



Do Central Bank Digital Currencies Make Sense for Emerging Market Economies?

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Interest in central bank digital currencies, or CBDCs, is sweeping the financial sector, financial media, and the central bank community. CBDCs are electronic currencies that can be stored in digital “wallets” and used for electronic payments. Unlike private digital currencies (aka cryptocurrencies) such as Bitcoin, CBDCs are direct liabilities of central banks, and thus are as safe as conventional currency (aka coins and paper money). Ninety percent of central banks around the world are investigating design and implementation issues surrounding CBDCs in their jurisdictions, and CBDCs are a major focus of the Innovation Hub Centres recently stood up by the Bank for International Settlements (BIS) around the world.¹ However, many governments and central banks are still weighing the costs and benefits of CBDCs, and actual issuance of these digital currencies is not a foregone conclusion in most jurisdictions.

Fabrizio Zampolli of the BIS’s Mexico City office, Viviana Alfonso of the Central Bank of Colombia, and I recently completed a study of the benefits, costs, and challenges of issuing CBDCs in Latin America and the Caribbean.² Most of the main insights from our research carry over to emerging market economies (EMEs), in other parts of the world as well. This note summarizes those insights and their implications for government policy.

Considering the enormous challenges facing EMEs—mounting fiscal debt, soaring inflation, scarring from the COVID-19 pandemic, and underlying structural impediments to growth—improving the payments system might

seem an especially paltry reform. But an efficient and inclusive payments system can provide important support for the process of economic growth and development. Indeed, in many respects, CBDCs may offer more benefits to EMEs than to advanced economies (AEs), such as the United States or Europe. In part, for this reason, central banks in EMEs have been as active in exploring CBDCs as their counterparts in the advanced economies, and EMEs have been first out the gate in issuing CBDCs: The Bahamas (not exactly an EME), China, the Eastern Caribbean Central Bank, Jamaica, and Nigeria have all conducted successful pilot programs or issued CBDCs on a permanent basis.

To be sure, not all of the rationales for CBDCs suggested for advanced economies carry over to EMEs. For economies such as Sweden’s, where physical currency has been almost entirely replaced by electronic payments, CBDCs are touted as a way to continue to provide its residents with a safe, official claim on the country’s central bank.³ But physical currency remains widely used in many EMEs, making this a much less relevant selling point for CBDCs.⁴

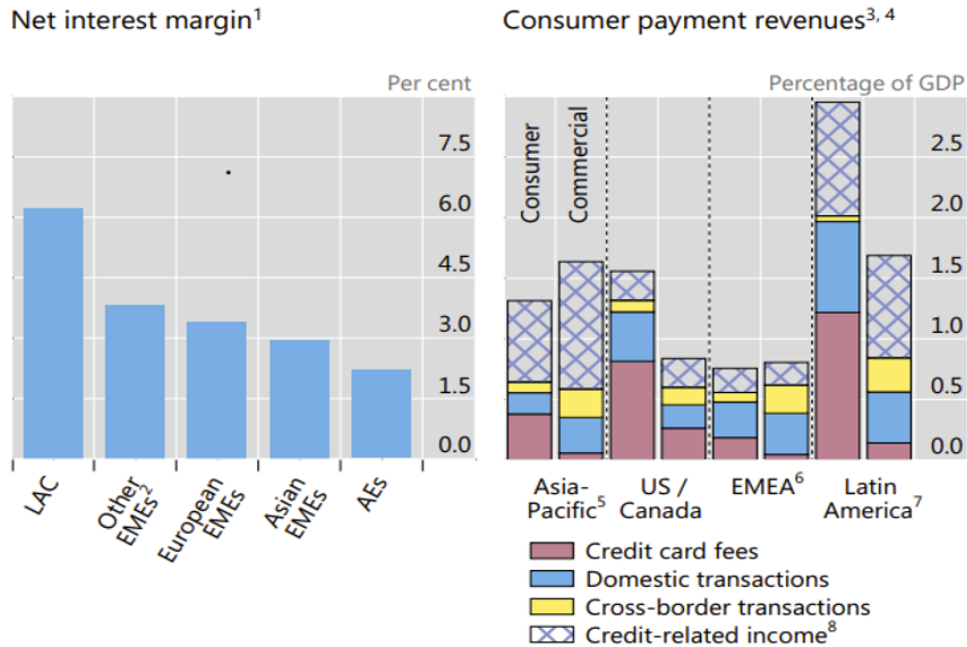
However, EMEs may be better positioned to benefit from CBDCs than advanced economies in other respects. To begin with, many EMEs, especially in Latin America, are burdened by highly concentrated and inefficient banking systems, and, as indicated in Figure 1 below, this leads to unusually high interest margins and payments costs. CBDCs could boost competition and lower the cost of payments, both by offering a direct alternative to

