

market notes:

A digital euro...

by way of fiat?!?

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10/13/23 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Use it or lose it – avoiding muscle atrophy is key for investors, too. The longer careers run, the farther decision-makers get from the process that led to their ascent. Quarterly filings, pouring through footnotes, probing central banking models. For me, financial plumbing is the “it” to avoid losing. Fortunately, it has a natural home in crypto. If digital rails are the future of finance, we better “use” our tools to understand the traditional layers they are meant to improve.

2. Financial plumbing notes tend to be US-centric. It's not by design or bias. Finance is dominated by the US dollar. Despite the debate about the dollar losing reserve status, it reached a [record high](#) on international payments on the latest data. Even in digital asset markets, the US dollar is king by market decree. If anything, US regulatory obstinance is inviting alternatives that haven't arrived – foreign markets are building rules around US dollar stablecoin.

3. But international plumbing matters, too. Like Europe. After green shoots in 2009 looked like global markets were smooth sailing, the European Debt Crisis left investors scrambling to understand the fine print of its monetary union. Can a country default? Should the IMF bail them out? Is expulsion possible? Will Greece leave and keep printing euros? How do intra-European central bank liabilities clear? Those were critical details that were driving global capital markets.

4. I was invited to evaluate the pipes of the European Central Bank (ECB) in late August. I welcomed the opportunity to refresh those skills. It led to feedback ahead of the 2023 IMF Annual Meetings, happening now. But there's a big shift in focus. In 2013, during my title-inflated “Visiting Scholar” stay with the IMF, the emphasis was on how the Union would survive. Now, the issue is whether the tools used to keep the Union together can transition to digital rails.

5. (Spoiler alert – no.)

6. Bear with us on some details. We can simplify the conclusions. It's just important to know where they're coming from. Here's the exercise we ran: decompose the Eurosystem balance sheet into 20 individual central bank balance sheets and then evaluate asset-liability line items. An imbalance is judged by the asset-liability distribution relative to its neutral weight within the Eurosystem, known as the capital key. It's not a trivial exercise. But the math is elementary.

7. The most important initial observation – the European Monetary Union is not a centralized entity, even though it is reported that way. Think of the ECB as the “governance layer” to the protocol of

monetary policy.¹ The ECB takes decisions on the direction of policy, which is executed by country-specific central banks. Put differently, balance sheets sit with the regional central banks. That's where the decay in plumbing will be evident, not in the aggregate data.

8. What did we find? German pipes are leaking, and Italy is collecting the water in buckets. We take the thousands of data points and show the conclusion in Figure 1. It compares assets and liabilities across the regional central banks relative to their capital-neutral weights. The asset side is securities purchased (quantitative easing, or QE). The liability is how those assets were funded. In harmony, like pre-2008, the numbers are zero. We're in a state of cacophony.

9. What's going on? Germany is the engine of subsidization, the glue to the monetary system. On the asset side, the Bundesbank buys the lowest share of bonds in QE relative to its weight in the Eurosystem. On the liability side, Germany is the largest financier of QE. Countries like Italy, Spain and France are the beneficiaries – the Bundesbank is exporting capacity to regional central banks to buy more government bonds, lowering borrowing costs to Italy and others.

10. Germany knows this. Imbalances are not new. Germany is a willing participant, anchoring the system to her strong balance sheet. Others know their good fortune. But Germany will demand more orthodoxy – tighter monetary and fiscal policies. After all, their strong position isn't guaranteed to last. It's an awkward equilibrium. Breakup is a nuclear option best to avoid. If it happened today, the ECB would owe Germany ~1,069 billion euros – the ECB's capital position is ~120 billion.

