The Big Read European Central Bank

The digital euro: a solution seeking a problem?

Europe's central bank is pushing ahead with the development of electronic currency even as politicians question its purpose

Martin Arnold in Frankfurt and **Sam Fleming** in Brussels 7 HOURS AGO

When more than 1,000 demonstrators marched through the streets of Amsterdam in early February, they directed their ire at something that does not even exist: the digital euro.

The protesters voiced a kaleidoscopic array of objections to the European Central Bank's plan to issue an electronic version of the continent's single currency. Some feared the state would use it to track and control their spending, while others suspected a plot to replace cash. One protester told Dutch media she feared the authorities would stop her buying meat or alcohol.

Willem Engel, the event's organiser who was a ringleader for Dutch opposition to Covid-19 vaccines, whipped up the crowd by telling them to "avoid companies that don't accept cash".

This cocktail of suspicions and conspiracy theories about the digital euro comes at a highly delicate moment for the ECB and eurozone politicians. On the one hand, they are eager to step up preparations for the digital currency over the next few months, with the hope that it could be launched in as little as three years' time.

Yet at the same time, they are also struggling to communicate convincing arguments for the project, which is only increasing the scope for conjecture about the plans.

While China has the most advanced plans for a central bank digital currency among the larger economies, Europe is the furthest ahead among the main western central banks. Christine Lagarde has embraced the project since taking over as ECB president in 2019 from Mario Draghi, who barely mentioned the idea.

The Frankfurt-based institution is expected to announce in October that it will move into an implementation phase and start a pilot scheme. Lagarde has said she expects it will be ready to make the final decision of whether to launch a digital euro in 2026 or 2027.

This summer the European Commission will set out legislative proposals setting out some of the key design features of the putative currency, a landmark step towards that goal.

Supporters of the project say it would modernise European payments by giving people an electronic alternative to cash that is riskless and universally accepted.

"We need a risk-free asset and the only one that exists is central bank currency," Fabio Panetta, the ECB executive board member overseeing its digital euro work, told the Financial Times.

Always jealous of the dominant position of the dollar in the international financial system, Europe is eager to find new ways of promoting the euro's weight globally. It is also wary that China's digital currency will allow Beijing to expand its role. Like other central banks, the ECB is also concerned that privately controlled digital currencies will gain traction in the financial system as consumers increasingly shun cash.

However, there are mounting questions among consumers, financiers and politicians over exactly what the project actually aims to achieve and whether the potential risks outweigh the benefits.

These questions have only grown as the immediate threat from cryptocurrencies has faded along with the decline in the value of bitcoin and other rival forms of money. The subtleties of central bank currencies are hard for policymakers to explain: many people consider they are already in effect using digital money when they use their contactless payment card or mobile banking app, rather than cash.

Some European policymakers fear that a failure to make a clear case for the digital euro will undermine the project before it is even born — that it will come to be seen as a solution that does not quite know what problem it is solving.

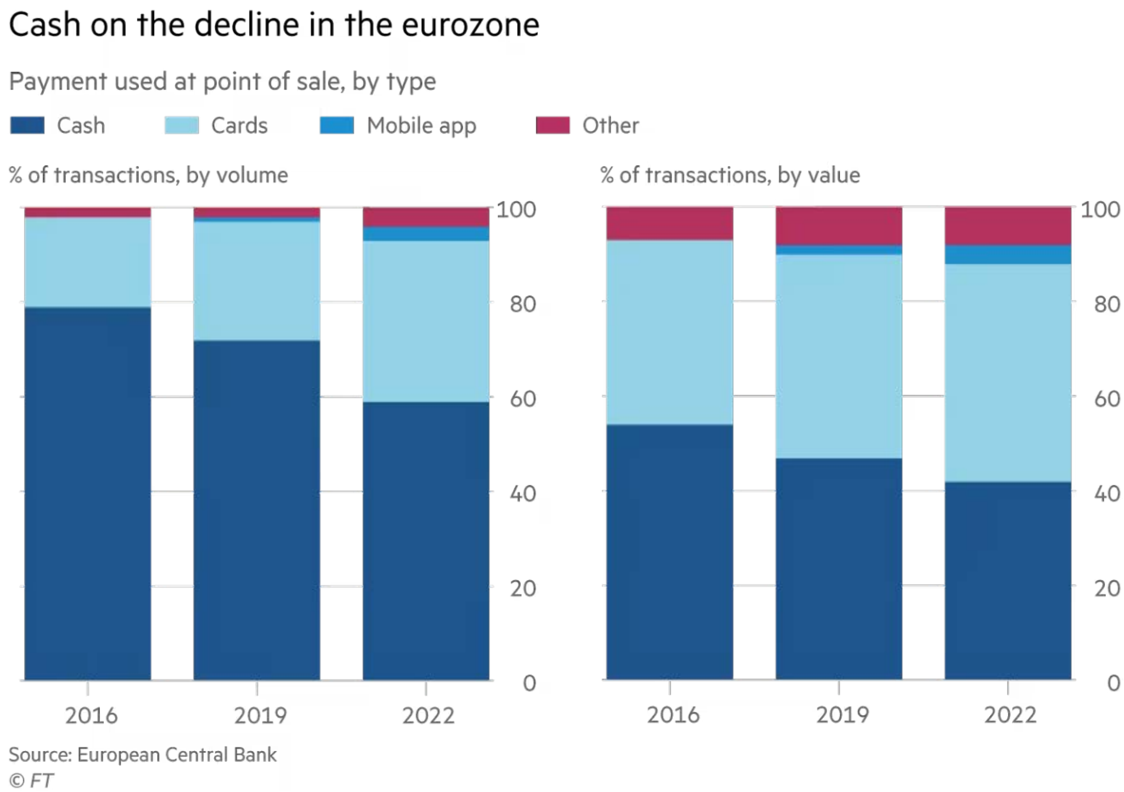
"What is the compelling reason for making this reform? This is the big unanswered question," says Ignazio Angeloni, a former ECB official who is now a part-time professor at the European University Institute in Florence. "I don't see any big failures in the market that require the public sector to step in and provide a digital euro."