private payments providers and by providing a digital platform that allows more private operators to enter the market.⁵

the unbanked share of the population. The popularity of M-Pesa, Kenya’s private mobile banking and payments network, attests to the potential benefits of a digital currency initiative.

Figure 1: High Costs of Banking and Payments Concentration in EMEs.⁶

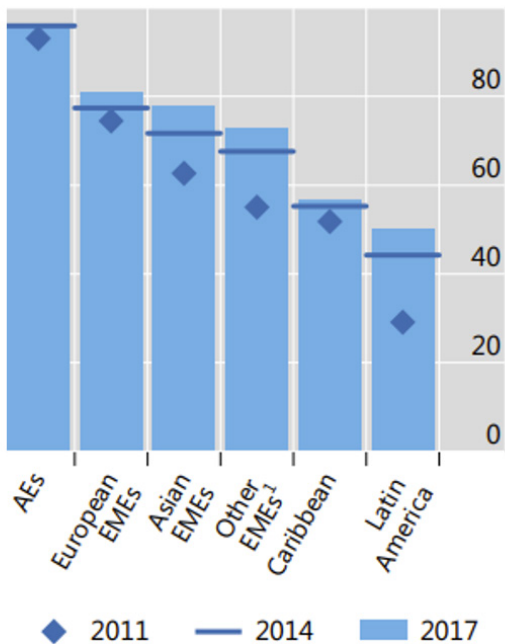
Figure 1: High Costs of Banking and Payments Concentration in EMEs⁶



Reducing the cost and increasing the convenience of retail payments should not only help boost sales and incomes, but should also support progress toward another well-emphasized potential benefit of CBDCs: financial inclusion.⁷ While relatively few residents in the advanced economies are unbanked, they represent roughly half of Latin America’s adult population⁸ and substantial shares of people in other EMEs, and this remains a significant impediment to economic development and prosperity. CBDCs offered through mobile phones may help overcome such barriers. In Latin America and the Caribbean, for example, mobile phone penetration is 69%, well in excess of

Figure 2: Share of Adults with Transaction Accounts⁹

The figure below summarizes results from a survey of central banks conducted by the BIS annually from 2018 to 2021. Respondents were asked to rank the importance of different motivations for issuing a CBDC. Consistent with the discussion above, central banks in emerging market and developing economies (EMDEs) consistently rated financial inclusion and the efficiency of the payments system as the most important factors in their interest in CBDCs.

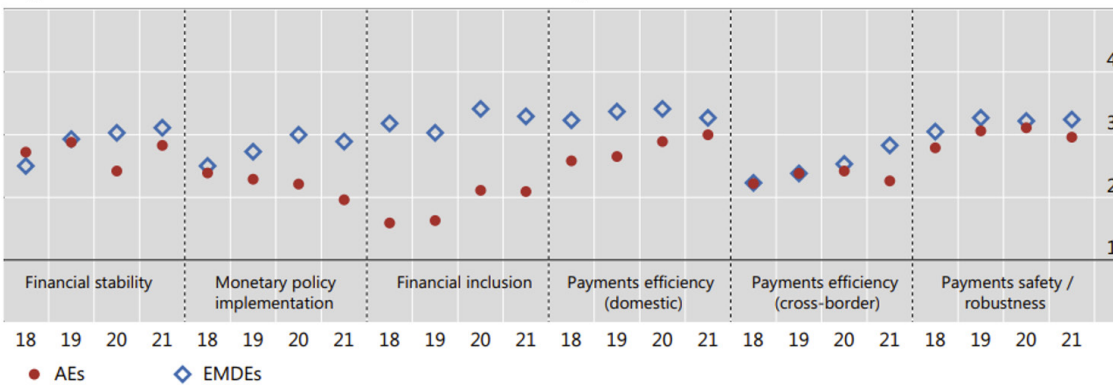


¹ Middle East, Russia and South Africa.

