Crypto in Crisis: Are Digital Currencies the Answer? Short answer: CBDCs, no. Private digital currencies, it depends.

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Fear and raging inflation have roiled hot but still nascent digital currency markets. From November 15 to May 26, the cryptocurrency market plunged 57 percent, with $1.6 trillion of value lost. At the same time, the price of leading cryptocurrencies bitcoin, ether, and XRP fell 55 percent, 60 percent, and 67 percent, respectively.

Stablecoins — digital currencies designed to have less volatility than classic cryptocurrencies — were not immune. Notably, stablecoin TerraUSD, sold as a currency pegged to the U.S. dollar, collapsed, trading as low as 3 cents on Friday. In reaction, Treasury Secretary Janet Yellen decried stablecoins' risk. But TerraUSD is an "algorithmic stablecoin" not backed by dollars, dollar-denominated debt, or an asset like gold. It was tied to the cryptocurrency Luna. When Luna's value fell below $1, TerraUSDs were "burned" in exchange for Luna worth $1. This was too clever by half and, when stressed, failed. Luna was all but dead by May 20, trading at .01 cents.

What Caused the Crisis?

The cryptocurrency bubble was fueled by giddy enthusiasm that cryptocurrencies would revolutionize payments and money and also, critically, by the Fed's reign of easy money. Since the dawn of the cryptocurrency era with Bitcoin's 2009 debut, the Fed's real wholesale benchmark interest rate has been negative, except for briefly breaking zero in 2019. Ultra-low interest rates caused excessive risk-taking and inflation in equities, housing, and cryptocurrencies.

Many viewed cryptocurrencies, particularly Bitcoin, the supply of which is capped, as an inflation hedge. But they are just electronic bits whose value as an inflation hedge is predicated on somebody — the proverbial greater fool — being willing to pay more for them next month. They don't generate cash. Nor do they have any intrinsic value.

With the Fed belatedly acknowledging that price inflation is a problem and beginning to reduce the bloated money supply and increase interest rates, the crypto bubble is deflating.

The Rise of Cryptocurrencies

Digital currencies launched in the '90s with systems like Digicash, Beenz, and Flooz, but these were not compellingly better than existing options and failed to find a path to network critical mass.

Bitcoin launched the next wave, cryptocurrencies. Bitcoin is a permissionless, network-enabling, cryptography-validated, peer-to-peer value transfer on a public digital ledger.

Evangelists predicted cryptocurrencies would upend reigning payment systems like Mastercard, Visa, Western Union, and Swift; fiat currencies; and traditional financial institutions. Capital poured into digital currencies, betting they would disrupt the money and payments ecosystem.

However, cryptocurrencies face significant challenges: Regulators are hostile; they have performance and governance problems; there are yet to be compelling licit payment uses; and incumbent payment systems work well. Major cryptocurrencies are a volatile, speculative investment. Most of the thousands of cryptocurrencies will fail.

The Innovation of Stablecoins

Stablecoins were developed to deliver digital currencies' touted benefits without some of the deficiencies. They are electronic tokens backed by an asset such as fiat currencies, fiat-currency-denominated debt, or gold. They are designed to be less volatile and therefore more suitable as money than cryptocurrencies. If they are issued by regulated financial institutions, it is hard for the state to object.

A private-sector stablecoin market is emerging with coins like Circle, Tether, and Binance. While today stablecoins are used almost entirely to trade cryptocurrencies, issuers are looking for additional purposes.

Legal and regulatory certainty is needed. With that in mind, Republican Sen. Pat Toomey of Pennsylvania wrote a bill titled the "Stablecoin Transparency of Reserve and Uniform Safe Transactions Act of 2022" and new Jersey Democratic Rep. Josh Gottheimer created the "Stablecoin Innovation and Protection Act of 2022." Toomey's bill would authorize banks and Office of the Comptroller of the Currency-licensed nonbank issuers to offer stablecoins. There is no compelling prudential reason to only allow banks to offer low-risk dollar tokens.

For much of America's history, banknotes were money. Stablecoins are the electronic analog. Competing electronic banknote issuers serving U.S. and foreign consumers and businesses would spur innovation in money.

Central Banks Are the Elephant in the Room

In a recent talk at Columbia University, European Central Bank board member Fabio Panetta captured the zeitgeist of central bankers, decrying cryptocurrency risk and calling for greater regulation and central bank digital currencies (CBDCs).