Taking on Facebook

The idea of creating a digital euro first emerged a few years ago as a defensive response to Facebook's idea of launching a virtual currency of its own, which policymakers feared could undermine the ECB's control of the money supply.

Since then, the US social media group's digital currency, known initially as Libra and then Diem, has largely fizzled out. Yet the ECB is still pressing ahead.

A key motivation for the ECB is the declining use of cash, which has fallen from 79 per cent of all point-of-sale transactions in the eurozone in 2016 to 59 per cent last year, according to a recent survey by the central bank. The proportion of people in the bloc preferring to pay with cash has fallen from 32 per cent to 22 per cent in the past six years.



Officials say cash acts as an important stabilising force in the financial system by giving people access to a means of payment that is riskless because it is backed by the central bank. People are happy to deposit money at commercial banks in part because they know they can withdraw it as cash at any time, officials say. The digital euro is designed to preserve this role as cash usage declines.

"Digitisation of society means everyone wants to pay digitally," Panetta says. "But there is no single digital means of payment you can use everywhere in the euro area. Visa or Mastercard are controlled by non-European companies and are widely used, but many shops do not accept them. Even cash is not accepted everywhere."

Policymakers worry that Europe lacks its own payments champion, leaving it overly reliant on the likes of Visa, Mastercard, PayPal or even Apple, which recently launched savings accounts and a credit card in partnership with Goldman Sachs.

There is also a fear that as cash usage falls, people could switch to other means of payment, including stablecoins, which are digital tokens backed by fiat currency, or digital currencies launched by other countries, such as China's planned digital renminbi.

Christine Lagarde, president of the European Central Bank. She has embraced the digital euro project since her appointment to lead the central bank in 2019 © Abdesslam Mirdass/Hans Lucas/Reuters

"If the sovereign doesn't offer this, then others will take its place," says Panetta. "We want to build an app that ensures you can pay with the digital euro in the same way in every part of the euro area."

The ECB is keen to stress that it sees the digital euro as a complement to cash and not a replacement for it. It plans to build the infrastructure and to issue the tokens for the new system but to leave the day-to-day operations to commercial banks.

Consumers are likely to be offered the chance to buy digital euros through their commercial bank, rather than direct from the ECB. The new tokens are unlikely to earn interest and may be held in a separate app provided by their bank, but otherwise they could be largely indistinguishable from regular bank deposits.

It has something to do with how you define yourself as a nation and how the monetary system operates in

The banking sector has given a lukewarm response to the idea. Executives worry that the digital euro will make bank runs more likely by acting as a safe haven into which people can transfer their money during a crisis. The European Banking Federation warns of "a significant risk for banks due

your country — this is not a technical thing

to the potential shift of significant funds that are currently held as bank deposits to digital euro accounts/wallets".

To counter this, the ECB is considering imposing a limit on how many digital euros anyone can hold of about €3,000, or a punitive interest rate on holdings above a certain level.

But others argue the project is more seriously flawed, fearing that the ECB plans to add to inefficiency and complexity by creating a duplicate payments system that would only be used by the digital euro.