Figure 3: Central Bank Motivations for Issuing CBDCs¹⁰

The flipside of large unbanked populations

Figure 3: Central Bank Motivations for Issuing CBDCs¹⁰



(1) = not so important; (2) = somewhat important; (3) = important; (4) = very important.

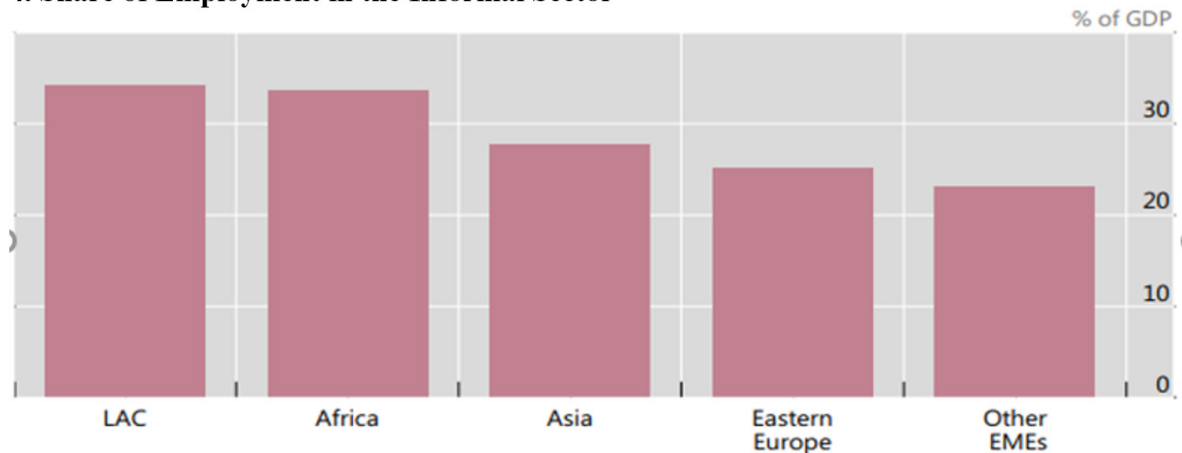
using cash are large informal sectors taking cash. The informal or “shadow” economy is generally made up of small firms and individual workers who generate a living outside formal institutional frameworks or reporting. As indicated in Figure 4 below, Latin America and Africa are unusually dependent on informal

activity. Informality deprives governments of tax revenues, discourages long-term capital investments, and constrains firms from growing sufficiently to achieve economies of scale and innovation. If CBDCs were widely adopted by consumers in these countries, this could encourage informal retailers to accept them as payment and, ultimately, help push some of these enterprises into the formal sector.¹¹

Figure 4: Share of Employment in the Informal Sector¹²

they would have particular salience for EMEs. By the same token, we did not find

4. Share of Employment in the Informal Sector¹²



A final advantage of CBDCs that could especially benefit EMEs is the reduction in the cost of cross-border payments. Moving money across borders is costly and time-consuming, partly because of extensive regulations, partly because such payments are executed through long chains of correspondent-banking relationships, and partly because of lack of competition. The development of systems that could allow CBDCs in different countries to interact with each other has been touted as a means of making cross-border payments faster, more efficient, and cheaper¹³. Like financial inclusion and reducing informality, this could be especially beneficial for EMEs, given the dependence of many of them on cross-border remittances.

the various costs and risks of issuing CBDCs often cited by observers, including cyberattacks and criminal usage; runs on the banking system; and accelerating capital flight to be insuperable, either for EMEs or for advanced economies.

