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Why Sunak should think twice about a central bank digital currency

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Nobody has provided a satisfactory answer yet as to "why do we actually need this?" but Western central banks seem intent on creating their own "central bank digital currencies" (CBDCs).

The proliferation of cryptocurrencies, stablecoins, Facebook's Diem project and China's "digital yuan" has apparently left policymakers fearful of missing the boat on the next stage of currency evolution. HM Treasury and the Bank of England, for example, have been scoping out the case for what's been dubbed "Britcoin" since April.

Last week, one of the many dangers of such a project became clear: the possibility of its use for rampant paternalism. Tom Mutton, Director of the Bank of England, explained that the British government must decide whether any British CBDC should be "programmable."

That innocent-sounding function – reflecting whether or not the money can be set up to be released only for certain purposes or after conditions are fulfilled – could have profound consequences, if the contours are set by politicians.

Even casting aside the privacy dangers associated with central bank electronic currency, "programmability" could allow governments to preclude certain uses of this new form of money. Sandra Ro, Chief Executive of the Global Blockchain Business Council, has said the technology might allow governments to restrict what state benefits can be spent on, for example.

Given the current zeitgeist, one could imagine future constraints on whether electronic money could be used to buy carbon-intensive products or other things deemed legal but "socially harmful," such as gambling products or alcohol. The possibilities for the nannies of all the parties would be endless.

Let's back up for a second, though, to remember what this digital currency idea is about and why it matters. Central banks currently have a monopoly over the provision of physical banknotes (i.e. paper cash). They also provide digital money in the form of central bank reserves or

settlement balances held by banks and some other financial institutions. But private banks are the major source of digital money more broadly in the form of bank deposits.

A CBDC would, in essence, make a new form of electronic money issued by the central bank available to all households and businesses, denominated in pounds, at a time when the use of cash is declining sharply. As economist Ethan Ilzetski has explained, it "can be seen simultaneously as a way to replace cash with a digital alternative" while also allowing the public to hold a form of government money electronically outside of private banks.

Details differ as to how any given CBDC would work in practice. A lot of proposals globally would see the central bank itself provide retail account services to all who want them. The Bank of England has instead talked of a core "ledger" to provide a simple payments infrastructure, facilitating what it hopes will be a private, competitive market in "payment interface providers" who are regulated and connect to that system.

Whether that core ledger is delivered through blockchain-style technology is yet to be determined. The major potential upside from a pro-market perspective is that, conceivably, it could allow other institutions to offer accounts to people on a level playing field with banks.

Yet a CBDC as a new form of government-issued electronic money is not without severe dangers and trade-offs. Perhaps most radically, it would allow major changes to the operation of monetary policy. Under this system, the central bank could directly deposit digital currency into accounts through payment interface providers, instituting helicopter money to the public. It could also charge negative nominal interest rates on holdings – in effect, taking money from those who choose to forego spending this form of money.

The other purported "benefits" of CBDCs are that they would help improve financial inclusion and generate innovation in payments provision. But a lot of payment service innovations, such as Paypal, Venmo, Zelle, Alipay, WeChat Pay, PayTM, M-Pesa, Transferwise, and stablecoins are already operational and reducing the costs of digital payments without CBDCs.

Meanwhile, a large proportion of those "unbanked" or financially "excluded" from digital payments are so because of a lack of ID or due to a desire for privacy. These issues would not be alleviated by CBDCs. Indeed, why would we expect more innovation to result from a government-regulated digital currency system than in a private, competitive currency market?

What CBDCs would certainly do is heighten privacy concerns and risk the regulators controlling more closely how money is spent or invested. Those most keen for CBDCs tend to want to abolish cash, in part to eliminate (often victimless) illicit activity. Rishi Sunak and the Bank have rushed to insist that any Britcoin would exist alongside banknotes and bank deposits. But it's noticeable that those most keen on CBDCs tend to want to phase out cash entirely.

One fear with any government electronic money is that people opting to use direct central bank retail accounts, or services that create accounts there, could diminish ordinary deposits in commercial banks. That would mean less money available for banks to make small business loans, with the central bank left making more decisions about who can borrow.

In theory, the central bank might avoid this disintermediation problem by simply auctioning its funds, so "passing through" the money back to commercial banks to lend according to normal criteria. But would that be free from conditions? The likeliest outcome is surely that central banks and politicians would determine that passed-through funds must or must not be used to

achieve certain social, environmental, or even racial objectives. In other words, another form of government control over investment.

And that, I think, is an underappreciated danger of the CBDC idea. It would give the central bank and the politicians that set its mandate the tools to much more easily manipulate economic activity. Not just in terms of crowding out innovative private currency provision, payment systems, or the intermediation role of banks. No, as last week's debate made clear, any programmability built into the new form of money could open the door to more control over how we spend our own resources too.

There's a tendency in politics to observe new innovation in markets and presume that, if it's important enough, government institutions must get in on the act. But the Treasury should think carefully about what a CBDC actually delivers that ongoing private sector innovation cannot. And Tory MPs that care about economic and social liberties should be very wary of granting a free pass to the creation of new tools that could lead both to more government direction of investment and tighter paternalistic controls on private spending.

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