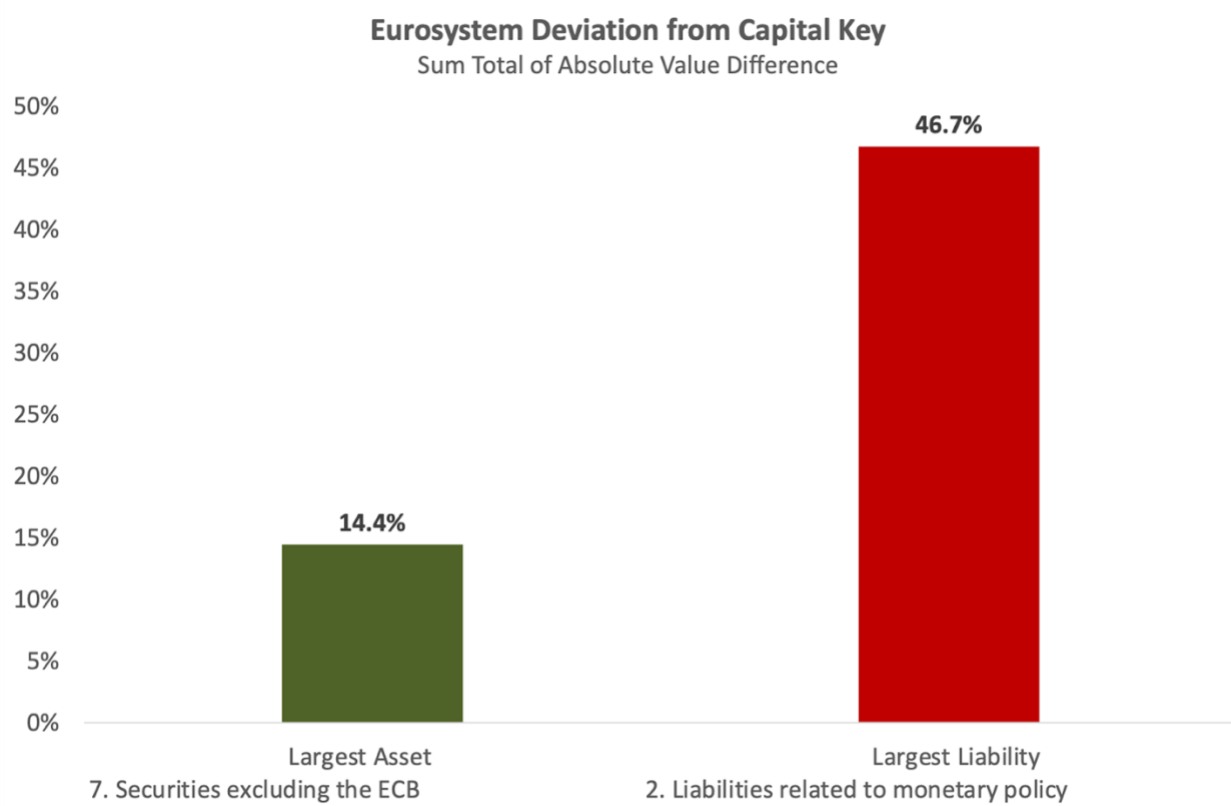
11. Now, let's introduce blockchain rails like a central bank digital currency (CBDC). A CBDC would be added to the ECB governance layer – regional central banks would mint the currency based on the demands of the economy, like cash now. The efficiency and scale of CBDCs means there is less currency needed to support the economy. Central bank balance sheets either contract or the ECB does larger asset purchases. Germany's subsidy grows even larger.

12. If you were to start a monetary union from scratch with definitive rules, there's no issue. But the starting point is a fiat system where an unusual share of capital wants to centralize in one state – Germany. And policymakers have accommodated the outcome. So, what happens when there is a negative shock? Digital capital can run from Spain much easier. And it runs to Germany. Capital controls may be the only tool. And they are also **easier** to implement!

13. An added complication – there's no natural demand for digital euros! Tether's USD stablecoin is the largest market capitalization at \$83 billion. Its euro version is \$38 million. It can be required that enterprises use digital euros, to be sure. How ironic it would be that executive decree – the definition of fiat – may be the only pathway to a deep digital euro. By way of imbalances, the digital euro would be on Germany's terms. Fate loves irony.

¹ The Governing Council is the decision-making body of the ECB, a natural name for its Governance Layer. We add Wim Duisenberg, its first ECB President, to the bingo card of Satoshi candidates.

Figure 1 – ECB Cacophony, The New Harmony



Source: ECB. CBAM calculations. As an example of a figure in the calculation, Germany's capital key in the ECB is 26.1% and its share of the aggregate ECB system deposit facility is 32.1%. The absolute value of the difference, 6%, is aggregated with the other 19 regional central banks to arrive at the 46.7% number. Pre-2008, these figures were zero.

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