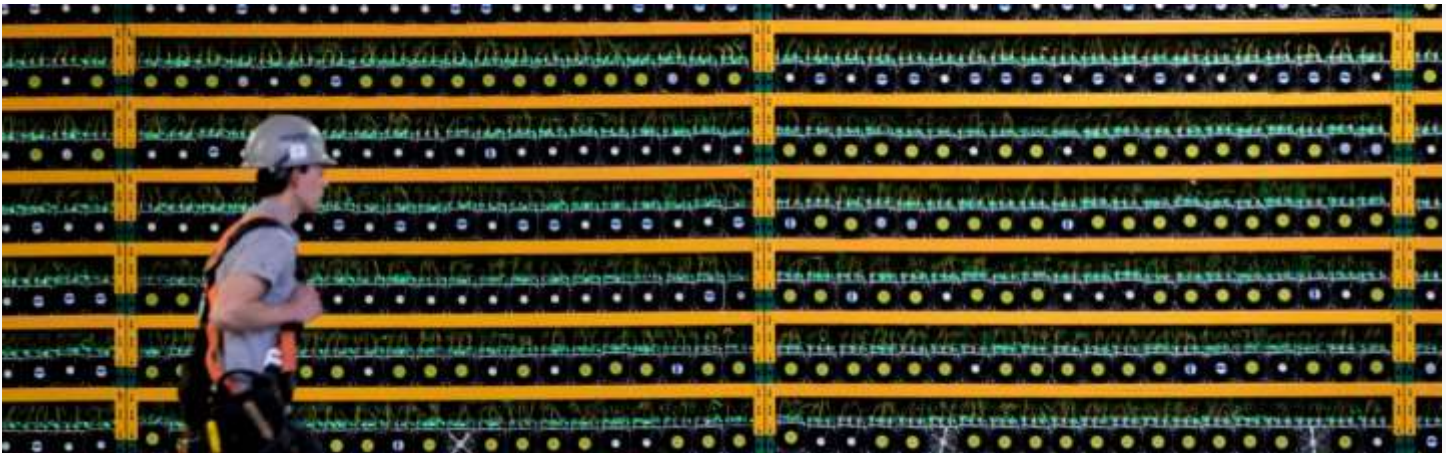


## Why Central Banks Could Mint Their Own Digital Currency

### Assessments

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Mar 28, 2018 | 08:00 GMT



(LARS HAGBERG/AFP/Getty Images)

- **Highlights**

- Only 8 percent of global financial transactions today involve cash, but that figure will diminish even further as digital currencies gain prominence.
  - Faced with the growth of cryptocurrencies such as bitcoin, central banks around the world will continue their research into introducing their own digital currencies.
  - By entering the market for cryptocurrencies, central banks could pose a profound threat to the commercial banking business model.
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From the [Marshall Islands](#) to Russia, it seems everyone's on board with the year's hottest trend: digital currency. Following the boom and (partial) bust of various private cryptocurrencies over the last six months, several central banks are now seriously considering introducing their own national digital currencies in the near future. These currencies won't just be bit players in a field dominated by the likes of bitcoin; instead, the central banks' entry into the crypto game could have a significant effect on individual customers, commercial lenders and the international monetary system itself.

## Big Picture

The decline of cash and the rise of private cryptocurrencies such as bitcoin are driving central banks around the world to consider issuing their own digital currencies for the first time. The development could transform the global monetary system and create new risks for the banking sector.

[See A Weaker Banking Sector](#)

## From the Physical to the Digital

Money emerged independently in every corner of the world, but the British Empire was especially influential in laying the groundwork for many countries' modern financial systems. In response to the onerous task of transporting gold to make payments, gold merchants in the United Kingdom began to issue exchange notes — in effect, paper money — as proof of funds. The system developed into a constellation of private banks, each of which issued currency in its own name, and soon drove up inflation as the institutions overprinted currency to improve their own profits. To rectify the issue, the British government chose one bank, the largest, to become the sole issuer of national currency. And so the modern central bank was born.

Thanks to its government-enforced monopoly, the central bank became an arm of the administration over time. It became the safest repository for the funds of other banks, since its fate was tied to and guaranteed by the government's own balance sheet, and the source of bailouts when they encountered trouble. At the same time, as it stopped receiving deposits from private citizens, the central bank ceased to function as a commercial lender on its own behalf and turned its focus solely to its official responsibilities in the larger system.

Today, the monetary system consists of two main parts: physical money and digital money. Physical money — cash — is the last direct link most citizens maintain with the central bank through bank notes and coins, which essentially are IOUs tied to the government balance sheet. Digital money, by contrast, embodies citizens' relationship with commercial institutions and involves a transfer of funds between banks (assuming

the payer and payee do not use the same institution) in a process that the central bank oversees and underwrites. Cash currently accounts for just 8 percent of global transactions, and its use may diminish even further as [rapid developments change the global economy](#).

