

## THE DIGITAL EURO AND THE ROLE OF CENTRAL BANK CURRENCY ANCHOR

Monetary anchoring is one of the main arguments put forward by central banks to justify an eponymous digital currency. According to supporters of the digital euro, a reduction in the use of paper money or even its disappearance would be the natural next step and result in the creation of a digital form of central bank currency that would be the only guaranteed way of keeping the currency anchored in the digital era. Nothing could be less obvious.

In November 2021, during a speech on the digital euro, Fabio Panetta, then a member of the ECB's executive board, stated: *"People's confidence in private money is underpinned by its convertibility on a one-to-one basis with the safest form of money in the economy – central bank money, the monetary anchor – and hence with other regulated forms of money"*<sup>1</sup>. He added: *"Private issuers [of currency, i.e. banks, editor's note] have to rely on convertibility, as their money is exposed to operational, credit, liquidity and market risks,"* while also noting that *"these risks are reduced through public policy safeguards, such as financial supervision, capital requirements and deposit insurance"*.

In a recent article also addressing concerns – which they believe to be exaggerated – about bank disintermediation as the result of a digital euro, Bindseil, Cipollone and Schaaf (2024)<sup>2</sup> posit the theory that the decline in use of banknotes for daily transactions will also eventually reduce the structural demand for banknotes. To support their claims, they point out that the nominal stock of banknotes decreased in 2023 for the first time since 2002 in the euro area, which they attribute to higher interest rates and the digitalisation of payments. In the light of the supposed risk of the reduced role as anchor coupled with the fall in banknotes in circulation, the ECB needs to ensure that *"the money [it issues] maintains its role as a monetary anchor"*<sup>3</sup>.

But the combination of a reduction in use of banknotes as a payment instrument and a decline in banknotes in circulation does not really stand up to the facts. Despite decreased demand for banknotes for retail transactions, banknotes outstanding rose by 2.4x between 2002 and 2022 while, at the same time, its relative size increased from around 10% of household current accounts to 17.5%. These opposing trends are known as the "paradox of banknotes"<sup>4</sup>. Meanwhile, cash is still the most frequently used payment method at the point of sale, despite the sharp decline in use of cash since the Covid pandemic, with 59% of transactions (in terms of the number) still paid in cash in 2022<sup>5</sup>.

According to ECB estimates, demand for banknotes in 2019 was motivated more to keep them as store of value (between 28% and 50%) than to pay for transactions (between 20% and 22%). A large proportion of demand also came from non-EU residents (between 30% and 50%).

In any case, the quality of anchoring of the commercial bank money to the central bank currency is not measured so much on the basis of the amount of the cash currency in the economy as on the basis of use of the commercial bank currency that is anchored to it. Economic agents willingly use the commercial bank currency rather than the central bank currency because they are confident that they will be able to convert deposits held with commercial banks into the central bank currency (hence the risk of a bank run when confidence slips). And this confidence in the value of the commercial bank money cannot be underpinned by just the deposit guarantee. Although this system guarantees reimbursement of a certain amount expressed in the euro unit of account as issued by the central bank (€100,000 since 2014 in the European Union). But the uniqueness of the value of the euro irrespective of the issuer (central bank or commercial banks) is ensured only by the ability to convert the commercial bank currency into the central bank currency at parity (cross-parity of euros from different commercial banks, in some way, by analogy with cross exchange rates). In other words, the ability to go to a bank counter or ATM to get cash in exchange for funds deposited with the bank, at parity. The number of ATMs has been in decline in the eurozone since 2015 but, as the ECB stresses, the density of ATMS is not the most relevant measure of ease of access to cash. The interpretation of this indicator is based on the implied assumption that cash machines' elimination is distributed uniformly across each country and among its population, which is not the actual situation. In this regard, a recent ECB study<sup>6</sup> states that the proportion of people living within 5 km of the nearest cash access point in 2020 ranged from 77% to 100% in the various countries in the eurozone, with a median of 95% for all countries.

<sup>1</sup> Panetta F. (2021), "Central bank digital currencies: a monetary anchor for digital innovation", Speech by Fabio Panetta, Member of the Executive Board of the ECB, at the Elcano Royal Institute, Madrid, 5 November.

<sup>2</sup> Bindseil U., Cipollone P., Schaaf J. (2024), "The digital euro after the investigation phase: Demystifying fears about bank disintermediation," VoxEU/VoxEU – CEPR's policy portal, 19 February.

<sup>3</sup> Panetta F. (2023), "A digital euro: widely available and easy to use", Introductory statement by Fabio Panetta, Member of the Executive Board of the ECB, at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 24 April 2023

<sup>4</sup> Zamora-Pérez A. (2021), "The paradox of banknotes: understanding the demand for cash beyond the transactional use", ECB Economic Bulletin, Issue 2/2021.

<sup>5</sup> ECB (2022), Study on the Payment Attitudes of Consumers in the Euro area (SPACE), December.

<sup>6</sup> Zamora-Pérez (2022), "Guaranteeing freedom of payment choice: access to cash in the euro area", ECB Economic Bulletin, Issue 5/2022.

The quality of the anchoring of the commercial bank's money to the central bank's currency is not reflected in the stock of notes and coins but, on the contrary, in the confidence in the money issued by commercial banks, and the use stemming from it.



Furthermore, in 2019, 89% of citizens of the eurozone considered it “easy” or “very easy” to access an ATM, while just 2% considered it “very difficult”. Furthermore, it should be noted that the withdrawal of cash at some merchants (cashback) sometimes supplements the ATMs in areas with low density levels.

The ECB is presenting the digital euro as the digital counterpart to coins and banknotes. However, there is a real risk that consumers will regard it more as a substitute for bank accounts, particularly due to the similarity in means of payment and means of holding money between the digital euro and euros held in a commercial bank account (which, incidentally, has been a kind of “digital euro” since the euro was created in 1999). Importantly, there is the risk of an increase in the cost of banking resources (with the need to replace customer deposits with more expensive refinancing) and hence of bank loans. We believe that the only characteristics of the digital euro that could stem this risk would be a very low holding limit – comparable to the amount of cash reasonably held by each citizen for transaction purposes (a few hundred euros at the very most) – or an exclusively “offline” digital euro held in the form of a digital token stored on a mobile phone, the loss or theft of which would be final, as is the case with... cold, hard cash.

According to Aristotle, the three functions of money are as a medium of exchange, a store of value and a unit of account. These three functions, which are still relevant today, cannot be separated. It is up to the user rather than the issuer of the money to decide the main function they want to attribute in practice to each form of money. For example, we have seen that demand for banknotes was motivated more by the function of money as a store of value rather than as a payment instrument. Despite its clear and justified desire to restrict the “digital counterpart of banknotes” to its role as a medium of exchange, the ECB would be risking creating a new kind of store of value to rival banknotes... and bank deposits, to the detriment of financing the economy, monetary policy transmission, and financial stability.”.

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