"Parallel payments systems could tie up capital and liquidity, the new system would likely face the same pain points, and it would be expensive," says Tim Adams, chief executive of banking lobby group the Institute of International Finance.

Bankers fret about having to shoulder the costs for such a major project with little upside, especially as the ECB has said basic payments with the digital euro should be free. The EBF says "public funding should be made available to support the investments that will be required" and recommends that merchants pay fees for accepting digital euro payments.

The Eurogroup, which convenes the finance ministers of the countries that share the euro, has been debating the topic intensively alongside the ECB since 2021. Discussions at a political level have been dominated by technicalities, as ministers struggle to get to grips with an enormously complex project.

Recently ministers have become increasingly conscious of the need to get out and make a more proactive case to households. This, officials admit, is not easily done given the complexity of the economic arguments behind the project and the ease with which consumers already transact with their mobile phones and payment cards.

Sigrid Kaag, the Dutch finance minister, told colleagues privately at a meeting in March that it was difficult to explain to citizens why a digital euro was needed, not least given the eurozone's payment system was already reliable and innovative, according to people familiar with the meeting. There was a need for politicians to get out and explain what the benefits of the currency would be, and to make them tangible, she argued, without which the new project might not be accepted.

accepted.

Customers wait to enter a Bank of the Bahamas in Nassau. The Bahamas is among the countries to have a fully live central bank digital currency © Tristan Wheelock/Bloomberg

"I accept that we may not yet have made the use case sufficiently clear for consumers," Paschal Donohoe, president of the Eurogroup, told the FT. "The value of concepts like financial stability [is] sometimes only understood in their absence . . . if a decision is made to move towards the realisation phase, more will need to be done to educate and explain to consumers."

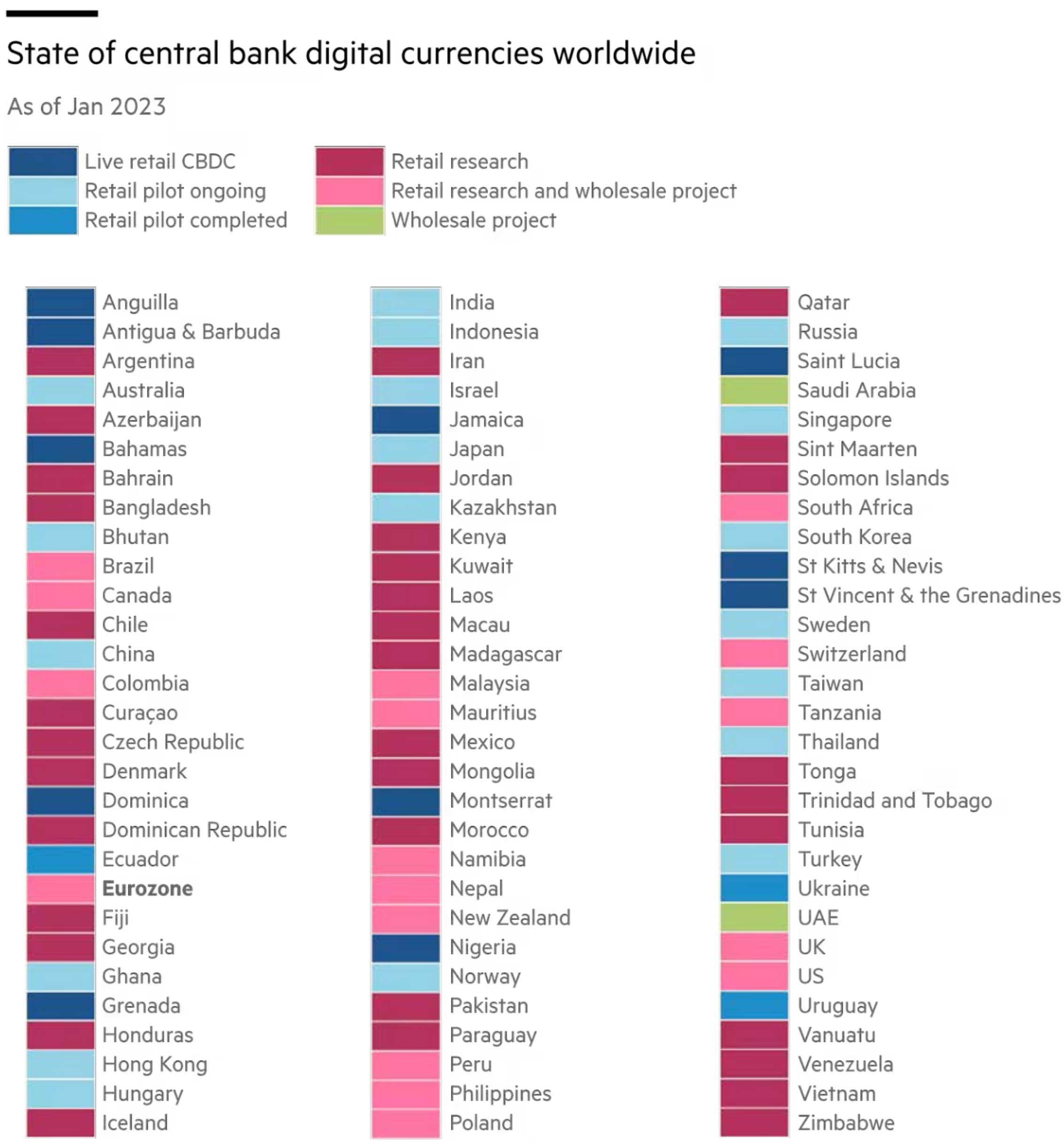
The European Commission is preparing draft legislation that aims to provide the legal framework underpinning the digital euro. Among the outstanding questions officials are grappling with is how to hardwire limits on digital euro accounts. Another is how to address the privacy concerns dogging the concept — a point that has been heavily stressed by Kaag, among others.

