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BULLETIN

Digital (R)Evolution: Germany on Plans to Introduce an E-euro

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A single e-currency is seen by Germany as an opportunity to create more effective payment systems, accelerate the digital transformation, and strengthen the economic and political position of the European Union. However, possible side effects for the banking sector and concerns about the extent of protection of citizens' privacy will lead Germany to introduce the e-euro as a complement rather than an alternative to cash, and to strictly regulate it.

In mid-January 2021, public consultations organised by the European Central Bank (ECB) on the possibility of introducing a digital euro ended. In the coming months, analysis will be continued in a special group of experts from EU institutions. The aim of the work is to define the technical and legal framework for the existence of the so-called "central bank digital currency" (CBDC)—a new form of fiat issued by the state and recognised as the official tender. The head of the ECB, Christine Lagarde, announced that the introduction of the e-currency will take place within five years. The monetary union thus follows a global trend: according to the Bank for International Settlement (BIS), 86% of central banks are working on their own digital currencies.

These plans are closely watched by Germany, which, as the largest economy in the euro area, will have a significant impact on the final shape of the solutions. A common CBDC could bring many benefits from Germany's point of view, but it is not without danger.

Advantages. The basic argument in favour of this new form of money is to improve payments, especially in the global space. Cross-border clearing systems could emerge that are faster and cheaper than current banking platforms and web applications. The popularisation of digital currencies will also help to expand access to financial services and credit in less developed countries. As a result, demand may increase, which would benefit, among others, the export-oriented German economy. The e-euro also could support the digital transformation, the pace of which in the German economy still leaves much to be desired. It also could encourage companies to innovate, for example, to program direct payments between machines.

At stake in the project is strengthening the position of the European currency in the global economy as a reserve currency and mean of payment, competing with the dollar. The digital euro could, for example, support the global sale of bonds issued in connection with the implementation of the pandemic "recovery fund". The new technology also could facilitate the construction of a clearing platform alternative to the growing strength of Apple Pay, Google Pay, PayPal and the system based on Visa, Mastercard, and SWIFT. The 2018 dispute over financial sanctions against Iran showed that the issue could be significant politically: the EU had no tools to circumvent the restrictions imposed by the U.S. despite demands by some Member States. A digital euro also would allow the EU to maintain a financial advantage over an increasingly ambitious China. A digital yuan is already being tested and will be heavily promoted as the "new" international currency.

States' own digital currencies are also expected to tame the popularity of private cryptocurrencies. Germany fears that these will someday pose a threat to the stability of the global financial system due to exposure to speculation, hacker attacks, and expansion of the shadow economy. The plans by large corporations, including Facebook ("diem"), to introduce cryptocurrencies are even more worrying. Given the already enormous impact of this platform on society and politics, the creation of its own financial tools could call into question the power of a democratically legitimate authority.

Reservations. A CBDC-based system probably will allow households and companies to set up individual accounts at the central bank. A side effect of this solution could be the withdrawal of deposits from the banking sector and the flow of capital to the issuing institution, if only because of the higher security of deposits. Banks should react by raising interest rates on deposits, but after almost a decade of almost zero interest rates, they will not be able to afford it. This problem applies in particular to the German banking sector where even large players have problems with profitability. The situation has forced, for example, the second largest institution, Commerzbank, to announce in January the reduction of 10,000 jobs and closures of nearly half of its branches.

Concerns in Germany are also raised by the possibility that an e-euro will open a new field for experimentation with monetary policy—potentially much wider than the still controversial "quantitative easing" (bond purchases). One can imagine, for example, direct, cheap loans or even financial transfers made to individual households and companies, bypassing commercial banks as intermediaries. The emergence of such opportunities would provoke questions about the stability of money—an issue to which Germany attaches great importance. It cannot be ruled out that the central bank, with such new tools at its disposal, would be subjected to political pressure and attempts to limit its institutional independence.

Another obstacle may be the financial conservatism of German society. Although the attachment to cash payments has slightly weakened during the pandemic crisis, Germans remain wary of new tools, e.g., contactless card payments. It is not surprising then that, according to Deutsche Bank research from 2020, as much as 42% of respondents were reluctant to accept an e-euro. The concerns are related not only to the sphere of trading security and the possibility of hacking but also to a perceived threat to privacy. From the point of view of many Germans, the digital currency gives governments far-reaching possibilities to spy on citizens. Technological progress in this area is of benefit to authoritarian states such as China and Russia, which are then able to tighten systems of social control and obtain new tools of financial repression.

Conclusions. Germany will support the introduction of a digital euro due to its benefits for the economy and the potential strengthening of the EU's global rank. The risks already visible however, likely will induce Germany to significantly regulate the use of the CBDC and proceed in an evolutionary, not revolutionary change of the system.

Concern about the situation of commercial banks will encourage Germany to treat the digital euro only as an additional form of money complementing cash and to regulate the access of households and companies to individual accounts at the ECB. A more liberal approach would entail a risk of capital flight from commercial banks and could force an increase in aid to the sector, for example, through the repurchase of bonds by the ECB or the opening of further preferential credit lines. The use of each of these tools, however, is associated with side effects, such as a deepening dependence of highly indebted euro area members—already enormous—on the intervention of the central bank. A swift transition to a monetary system dominated by an e-euro could also force Germany to agree to the introduction of joint bank deposit insurance, which has so far been contested due to the risk of significant transfers within the euro area.

In negotiating the rules for introducing the digital currency, Germany also will carefully examine the possible consequences on the mandate of the ECB in monetary policy. An e-euro cannot become a channel for additional, uncontrolled expansion of the money supply, nor can it become a tool to circumvent the treaty ban on financing government expenditure by the central bank. Germany will also quickly cut short discussions on the possible use of the digital currency to cancel the bonds of the most indebted countries in the euro area. It is therefore possible that the introduction of a common CBDC will open up another front in the disputes between the North and the South of the monetary union.

The effects of introducing an e-euro will not be limited to the euro area: it also has serious consequences for other EU Member States, including Poland. It not only exacerbates the dilemma of whether to create its own CBDC within the single internal market or stick to the traditional form of money (Sweden, for example, has already opted for the former). In the event of shocks and crises, existence of digital currencies could provoke much larger and faster movements of capital and changes in exchange rates. This means that countries outside the eurozone would have to maintain larger reserves in order to intervene in their financial markets and factor in a more serious limitation of the room for manoeuvre in their own monetary policy. If these states are included in the discussion on the e-euro, they probably will support a position similar to the Germans, opting for gradual, controlled digitisation of the single currency.