Istituto Affari Internazionali

A Digital Euro in Search of an Identity

by Franco Passacantando

The recent proliferation of crypto assets and other digital currencies is rapidly transforming the financial industry and the very concept of money. In response to these developments, many central banks are considering the possibility of introducing a central bank digital currency (CBDC), to be used as an alternative to cash.

These trends have led to a lively debate on the role that a new sovereign digital currency could play in the monetary system. Some claim that the creation of a CBDC looks like a solution in search of problem because the private sector is already responding to the needs of faster and cheaper payment services.[1] The opposite view is that, if nothing is done, central banks could eventually lose the capacity to conduct monetary policy, to preserve financial stability and to ensure the proper functioning of the payment system.

While the European Central Bank (ECB) has yet to make a final decision, in July 2021 it announced the start of a two-year "investigation phase" on the possible introduction of a euro CBDC, in which the views of prospective users and of those who will distribute the new currency will be sought.

Motivations

There are three main motivations behind the proposal of the ECB.[2] The first is the need to respond to the continuous decline in the use of cash as a payment instrument. Confidence in private money depends on the ability to convert it into public money, especially in times of crisis. If cash were to disappear, the monetary system would lose its anchor.

[1] Christopher J. Waller, *CBDC - A Solution in Search of a Problem?*, speech at the American Enterprise Institute, Washington, 5 August 2021, https://www.bis.org/review/r210806a.htm.

[2] Ulrich Bindseil, Fabio Panetta and Ignacio Terol, "Central Bank Digital Currency: Functional Scope, Pricing and Controls", in *ECB Occasional Papers*, No. 286 (December 2021), p. 5-6, https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op286~9d472374ea.en.pdf.

Franco Passacantando is Scientific Advisor at the Istituto Affari Internazionali (IAI).
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A second motivation is the concern that a few large foreign players could gain a dominant role in the European payment market, where large US networks like Visa, MasterCard or PayPal already play leading roles. New assets which are rapidly growing are the so-called stable coins, which are private payment instruments fully backed by risk-free assets, redeemable into official currencies. Their entry into the payment system could be the first step of a strategy of expansion in the broader area of financial services, including credit and insurance.

"Monetary strategic autonomy" is another motivation. It is believed that China could gain a first-mover advantage with the launch of its own digital currency; the e-CNY, which is already in the testing phase. According to the People's Bank of China, there are already 140 million users of the new currency whose experimentation started in January 2021.[3]

The narrow space for a new central bank money

The ECB has called the euro CBDC a retail payment instrument which would give access to central bank money to the public at large.[4] It has given ample reassurances regarding the risks of bank disintermediation and of "digital runs" i.e. the substitution of bank deposits with the CBDC in times of crisis.[5] To mitigate these risks the ECB would introduce quantitative limitations (e.g. 3,000 euro per person) and apply remunerations less convenient than those of bank deposits. It would also delegate to banks and other licensed payments service providers the role of distributing the currency to the public.

There is however also the risk that the new instrument, in part because of these limitations, would not meet the interest of the public. This is not a negligible risk for at least three reasons. First, the "anonymity issue". The ECB will have to comply with anti-money laundering and anti-terror financing regulations, which require some form of identification and tracking.

Second, the main advantage of central bank money is that it is free of credit risk, meaning the risk of failure of the issuer. However, deposit insurance already protects holders of small value deposits from this risk. Those who would benefit most from a digital euro would be large value depositors, firms, merchants, or non-residents, who are not covered by deposit insurance. However, the ECB wants to put limits on the use of a euro CBDC by these categories of depositors to prevent the new currency from being used as an investment vehicle.

Finally, a digital currency may enable faster payments, but considerable progress has already been achieved on

[3] "China's PBOC Says Digital Yuan Users Have Surged to 140 Million", in *Bloomberg*, 3 November 2021, https://www.bloomberg.com/news/articles/2021-11-03/china-s-pboc-says-digital-yuan-users-have-surged-to-140-million.

[4] European Central Bank (ECB), *Report on a Digital Euro*, Frankfurt am Main, ECB, October 2020, https://www.ecb.europa.eu/euro/html/digitaleuro-report.en.html.

[5] Franco Passacantando, "Could a Digital Currency Strengthen the Euro?", in *SEP Luiss Policy Briefs*, No. 9/2021 (5 May 2021), https://sep.luiss.it/brief/2021/05/05/f-passacantando-could-digital-currency-strengthen-euro.

this front. The main banks belonging to the Euro Banking Association (EBA) clearing system have in recent years developed an instant payment service (the Rt1) and the Eurosystem has launched the TARGET Instant Payment Settlement (TIPS) which has the capacity to move funds immediately after a payment is initiated. The volume of operations on both systems is rapidly increasing and Europe is gradually emerging as one of the global leaders in this domain.

