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### Central banks must not be blind to the threats posed by CBDCs

The challenge is to make digital currencies viable without letting them displace private payments altogether

[ESWAR PRASAD](#)



Digital currencies can include cryptocurrencies. However, central bank digital currencies raise different risks, such as governments using them to further their social objectives © Nathaniel Noir/Alamy

**Eswar Prasad** 9 HOURS AGO

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With cash on its way out, many [central banks around the world](#) are experimenting with — or in some cases rolling out — retail central bank digital currencies. Their time may have come and they have many advantages over cash, but CBDCs also pose threats to the very institutions issuing them.

Private digital payments are working well in many countries, limiting demand for CBDCs. Central banks face the challenge of making the latter viable in retail and peer-to-peer payments but not so successful that they displace private payments altogether. Consequently, the notion of a CBDC as the digital equivalent of cash, bearing a zero interest rate and with no special features, is giving way to the prospect of programming digital money for specific purposes.

The possibilities are exciting. The Monetary Authority of Singapore’s recent [white paper](#) describes how such “purpose-bound money” can be designed to be “utilised for its intended purposes, such as validity within a certain period, at specific retailers, and in pre-determined denominations”.

Doling out money with expiry dates could incentivise consumption. Government cash transfers in times of heightened uncertainty, such as Covid-19 stimulus payments, often go into savings, reducing their impact. Such money could be targeted even more precisely, gov

into savings, reducing their impact. Such money could be targeted even more precisely, say for purchases of durable goods, sharpening the economic potency of transfers.

With cash gone, other options also come into play: imposing negative nominal interest rates to disincentivise saving and boost demand in periods of extreme economic distress. The programmable aspects of money could facilitate contractual arrangements, with funds automatically released only when conditions are met by all contracting parties.

Such innovations open up new vistas of how money could improve the functioning of economies and societies. But it is worth reflecting on the darker sides of any new technology.

Cash can be used anonymously and has a stable value (in nominal, not inflation-adjusted terms) relative to an economy's unit of account, which is usually central bank-issued fiat currency. If units of central bank money with different characteristics were put in circulation, secondary markets for trading them become conceivable. People who prefer to save rather than spend might willingly trade their "programmable" money at a discount.

Money held in CBDC digital wallets may be seen as safer than that in commercial bank deposits. After all, central banks never fail. A flight of money into CBDC wallets could decimate bank deposits and put central banks in the undesirable position of making credit allocation decisions.

These risks can be limited. New cryptographic tools could restrict the use of CBDCs by unverified persons while allowing for privacy in low-value transactions. Capping balances in CBDC digital wallets would reduce the risk of deposit flight from banks. Legislative guardrails could prevent central banks from becoming too closely tied to government operations.

Still, innovations in money do pose subtle risks. Central banks could be viewed as political agents if their visibility into payment transactions is used for law enforcement or surveillance purposes. "Helicopter drops" of money by the government into CBDC digital wallets are fiscal operations but in the public mind would become associated with central banks, causing these institutions to be seen as instruments of fiscal policy. In times of financial panic, caps on CBDC digital wallet balances could prove difficult to sustain, causing central banks to displace commercial ones as the main repository of an economy's savings.

What's worse, authoritarian or even ostensibly benevolent governments could consider central bank money as a means to achieve their social objectives. They could prohibit its use for purchases of ammunition, illegal drugs, pornography, or for services such as abortions.

Central banks already face threats to their independence, credibility and legitimacy. The more extensive the functionality of the money they issue, the greater the political pressures

they will be exposed to. At a minimum, such innovations pose risks to the integrity of central bank money.

It would be a sad irony if digitising central bank money to maintain its relevance undermines the very features that make it trustworthy. While they have little choice, central banks may well come to rue the day they embarked on upgrading their retail money.

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