Mairead McGuinness, the EU's financial services commissioner, has insisted the digital euro will not be a "big brother" project. Officials say households are already surrendering far greater privacy to private sector tech giants via the use of their mobile phones and apps. But ministers are acutely aware of the risks that the project gets tarnished by a perception that it is a vehicle for government snooping on households' spending.

The ECB aims to address privacy fears — the main worry for more than 40 per cent of respondents to its initial consultation — by keeping users' identities separate from payment data unless criminal activity is suspected.

"We will design it in a way that means we cannot track if you have been to the bakery, or whatever," Evelien Witlox, head of the ECB's digital euro project, said on a podcast recently.

Given the proliferation of government-backed digital currencies around the world, officials feel that they have little choice but to plough ahead in the eurozone as they seek to promote the single currency's global status. Alongside a handful of fully live retail CBDCs, including Nigeria, Jamaica and the Bahamas, are pilots in 34 jurisdictions covering wholesale and retail CDBCs, according to the Bank for International Settlements.

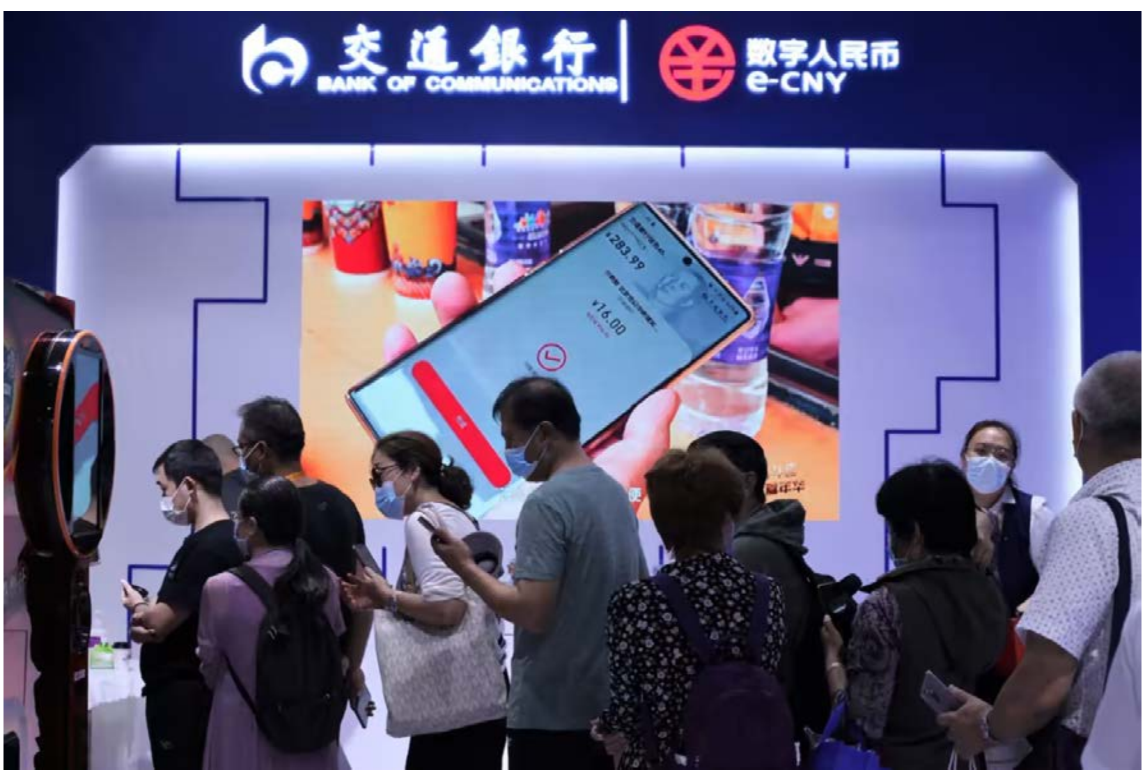


Source: BIS; Auer, Cornelli and Frost: 'Rise of the central bank digital currencies'
© FT

Sweden's Riksbank has been one of the early movers in the field after starting its e-krona project in 2017. Stefan Ingves, the former governor of the central bank, says that with people gradually moving out of cash in technologically advanced countries including his, the public sector needs to develop its own digital currency. "It has something to do with how you define yourself as a nation and how the monetary system operates in your country — this is not a technical thing," he says.

"If you want to hold something really safe, that thing is central bank money." Households do not need to buy into the central bank digital currency on a massive scale, he adds. "You just need to start somewhere".

The decline of cash by no means guarantees that consumers will embrace an official digital currency instead, however. Arguably the most closely watched of the various projects has been the digital renminbi in China. While the central bank has been expanding the number of pilots under way, paying more civil servants in digital renminbi for example, take-up has remained puny. The People's Bank of China says only Rmb13.61bn ($1.9bn) of the digital currency was circulating at the end of last year. That was 0.13 per cent of the currency in circulation.



A queue to buy discounted coffees using digital renminbi. Despite China's central bank expanding the number of pilots of the currency, take-up has been underwhelming © Bloomberg

Part of the problem is that private sector offerings such as Alipay and WeChat Pay are already widely used, and it is not obvious what advantages the official digital currency confers.