One cannot exclude that the public could be interested in an instrument available at limited, or zero cost, which would be highly secure and easy to use, especially if the central bank will implement adequate safeguards regarding privacy. In this respect, the ECB has repeatedly stated that it will guarantee privacy and that it could use "privacy-enhancing techniques" while still complying with "regulations on anti-money laundering and combating the financing of terrorism".[6]

A digital euro could be designed in a way to facilitate access to digital technologies for disadvantaged segments of society, like older people or the poor, who often lack the experience and means to use the Internet. It could also facilitate cash transfers to and from the government and the provision of other services which require a digital identity. However, it remains to be seen whether the social and economic returns on such an instrument will be adequate to cover the risks and costs that its development will imply.

Addressing the main market failures

An alternative, or complementary approach would be for the digital euro project to address the most critical market failures that limit the competitiveness of the European payment system.

One of the main failures is the fragmentation of the retail payment system in Europe. The ECB has traditionally played a key role in this respect by managing the core infrastructure, the Target 2 system, which allows banks to settle in central bank money. As previously said, important results have been achieved by extending this system for instant payments. Further progress could be achieved in ensuring that the numerous innovative payment platforms being created by the private sector interact with each other.

Another area is that of the "wholesale CBDC", or the currency used to settle payments between financial institutions in central bank money. The dissemination of new technologies, like the distributed ledger technology (DLT), require the interaction between private players, the central bank and the issuers

[6] Fabio Panetta, *A Digital Euro to Meet the Expectations of Europeans*, speech at the ECON Committee of the European Parliament, Frankfurt am Main, 14 April 2021, https://www.bis.org/review/r210414h.htm. See also Fabio Panetta, *Central Bank Digital Currencies: A Monetary Anchor for Digital Innovation*, speech at the Elcano Royal Institute, Madrid, 5 November 2021, https://www.bis.org/review/r211123b.htm. The possibility to allow some degree of anonymity for lowest-value transactions has also been considered. See, ECB, "Exploring Anonymity in Central Bank Digital Currencies", in *In Focus Papers*, No. 4 (December 2019), https://www.ecb.europa.eu/paym/intro/publications/pdf/ecb.mipinfocus191217.en.pdf.

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of bonds. By setting the standards in this area and running central facilities where industries could develop their own applications, the ECB could play a key role in promoting innovative payment services.[7] Some central banks in the euro area are already conducting experimentations on the use of DLT for the exchange and settlement of financial assets.[8]

Finally, a well-recognised market failure is that which concerns cross border payments, even within the Eurozone. The Bank for International Settlements has been very active in proposing mechanisms to integrate the CBDCs being created in different jurisdictions. Europe, with its CBDC project, could play a key role in setting global standards, an area in which China is already very active.[9]

Ultimately, much remains to be done to fully develop a functioning identity for the European digital euro project. There are a number of different pathways that one may pursue. A first would lead to the creation of a new payment instrument for domestic retail transactions. However, the design of an instrument which would not overshadow the traditional role played by private sector providers while still being attractive for users is particularly challenging.[10] The market space for such an instrument is narrow and it is uncertain whether its benefits would outweigh the costs.

Another direction is for the ECB to enhance services in central bank money provided to financial institutions, for instance by offering what is usually labelled as wholesale CBDC. In this respect the ECB could play a key role in promoting digital innovation, improving the competitiveness of the European financial sector and facilitating the interaction with other central banks for cross border payments and foreign exchange transactions.

The choice between different options will be a difficult one, not only because the problem is technically very complex but also because of differences in payment habits and financial structures across various member states. It will however be important that a choice be made quickly and decisively because new players in the digital world are rapidly growing and the whole financial industry needs to know how to orient its investments to respond to the new challenging environment.

Ultimately, the direction that is pursued will also be of fundamental

[7] An example could be the development of applications for "smart contracts" or programmable money which would automatically send payments when some specific conditions are met. Cfr. Emanuele Urbinati et al., "A Digital Euro: A Contribution to the Discussion on Technical Design Choices", in *Markets, Infrastructures, Payment Systems*, No. 10 (July 2021), https://www.bancaditalia.it/media/notizia/a-digital-euro-a-contribution-to-the-discussion-on-technical-design-choices.

[8] See for instance Banque de France, *Wholesale Central Bank Digital Currency Experiments with the Banque de France*, Paris, Banque de France, November 2021, https://www.banque-france.fr/sites/default/files/media/2021/11/09/rapport_mnbc_0.pdf.

[9] Nicola Bilotta,"An International Digital Yuan: (Vane) Ambitions, (Excessive) Alarmism and (Pragmatic) Expectations", in *IAI Commentaries*, No. 21|44 (October 2021), https://www.iai.it/en/node/14157.

[10] Ulrich Bindseil, Fabio Panetta and Ignacio Terol, "Central Bank Digital Currency", cit.

importance for the future strength and attractiveness of the European Monetary Union.

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Via dei Montecatini, 17
I-00186 Rome, Italy
Tel. +39 066976831
iai@iai.it
www.iai.it

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