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Future of Money
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Wellington

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Dear Sir/Madam

Submission on Central Bank Digital Currency consultation

1. This letter is my submission on the Bank's issues paper on the possibility of a future new (general purpose) central bank digital currency (CBDC).

Summary

2. The case for a possible future central bank digital currency is not persuasively made, and seems to rest on very weak (some simply inaccurate) analytical foundations and characterisations of history, inflated with overblown claims about the role of central bank money. There may be a case, at some point in the future, for a very basic form of digital central bank-issued New Zealand dollar to be available for use by members of the general public. But I would expect that demand for any such product (so long as fairly-priced and not supported by regulatory restrictions on other forms of money) would be quite limited, both in normal times and perhaps even in (extremely rare, by construction of prudential policy) systemic financial crises. This is consistent with the experience with physical central bank money, which is used largely only because private issuance is outlawed. In the shorter-term, and whether or not the Bank ever issues a general purpose CBDC, a much more liberal approach should be taken to allowing access to the Reserve Bank's exchange settlement account system.

Body of Submission

3. The weaknesses in the consultation document start early. For example, there is the grossly overblown claim on page 6 that "central bank money can be considered systemic in all societal domains [whatever that means] – it underpins people's …. environmental, social and cultural wellbeing". There is no analysis presented in support of a claim that seems almost laughably inconsistent with the fact that most countries didn't have central banks until 100 or so years ago. Central bank money has a useful, indeed important, potential role to play in macroeconomic stabilisation - the reason the Reserve Bank of New Zealand was established – but the implied suggestion that without their new central banks our grandparents (or the great-grandparents of Americans) somehow had impaired cultural or environmental wellbeing [again, whatever either phrase means] seems, at best, a stretch.

4. By page 8, we read the claim that "over time central bank money has proven more robust than commodity-backed money". Since historical fiat money systems (notably in China) failed, and the current use of fiat money almost everywhere is perhaps (depending on definitions) a hundred years old, and has been characterised by a sustained uptrend in the price level, it seems early to suggest that the current system is more robust. It also isn't clear why the claim is relevant to the consultation paper, including because none of us can see the far-distant future or what models of money might be best-suited several decades hence.

5. Another dubious claim follows a paragraph later where you assert that "confidence in Reserve Bank-issued money…draws on the fact….the independence of the Reserve Bank from the New Zealand government (to ensure the government cannot issue money to raise revenue)", which seems not only to deliberately misunderstand the Bank's rather limited "independence" from the government (in implementing the policy settings to deliver a government-determined target for inflation), but rather ignores the durability of demand for New Zealand dollars during the many decades in which the Bank did not have any real degree of operational autonomy.

6. Perhaps these are each individually small points, but they help to undermine any confidence that the Bank has deployed the necessary analytical grunt to think carefully about monetary issues. In a similar vein it is perhaps surprising that there is no analysis of, or reflection on, the demand for safe short-term assets issued by the government or the Reserve Bank. Most notable, of course, is physical currency itself. There were only privately-issued bank notes in New Zealand prior to the establishment of the Reserve Bank, a period in which New Zealand had risen to generating among the very highest levels of real GDP per capita of any country. There was, in my view, a good case for establishing the Bank, but that case rested in macroeconomic stabilisation policy (primarily the ability to lean against severe downturns). Establishing a central bank monopoly on the issue of bank notes was not at all a necessary part of providing New Zealand with such flexibility. And without the establishment of such a monopoly there is no reason to suppose that firms and households would not have happily continued to use (primarily) privately-issued notes, in just the same way as they continued to use privately-issued deposit liabilities. In other words, retail demand for central bank money is - and always has been - primarily a product of legislative and regulatory interventions to prefer the central bank product.

7. Weaknesses pervade the consultation paper. For example, the Bank claims the issuance of a CBDC would "support the ability of central bank money to act as a fair and equal way to pay and save in our modern and inclusive economy", and has a lot of handwaving rhetoric around "financial inclusion" without (a) any serious attempt to document the nature and scale of any such issue or (b) any serious analysis of alternative options, if there is an issue. As far I could see, for example, there was no data in the paper outlining the percentage of the New Zealand resident (and legal) adult population that (a) does not have a bank account, and (b) would like one. Since even welfare benefits are (almost?) exclusively paid by direct credit to a bank account, it seems hard to believe that – for now anyway - there is a problem in New Zealand. We are not the United States. And when the Bank attempts to suggest that a CBDC might help those who are not just unbanked but those who are "underserved by the private sector by offering basic services at low or subsidised prices", there is no attempt to rigorously analyse who might be "underserved" (or even how that might be defined) let alone why Crown subsidies, via the Reserve Bank, might be desirable. Similarly weak, in the same section of the

paper, is the claim that provision of a general purpose CBDC would be a "public good". Being issued by a public agency does not make something a "public good".

