

Central Bank Digital Currencies have a role to play in commercial banking, and how!

Governments and central banks may work symbiotically with commercial banks to challenge large tech, e-commerce and fintech companies as well as cryptocurrencies from dominating the payments settlement space

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Commercial banks, public and private, form the bedrock of modern financial architecture. In most countries of the world, a substantial portion of payment settlements take place using deposit accounts held by the non-bank private sector (NBPS) at commercial banks. In the **UK**, for instance, 97% of broad money consists of bank deposits and only a small fraction of the total is currency in circulation.

Within the present financial system, state legal tender – cash or currency – is available to the NBPS only through commercial banks, which are authorised to swap deposits (its own financial liabilities) for cash (the financial liabilities of the state) at *par*. With the share of cash used for payment settlements showing a gradual decline in many countries, and more so since the ongoing pandemic began, there is a fear that state money – cash – may lose its significance in settlement of liabilities that arise from trade and exchange.

A new set of financial institutions that enable convenient and fast transfers between deposit accounts have arisen. Monopolization of information using fintech by these institutions is enabling them to gain control over financial decision-making. The only challenge to them perhaps comes from cryptocurrencies that allow settlements without intermediaries. The introduction of central bank digital currencies (CBDCs) could, however, not only challenge payment intermediaries but also cryptocurrencies, particularly if CBDCs utilize some form of cryptography. In this process, the commercial banking system may be impacted and its nature and role in the evolving financial architecture transformed.

The implications of CBDCs for commercial banking will to a large extent depend on the objective of a government and its central bank. If they choose to view commercial banking as an institution that allows for more decentralized financial decision-making then CBDCs could work *symbiotically* with them to challenge large tech, e-commerce and fintech companies as well as cryptocurrencies from dominating the payments settlement space. In such a framework, CBDCs may be issued through commercial banks just like cash. While the central bank can allow the NBPS to have accounts with it, which in the present system is not possible, the maximum amount held in such accounts will be capped. This would not only ensure that state money – cash or currency – remains a small portion of the total money supply but also makes it more viable for adopting crypto-technology-based CBDCs as most financial transactions will continue to take place using commercial bank deposits, ensuring traceability.

The other reason for adoption of a symbiotic model is because central banks recognize the importance of the knowledge commercial banks possess on the creditworthiness of borrowers, acquired from long-term relationships developed between both parties. Moreover, commercial banks are discerning and responsive to the specific needs of individuals and businesses for credit, which is often the starting point of the production process. The importance of this decentralized credit function of commercial banks in an economy can only be understood when their role is not reduced to that of an intermediary, which naively supposes that they take deposits and lend them out for consumption and/or investment spending. Instead, as contested by endogenous money theory (EMT), acknowledged by even the Bank of England, banks actually create money when they make loans. While it may be easier to replace the payments settlement function of deposit accounts, it is the loan function of commercial banks that will pose a bigger challenge to a centralized architecture.

In spite of these advantages, there exists a contrasting view over CBDCs, which asserts the foreseeable emergence of a more centralized financial system. This will happen because non-crypto CBDCs give central banks access to information about consumer spending, which in any case is already becoming increasingly available to private sector financial institutions using fintech and unsettling traditional insurance and banking services. Furthermore, greater centralization of banking functions will provide governments the ability to not only control the direction and flow of credit and investments in the economy but also facilitate closer surveillance over its people.

For CBDCs to become a primary means of payment

settlements over commercial bank deposit accounts, the NBPS must be given the option to open accounts at the central bank without limit. As we know, in the present system, government spending passes through the central bank and commercial banking system until it finally reaches the account of the NBPS. In the process, commercial banks are credited with reserve money in their accounts held at the central bank. If, however, the NBPS has accounts at the central bank, this primary source of reserve money for interbank settlements is eliminated. More importantly, any excess reserves that are usually swapped for government bonds by commercial banks and later used as collateral for repo transactions will also become scarce. Without adequate reserves and bonds to access reserves from the central bank, expansion of credit to the economy by the commercial banking sector is constrained, striking at the very root of endogenous money creation and the essence of modern banking itself.

The question, however, is why would the NBPS prefer to hold accounts at the central bank rather than commercial banks. Risk is obviously the primary reason. Not only is deposit insurance limited but the possible implementation of 'bail-in' laws wherein a bank's losses could be adjusted against deposit accounts further elevates risk. A risk premium will, therefore, have to be offered by commercial banks to attract deposits that would otherwise be held at the central bank. With the central bank bypassing commercial banks in the government spending process and the simultaneous scarcity of bonds, commercial banks will be almost fully dependent on deposit accounts as their source of reserves, reducing them to the position of non-banking financial companies (NBFCs), which in the present financial architecture seek finances before lending, rather than being creators of money.

Commercial banks also play an important role in the implementation of monetary policy, wherein the central bank seeks to incentivize the expansion or reining-in of credit by altering the cost of reserves through the setting of repo and reverse repo rates, which are then supposedly passed on to borrowers. A centralized CBDC model will, however, shorten the transmission mechanism as central banks would be in a position to influence the interest payable by commercial banks and consequently on loans made by them through changes in the interest paid on their own risk-free deposits.

Except for the Chinese DCEP (Digital Currency Electronic Payment) – although it is not a cryptocurrency – no other major country has made significant strides in the introduction of CBDCs and the discussion presently is, therefore, general and conjectural. The coming years are nevertheless likely to witness disruptive changes in the present financial architecture and monetary system with different countries choosing different paths in the introduction of CBDCs.

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