In Europe, the case for CBDCs recently suffered a further setback. Sweden has one the lowest levels of cash usage in the world — with only a third of the population now using it regularly, down from almost 80 per cent in 2016. This should make it fertile ground for a CBDC, but a government-appointed investigator concluded in March it "currently does not see a strong enough societal need" for an e-krona.

If there were a case for continuing exploratory work, it was a defensive one. Sweden's strong links to the eurozone "raise questions about whether a digital euro in the longer term could lead to the euro being used for payments in Sweden to a greater extent", the investigator found. This "could make monetary policy less effective" as well as creating risks for financial stability. Accordingly, the Riksbank was told to keep looking into it and come back with a proposal next year on whether to launch an e-krona.

For the ECB, a big challenge is deciding how successful it wants the digital euro to be. Huw van Steenis, a former Bank of England adviser now at consultants Oliver Wyman, calls this the "Goldilocks CBDC" issue — wanting to avoid a flop but not to create something so popular it undermines the banks. "The elephant in the room is that we have just seen what a digital-paced bank run looks like, for the 100-plus central banks investigating them it means we should pause for careful reflection before deciding to mint a CBDC," he says.

For the euro area there is a risk at the margin that a dollar-based stablecoin could come to dominate cross-border payments

Panetta believes that by setting a limit on holdings at about €3,000, the ECB can get the balance right. "The objective is not to gain a large market share," he says. "We don't want to become dominant or challenge the banks. If the digital euro becomes a familiar payment option among Europeans that is fine by me."

But others say tightly restricting a person's digital euro holdings undermines the currency's attractions. "It is like alcohol-free wine," says Peter Bofinger, an economics professor at the University of Würzburg, who recently wrote a paper on the digital euro with a colleague. The enforced abstinence imposed on the digital euro will convince people it's not worth bothering with at all, he argues. "I cannot see how this will not fail."

Ultimately, whether the ECB goes ahead with a digital euro could depend on what others do. Unlike the US, which benefits from the dominant position of the dollar in international trade and reserves, the euro is in a weaker position. With geopolitical tensions intensifying, ECB officials are already uneasy at how much Europe relies on foreign companies for much of its payments system — even if many are US-based.

"For the euro area there is a risk at the margin that a dollar-based stablecoin could come to dominate cross-border payments," says Eswar Prasad, a professor of trade policy at Cornell University and author of *The Future of Money*. The euro, he says, has already lost ground in international usage to the renminbi and the dollar, and policymakers are anxious to reverse that trend.

Ensuring the currency is available in digital form therefore might, he argues, "be more of an imperative for Europe".

Data visualisation by Liz Faunce