8. The Bank also attempts to build a case for a CBDC on grounds of stimulating innovation and competition in the payments market in New Zealand. But again, none of the supporting analysis and argumentation is very convincing, including because the entire focus seems to be on the immediate (or even prospective) impact of the CBDC - assuming it was not a little-used white elephant - and nothing at all on how a small public sector agency, with management never likely to be focused on consumer payments products, is likely to maintain a technological edge in the longer-term. Again, some of the history may be telling. No doubt those who favoured the introduction of monopoly central bank physical notes thought that there were (net) advantages to society, and yet in the process innovation in physical currency products was brought to a screeching halt. Aside from the security features of the notes themselves, the basic structure of a bank note – zero interest, payable in full on demand - has not changed since 1934. That, in turn, left us with the monetary policy problem of the effective lower bound on nominal interest rates - entirely a function of regulatory/legislative constraints. We can't tell what innovations might have occurred under a different model[1].

9. Even in the shorter-term few if any benefits would be likely if - as I suspect - demand for a fairly-priced general purpose CBDC was quite limited. Why would any private operator materially alter its own products - or the market evolve much differently - if the Reserve Bank introduced a product that no one much wanted? As noted earlier, widespread demand for Reserve Bank notes did not arise because of the superior quality of the product offering but because of the legislative monopoly Parliament handed to the Bank. We can tell that this is so by how comfortable households and firms have been over the years in holding funds as, and making payments using, deposits in commercial banks. The credit risk - such as it is - on a privately-issued note would, in principle, be exactly the same as that on a private deposit. People happily hold and use those private deposits, which have become an ever-more-dominant part of the payments and monetary system as the decades have passed.

10. Along similar lines, it simply isn't obvious who would want to hold any material amounts in a CBDC account, or that most people would even choose to have such an account (and if they didn't some of the claimed benefits simply vanish). What is the unmet demand for a product denominated in exactly the same NZD as the commercial bank accounts almost everyone already holds and uses? The paper makes no attempt to show this. There are various claims about payments products/services that the market does not (yet) offer, but no attempt to analyse why, or whether there is an effective market demand for such products. There is (understandable) angst about the costs and timeliness of some cross-border payments, but little engagement with the innovative products already being experimented with by market participants. When government officials think they can offer a better product/service than the market, they are usually wrong. What may eventually be economic, need not be so now. On the store of value side of the picture, revealed evidence is that few people are interested in paying the price for a retail instrument with no credit risk: less than $200 million of (government) Kiwi

[1] I have argued for many years that even now the legislative monopoly on banknotes should be repealed. Doing so would have no adverse monetary policy consequences, and could potentially afford some small efficiency gains, although at this late date it may be unlikely that any private issuer would reintroduce physical notes.

Bonds are on issue, even though these are directly issued by the New Zealand government and redeemable on demand.

11. The consultation paper expresses some unease about the possibility that a retail CBDC could either (a) disintermediate banks (or other private deposit-takers), and/or (b) destabilise the banking system in periods of stress by making it (a little) easier for retail depositors to run. The former is unlikely, and if it were to happen would have to revealing something about either (a) public confidence in the soundness of the financial system or (b) the pricing of the product. As the Bank will be well aware, one can generate a demand for almost any instrument if the price is right (or rather, wrong). Retail government inflation-indexed bonds were very popular in New Zealand for several years in the late 1970s and early 1980s, but only because they paid such a high yield (especially after-tax) relative to anything else the market could offer. Pricing of any CBDC instrument could relatively readily be set to keep demand to quite modest levels, if in fact there was revealed to be much demand at all.

12. As for bank runs, as a participant at a recent seminar arranged by the University of Auckland noted, there has been a significant increase in the possibilities for retail and wholesale runs in recent decades (even as well-managed banking systems, including our own, remain sound). It isn't obvious why we should provide fewer options to ordinary depositors than to others. And more generally, the way to stop a panic in a crowded theatre is not to bar the doors but (in this case) to support sound asset quality on bank balance sheets and high levels of capital. More generally, the threat of a run - and runs are more often rational than not – remains a powerful market discipline on banks, and concerns that market disciplines might have become attenuated have been increasingly to the fore in recent decades.