## Changing the Game

Technological progression, efforts to fight crime and the desire to implement negative interest rates have all prompted a decrease in worldwide cash use. Some governments have actively tried to advance the trend, most notably in the case of [India's dramatic demonetization](#) initiative in 2016. In more developed countries, the push toward a cashless society is uneven; while the United States, Germany and Japan are still attached to physical money, more than one-third of Swedes say that they never use cash at all.

The emergence of private cryptocurrencies is likely to have an even bigger effect on the world's current monetary system. Bitcoin, which first appeared in 2008, has induced worry among governments, because national financial authorities have little or no control over the currency, which could become a means of payment in their economies. As the use of cash decreases, officials fear that cryptocurrencies could soon fill the void. Wary of the solvency of banks — especially in the wake of the 2008 financial crisis — and unable to safely store wealth in physical cash, more and more people have reasons to turn to bitcoin or one of its numerous derivatives. Governments may as a result lose the ability to influence the money supply for the first time since they granted central banks a monopoly on the issue of bank notes and coins.

## If You Can't Beat 'Em, Join 'Em

Hoping to contain the threat posed by private cryptocurrencies, some countries have resorted to regulatory crackdowns. Others have begun considering whether it's time to wade into the fray themselves. In fact, several central banks, including the Bank of England and the U.S. Federal Reserve, have begun research into whether to issue digital currencies. Sweden's central bank, the Riksbank, has led the way in efforts to launch a digital currency, the e-krona, and the governments of many other countries are eager to expedite the introduction of their own cryptocurrencies.

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Venezuela has rolled out the most advanced — albeit perhaps least substantial — digital currency so far in the form of the [petro](#). As hyperinflation plagues the national currency and the threat of punishing U.S. sanctions looms large, Caracas took a chance with the introduction of the petro Feb. 20. The new currency, built on extensive oil reserves, provides an enticing option for those wanting to buy into the bitcoin wave and a potential avenue to evade sanctions. Still, it seems unlikely to pique the interest of too many investors. Venezuela's government, which directly controls the petro, has proved itself a questionable steward. Furthermore, powerful buyers such as the United States, China and Russia have signed deals to snap up a large portion of the country's oil reserves, and U.S. President Donald Trump slapped sanctions on the new currency March 19.

Beyond the petro, Russia's cryptoruble is the central bank digital cryptocurrency that is closest to becoming a reality. Russia has a long history with money laundering and illicit fund transfers into and out of the country. Digital currencies have provided a new route for these transactions. Like many of its counterparts abroad, the Russian government has cracked down on private cryptocurrencies as it plans to launch its own digital currency. The Kremlin, however, intends to include a 13 percent transaction fee payable to the government when investors buy into the cryptoruble without documenting the origins of their funds. The proposed policy suggests that Moscow recognizes the futility of trying to halt black money flows and wants to cash in on them instead. In addition, Russia is billing the cryptoruble as a way around sanctions, though the details and effectiveness of that strategy remain to be seen.

Estonia, meanwhile, is also thinking of launching a cryptocurrency, the estcoin. The currency would help the tiny Baltic state raise funds while also buttressing its pioneering virtual residency endeavor. Because it is already a member of a larger currency area — the eurozone — the country could face complications in achieving its ambitions, but Tallinn appears committed to pursuing them anyway.

Most consequential, though, are China's efforts to issue a digital currency. Exerting maximum control has long been important for the country's leaders, and Beijing has exhibited singular determination in stamping out private cryptocurrencies. At the same time, the People's Bank of China has emphasized its intent to introduce a digital currency that will enable the central government to better track the movement of money.

## **Enter the Central Bank**

Digital currencies operating under the auspices of a central bank could have major effects on several levels. To start, they would greatly increase efficiency in digital transactions. Under the current system, a digital payment must first go to a private



bank and then pass through a central bank before arriving at another private bank. Implementing digital payments at the central bank level would eliminate the need for a third party — the commercial banks — thereby accelerating the whole process and reducing transaction costs.

Accordingly, cryptocurrencies issued by central banks could threaten the business models of commercial lenders. The central bank's balance sheet would represent the safest liquid asset available to potential investors, since the national government guarantees it directly, while a private bank is at greater risk of experiencing bankruptcy. The rollout of central bank digital currencies could introduce a giant rival into the banking market and compel commercial banks to become ultracompetitive in their lending practices. If a crisis were to occur, moreover, customers could lead a stampede to pull their funds from private lenders for the comparative safe harbor offered by the central bank. Controls would be necessary to prevent such a run. Alternatively, the introduction of central bank digital currency could presage the implementation of narrow banking, in which central banks guarantee all commercial bank reserves but also [rescind lenders' autonomy to "create" money](#) by issuing loans not backed by hard deposits.

The monetary system that has emerged over many centuries is undergoing significant changes today. Though central banks will be careful not to make sudden or drastic moves on the money supply, the advent of cryptocurrencies and the imminence of a cashless era are forcing them to innovate and adapt. The structures of the new era will become clearer in time, but, whatever form they take, digital currencies will be here to stay.

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