Digital Dollars: A central bank-first approach to digital currency risks crushing innovation

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Citi Journal

August 31, 2021

Money matters, but most Americans don’t give much thought to its architecture. The Federal Reserve is studying the development of a digital dollar for public use, but money is too important to be left to central bankers. Congress, not the Fed, should set policy for general-purpose digital dollars.

Banks transact in central bank money. The public relies on commercial bank money and on Federal Reserve notes, which are central bank liabilities. A central bank digital currency (CBDC) would be a new Fed liability: digital cash that the public could use, equivalent to a deposit at the central bank.

Chairman Jerome Powell says that the Fed “would need buy-in from Congress, from the Administration, from broad elements of the public” to develop a CBDC, but Fed governors are split on the idea. One camp is keen to develop a CBDC for the public, while the second is inclined to let commercial banks take the lead in providing digital dollars. Fed governor Lael Brainard, a CBDC champion, contends that it would be safer than private alternatives; it would enhance financial inclusion and the ability to disburse relief and welfare payments, and respond to foreign CBDCs—such as China’s—that are used for cross-border payments. The development of a CBDC, Brainard suggests, would promote “innovation and competition in retail payments” while keeping the U.S. financial system at the cutting edge.

But a general-purpose Fed e-dollar actually risks stifling innovation on private payments. As the paramount regulator of the financial system and an entity with unlimited resources, the Fed could bury private competitors. In a talk, “Parachute Pants and Central Bank Money,” Fed official Randal

Quarles questioned the need for a CBDC, highlighted the risks, and reminded us of commercial banks' history serving consumers and businesses. In another thoughtful talk, Fed governor Christopher Waller expressed skepticism toward the case for a general-purpose CBDC. As Quarles and Waller argue, Fed e-dollars aren't necessary to defend the dollar's reserve-currency status or to reduce the number of unbanked households, the percentage of which has been falling. And of the 5.4 percent of households that remained unbanked in 2019, about 75 percent said that they don't want a bank account.

CBDC advocates warn of the threat from China's digital yuan, which Beijing is piloting in ten cities. But the dollar's status as the world's reserve currency won't be challenged by the lack of a CBDC. Dollar reserves and dollar-denominated foreign debt and trade are already electronic. Moreover, it's unlikely that non-Chinese businesses would find transacting using PBOC accounts attractive.

The private sector has a rich history innovating in payments and money. In the tenth and eleventh centuries, Chinese merchants created the first general-circulating paper currency. In the golden age of banking innovation, from the tail end of the seventeenth century to the early nineteenth century, Scottish banks pioneered interbank clearing of banknotes. More recently, banks created such global payment networks as Mastercard, Visa, and Swift, and the private sector developed person-to-person payment systems, such as Venmo, Square, and Zelle; digital wallets, such as PayPal, Apple Pay, and Google Pay; and cryptocurrencies, such as Bitcoin, Ether, and XRP.

Indeed, innovation in digital dollars is already happening. Circle's USD Coin and Tether's USDT are stablecoins—digital tokens, backed by dollars and dollar-denominated assets on account at regulated banks. To date, they've largely been used to trade in and out of cryptocurrencies. Chase and Signature Bank offer limited-purpose stablecoins that support instant payments between their business clients. Facebook's Diem, a dollar stablecoin, has a plausible path to widespread adoption. Banks could provide dollar stablecoins for public use; they'd be commercial-bank liabilities, not central-bank liabilities, but as a practical matter they'd be digital money.

A law proposed by Congressman Don Beyer, the Digital Asset Structure & Investment Protection Act, would authorize the Fed to issue digital dollars and give the Treasury Department plenary power to ban bank stablecoins. Such regulatory absolutism would be the wrong approach, though. Instead, Congress should establish a liberal private-sector-oriented dollar-stablecoin regime, spelling out basic conditions under which banks could issue stablecoins. Unlike with a centrally planned and managed CBDC, competing and iterating bank digital dollars would continually improve.

The U.S. payment system works extraordinarily well and is already largely digital. Digital dollars would have a bigger impact abroad, generating cross-border payments and displacing debased national fiat currencies and payment systems. Because e-dollars would be easier to hold than greenbacks, they'd reduce banks' deposit base to extend credit and curb central banks' ability to pursue negative interest rates. However, in a normal interest-rate environment, people would still keep most savings on deposit.

In any event, banks issuing dollar stablecoins would deliver the benefits CBDC evangelists tout—and more.

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