In our research, we reviewed a long list of other potential benefits of CBDCs, including getting funds to hard-to-reach parties; building financial resilience; fostering financial innovation; and augmenting the channels of monetary transmission. It is unclear that these are major selling points for CBDCs, or that

However, one concern that that is very salient for many EMEs, given their long history of monetary instability and dollarization, is the challenge coming from the issuance of digital currencies by private entities, such as stablecoins, or by foreign central banks.¹⁴ The widespread use of such currencies could lead to new risks to financial stability, such as currency substitution and reduced effectiveness of domestic monetary policy, especially if they are denominated in foreign currency and domiciled outside the country. Central banks may choose to counter the competition from other digital currencies by issuing their own CBDCs. However, this issuance will only succeed if the central bank is following sound policies and the primary motivation for people adopting other currencies is the ease, efficiency, and convenience of financial transactions, rather than high inflation and a volatile

financial environment.

All told, the benefits of CBDCs—especially higher efficiency and lower costs in both domestic and cross-border payments; greater financial inclusion; and reduced informality—likely outweigh the costs and risks. This is even more likely to be the case for EMEs than for the advanced economies. But, despite the hype frequently accompanying discussions of financial technology innovations, these benefits are likely to be incremental rather than transformative. Moreover, these benefits will not materialize through issuance of CBDCs alone. That issuance will need to be combined with an extensive educational outreach program; regulatory reforms that ease the cost of doing business and help small enterprises take advantage of digital currencies; and aggressive measures to improve competition in the financial sector. Finally, many of the benefits of CBDCs described above—such as increased competition, financial inclusion—do not necessarily require CBDCs to be achieved; more aggressive government outreach and regulatory reform could address some of these issues as well.

In conclusion, great care will need to be taken in design and implementation of CBDCs and their accompanying technical and institutional infrastructure. Accordingly, central banks should proceed deliberately and prioritize careful planning over speed of implementation.

Endnotes

- 1 Kosse, Anneke and Ilaria Mattei (2022), “Gaining momentum – Results of the 2021 BIS survey on central bank digital currencies” BIS Papers No. 125, May.
- 2 Alfonso, Viviana, Steven Kamin, and Fabrizio Zampolli (2022), “Central Bank Digital Currencies (CBDCs) in Latin America and the Caribbean,” BIS Working Paper No. 989, January.
- 3 Riksbank (2020): “E-krona”, <https://www.riksbank.se/en-gb/payments--cash/e-krona/>
- 4 For that matter, physical currency remains widely used in many advanced economies, including Japan and Switzerland, thereby undercutting this rationale for CBDCs even for these countries.
- 5 Group of Central Banks (2020): “Central Bank Digital Currencies: Foundational Features and Core Features, BIS Other Publications, October. Bank for International Settlements (2021), “CBDCs: an opportunity for the monetary system”, Annual Economic Report, Chapter III, June. Alfonso, Kamin, and Zampoli, 2022).
- 6 Alfonso, Viviana, Alexandre Tombini and Fabrizio Zampolli (2020): “Retail payments in Latin America and the Caribbean: present and future,” BIS Quarterly Review, December.
- 7 Kiff, J, J Alwazir, S Davidovic, A Farias, A Khan, T Khiaonarong, M Malaika, H Monroe, N Sugimoto, H Tourpe and P Zhou (2020): “A survey of research on retail central bank digital currency”, IMF Working Paper No. 20/104, June. Group of Central Banks (2020). Prasad, Eswar (2021), The Future of Money: How the Digital Revolution is Transforming Currencies and Finance, Harvard University Press, Cambridge, MA, 2021.
- 8 Alfonso, Kamin, and Zampolli (2022).
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- 10 Kosse and Mattei (2022).
- 11 Prasad (2021).
- 12 Auer, Cornelli, and Frost (2020).
- 13 Group of Central Banks (2020). Auer, R, P Haene and H Holden (2021), “Multi-CBDC arrangements and the future of cross-border payments”, BIS Papers, No. 115. BIS (2021).
- 14 International Monetary Fund (2020): “Digital money across borders: macro-financial implications,” IMF Policy Paper No. 2020/050, October.