market notes: A digital euro… by way of fiat?!?

What would it take for a digital euro to thrive? Maybe an executive decree – the definition of fiat, ironically. We study European imbalances that only add to the irony – it's Germany's decision.

13 October 2023
Marcel Kasumovich
Coinbase Asset Management

What would it take for a digital euro to thrive? Maybe an executive decree – the definition of fiat, ironically. We study European imbalances that only add to the irony – it's Germany's decision.

Marcel

market notes: A digital euro…by way of fiat?!?
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 Bundeskank 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 ECBs capital position is ~120 billion.

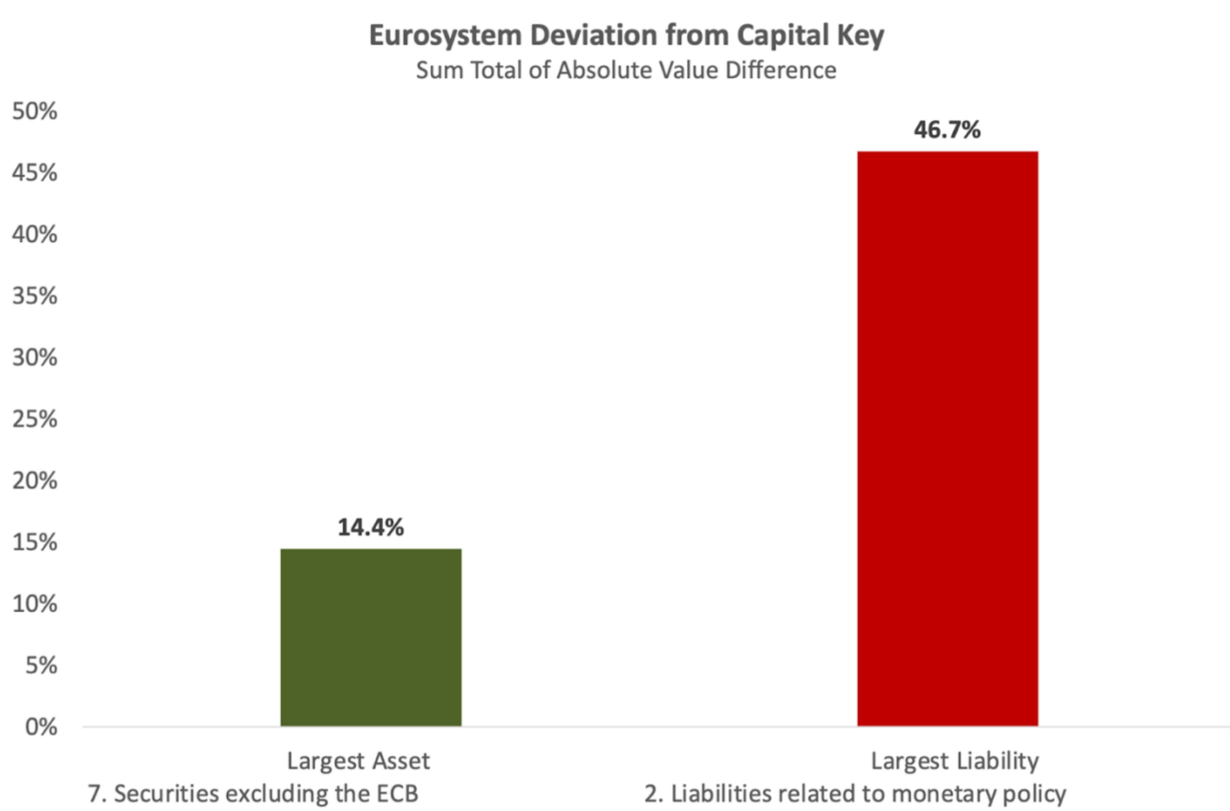
11. Now, let's introduce blockchain rails like a central bank digital currency (CBDC). A CBDC would be added to the ECB governance layer – regional central banks would mint the currency based on the demands of the economy, like cash now. The efficiency and scale of CBDCs means there is less currency 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.

Disclaimer:

This communication, including any attachments, is intended only for the use of the addressee and may contain information that is confidential or otherwise protected from disclosure. Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited. If you have received this communication in error, please delete this message, including any attachments, and notify the sender immediately. The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.

This communication may contain statements of opinion, including but not limited to, the author's analysis and views with respect to: digital assets, projected inflation, macroeconomic policy, and the market in general. Statements of opinion herein have been formulated using the author's experience, research, and/or analysis, however, such statements also contain elements of subjectivity and are often subjective in nature. In addition, when conducting the analyses on which it bases statements of opinion, the author(s) will incorporate assumptions, which in some cases may be shown to be inaccurate in the future, including in certain material respects. Nothing in this presentation represents a guarantee of any future outcome. The author(s) are under no obligation to update this document, notify any recipients, or re-publish the content contained herein in the event that any factual assertions, assumptions, forward-looking statements, or opinions are subsequently shown to be inaccurate.

Certain information contained in this Communication constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Forward-looking statements made in this communication are based on current expectations, speak only as of the date of this communication, as the case may be, and are susceptible to a number of risks, uncertainties and other factors. Assumptions relating to the foregoing involve judgments with respect to, among other things, projected inflation, the regulation of digital assets and macroeconomic policy, all of which are difficult or impossible to predict accurately and many of which are beyond our control. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation to future results or that the objectives and plans expressed or implied by such forward-looking statements will be achieved.

Certain information contained herein may have been obtained from third party sources and such information has not been independently verified by the author(s). References herein to third parties are for illustrative purposes and are not an endorsement or recommendation for products or services. No representation, warranty, or undertaking, expressed or implied, is given to the accuracy or completeness of such information. While such sources are believed to be reliable, the author(s) do not assume any responsibility for the accuracy or completeness of such information.

The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.