Master Thesis : Currency Substitution Due to Cross-border CBDC and Its Implications in Financial Stabilities

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February 20, 2023

Abstract

This paper considers the risk on bank run as cross-border central bank digital currency (CBDC) enters an emerging country. Bank run is a main consideration on the literatures of CBDC, as interest bearing CBDC might compete with demand deposits offered by commercial bank. Means can be legislated to prevent the risk, but cross-border CBDC, especially that coming from a highly developed country, which is overwhelmingly popular as a global means of payment, might be difficult to regulate as the technology of CBDC is digitalized, hence exacerbating the emergence of a bank run. In this paper, an agent-based model is used to approach this issue to simulate the dynamic currency substitution episode, as well as the emergence of a bank run episode.

1 Introduction

2 Model

2.1 Basis Flow and Structure

The model is composed of two open economies and three sectors — buyers/sellers banks, and government. Each country issues its own currency, but all buyers have the freedom to decide what means of payment (hereafter MoP) to use. There is an alternation of roles between buyers and sellers, with each transitioning to the other role once a successful trade is conducted. This setting is to assure that agents have the incentives to adjust its portfolio of MoP, conceptually similar to the idea given in Trejos and Wright (1995). For each period,

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buyers decide how much to consume and save, and base on the consumption budget, buyers meet with sellers during a search and matching process.

MoP is then decided under each trade. Both buyers and sellers observe the popularity of each Mop, hence deciding the optimal portfolio of MoP to hold. [1] For every trade and portfolio reallocation that involves altering the banks' ledger, it is immediately recorded, and this in turn causes the leverage of the bank to alter. The leverage of the bank is globally visible to all agents, signalling the soundness of the financial environment. Sensitive agents are then urged to withdraw any premature assets from the bank (in this model I consider only the deposit) if they sense a signal of instability, and through a herding behavior tha bank is thus exposed to a risk of run. This herding behavior can be modeled through introducing an imitation rule (Santos and Nakane, 2021). For simplicity, the bank has an exogenous credit level. Doing so allows the result to be focused on the effect of cross-border CBDC, instead of other financial acceleration coming from the capital market (Bernanke et al., 1996).

Central banks interest rates are temporarily set exogenously.

2.2 Consumption Decision

Following Dawid and Delli Gatti (2018), consumption decision for a buyer is separated into two steps: consumption budget and consumption bundle.

Definition 1 (General Rule of Consumption Decision)**.** For each buyer $b \in \mathcal{B}^t$, given the history of the individual states S_b^t and one's surrounding state $\mathbf{S}^t$, the agent's consumption decision can be denoted as $(C, \{q_j\}_{\forall j \in \mathcal{G}_b})$, where $C \in \mathbb{R}$ denotes the real consumption budget, $\mathcal{G}_b$ denotes the goods seller in contact with buyer b, and q_j denotes the quantity of goods b bought from seller j.

References

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[1] Under rational expectations, a representative agent looks forward and chooses the optimal mean of payment that provides one the largest lifetime utility. In the absence of perfect coordination and perfect foresight, however, an agent might possibly hold a depreciating currency solely due to the fact that it is the only means of payment widely used regionally.