13. The consultation paper has some, rather limited, discussion of the potential balance sheet issues for the central bank, and yet the asset side of the balance sheet got surprisingly little attention. Since I don't expect there would be much demand for any fairly-priced CBDC, perhaps it isn't an issue that needs too much attention. Nonetheless, in your discussions of high-demand scenarios it needs to be addressed. We should not find ourselves in a position in which the central bank is a significant influence on which economic sectors get easy access to credit (central bank buying their bonds), and we cannot - and should not - count on the government always choosing to run a sufficiently large debt that government bonds would always be a suitable repository for the proceeds of a large CBDC issue.

14. One issue the consultation paper did not touch on at all - and which might quickly become quite salient if somehow demand for a CBDC were to be large – is the pressures the Reserve Bank might be placed under to determine who has access to the product. The default option would surely have to be something like "any legal (adult?) resident in New Zealand", although there are arguments for allowing people anywhere to hold an account (subject - if you must – to AML/CFT laws). But equally it is easy to see pressure mounting on the Bank, or its own rhetoric feeding such pressures, to deny certain types of people and firms access to the product. According to political taste, these might include fossil fuel companies, entities associated with the PRC (or Russia or Myanmar or Israel or whoever), neo-Nazi groups, anti-vaxxers, sex offenders, murderers or whatever. One of the beauties of physical cash – the current central bank retail product - is precisely its anonymity. And commercial banks get to make - rather anonymous private - choices about who to offer accounts to. Perhaps such pressure would not arise much if there was not much demand for, or use of, the product but then…..in your own terms, why offer

such a product that few people want?   And how much confidence could we have in the Bank resisting such pressures – remaining as a narrow, non-discriminatory issuer – when under current management (and Board) the Bank has been so willing to wax eloquent on all manner of public policy issues for which it has no statutory responsibility?

15. Your discussion document has only a brief treatment of the issue of the payment of interest on a CBDC. I regard it as essential that if you do introduce such a product interest is paid (or charged) on very similar terms to the OCR paid on settlement account balances. If a CBDC were to be zero-interest product, the problems around the effective lower bound would be seriously aggravated, and there is no good case for a materially different rate being paid on retail balances than is paid to banks (albeit the rate might be slightly lower on very small balances). More generally, dealing with the effective lower bound issues, and normalising the possibility of deeply negative OCRs, seem like higher priority issues for the Bank at present than the CBDC path.

16. There is some discussion of issues around so-called "monetary sovereignty" in the Bank's papers. Whatever this actually means, there is no serious discussion as to how private payments developments might threaten the ability to conduct an effective monetary policy in New Zealand, or how a CBDC might materially limit any such risk. There was talk of the risk of "global stablecoin" somehow displacing New Zealand dollars, but there was no analysis - grounded in how use of individual national currencies has changed over time – of why such an offering would materially affect anything about the ability of the Reserve Bank to conduct an effective monetary policy. As the Bank will know, much about the usefulness and effectiveness of national monetary policy rests in the stickiness of domestic non-tradables prices and wages.   As long as, for example, labour is contracted for in New Zealand dollars, and New Zealand wages are sticky, monetary policy will, in principle, be able to undertake countercyclical stabilisation policy. And if ever that contracting in the real economy changes - as to currency or flexibility - New Zealand monetary policy will no longer be effective (or perhaps necessary). But short of hyperinflations I think the Bank would struggle to identify examples where domestic monetary policy has become so attenuated, or to explain how an offshore stablecoin, backed by some other national currency, could be likely to displace the NZD for the vast bulk of transactions, occurring onshore in the same currency as almost all of us earn.

17. There may still be an eventual case for a general purpose CBDC, but if there is such a case it is mostly to put the public on the same footing as banks - who have access to credit-risk free payments media through their exchange settlement accounts. It is an argument in principle, but it is hard to see it as any sort of priority for the (still scarce) resources the taxpayer allocates to the Bank, especially as deposit insurance is about to be introduced to New Zealand. It isn't obvious that the market could not provide risk-free payments media for ordinary firms and households as and when there is demand for such a product, and the government already issues a credit risk-free store of value asset that is readily available to households. If the Bank is concerned about widening access to its product, perhaps the place to start is a loosening in the rules on access to exchange settlement accounts, a desirable end in itself supported on competitive neutrality grounds.

Yours faithfully

Michael Reddell