potential benefits of central bank digital currencies without paying serious attention to the known risks. Central banks who are thinking too fast about central bank digital currency may find a lot of surprises after issuing a central bank digital currency and may spend a lot of time and resources in quelling many risk-fire after issuing a central bank digital currency. On the other hand, some central banks are choosing to think slowly about central bank digital currency – they do not want to hastily join the CBDC bandwagon, they want to be cautious, and want to fully understand the benefits and risks of issuing a CBDC before deciding whether to develop a

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