Central banks' interest in CBDCs has been stoked by cryptocurrencies, Facebook's 2019 announcement of stablecoin Libra (rebranded Diem before being shuttered earlier this year), and China's digital yuan. Ninety percent of central banks responding to the Bank for International Settlement's 2021 survey, including the Fed, are working on central bank digital currencies.

Since 1971, when President Richard Nixon severed the dollar's link with gold, the world has operated on fiat money. Federal Reserve Notes (cash) and banks' deposits at the Fed are central bank money. Consumers and businesses, however, rely principally on commercial bank money.

A Fed e-dollar would be central bank money consumers and businesses could make payments with in lieu of cash, checks, American Express, Discover, Mastercard, Visa, PayPal, Square Cash, Western Union, and Zelle. It could also be a wholesale e-dollar that financial institutions could use to pay each other.

Fed Chairman Jerome Powell said the Fed would need congressional authorization to develop a digital dollar. Powell's acknowledgment that the Fed is a creature of Congress subject to the law, not a free agent, was refreshing. When the central bank decided to develop a real-time interbank payment system, FedNow, to compete with the private sector, it briefed Congress but did not seek permission.

In January, the Fed published a studiously neutral CBDC discussion paper titled "Money and Payments: The U.S Dollar in the Age of Digital Transformation."

The Fed is not of one mind. Christopher Waller, a member of the Federal Reserve Board of Governors, argues a Fed CBDC is a solution in search of a problem. Existing money and payment systems' economic, legal, and social technologies and networks work well, have critical mass, and are habit. Vice Chair Lael Brainard, on the other hand, says she can't wrap her mind around a world with major CBDCs but no Fed digital dollar. It would not be "a sustainable future," she said.

Advocates contend a central bank digital currency would improve financial inclusion, respond to the threat of China's digital yuan, bolster King Dollar, improve domestic and cross-border payment system efficiency, be safer than private-sector alternatives, and increase private-sector innovation. Much of that case does not stand up to scrutiny.

On the topic of inclusion, only a small and declining fraction of American households are unbanked. Competing banks, neobanks, and fintechs continue to expand access to financial services. In 2019, 5.4 percent of households were unbanked, down from 8.2 percent in 2011. And 75.1 percent of the unbanked said they do not want a bank account.

Progressive CBDC champions distrust banks, markets, and consumers' ability to manage their own affairs. Consequently, they favor a greater role for Washington in delivering financial services and regulation. In reality, lighter regulation, including repealing debit-interchange price controls, would be a more effective path to boosting financial inclusion.

King Dollar Maintains Its Importance

While China can push the digital renminbi within its Belt and Road economic sphere, the menace to King Dollar is overhyped. Non-Chinese businesses, consumers, and banks won't be keen to transact in accounts at the People's Bank of China, subject to CCP surveillance and control. Moreover, the yuan isn't freely exchangeable.

Currencies are networks. The more people who use them, the stronger the currency. A tribesman in the Hindu Kush will happily accept a $100 bill, but not Lebanese lira. In money and payment systems, trust is critical. Venezuelans would prefer not to transact in debased bolivars. If, however, they could use a Citi e-dollar, many would.

While the U.S. has relentlessly and recklessly debased the dollar, there isn't an obvious replacement reserve currency.

The dollar accounted for 58.8 percent of the world's foreign exchange currency reserves in the fourth quarter of 2021, far surpassing the euro's 20.6 percent share and the Chinese renminbi's paltry 2.8 percent. In 2021, 63.9 percent of foreign currency debt issuance was denominated in dollars, and outside of Europe, the overwhelming majority of international trade, including oil, is invoiced in dollars.

While Beijing resents its dominance, foreigners worldwide love dollars. They circulate widely outside the U.S. for licit and illicit purposes. Roughly 60 percent of U.S. currency and 75 percent of $100 bills are held abroad. Dollars are used officially in Ecuador, El Salvador, Panama, and the Turks and Caicos. In Zimbabwe, while restricted, they are widely utilized. In Costa Rica, the greenback circulates in parallel with the national currency. In 2020, some 12 percent of Venezuelan payments in 10 cities, including Caracas, were between dollar-denominated accounts using U.S. banks' peer-to-peer payment system Zelle. Hong Kong, for now, pegs its currency to the dollar.

Is a Digital Dollar a Good Idea?

Digital dollars would enhance cross-border payments and supplant weak national fiat currencies and payment systems.

Evangelists contend CBDCs would be safer than private e-money. It depends. A Zimbabwean CBDC wouldn't be safe. Private stablecoins backed one-to-one by cash in FDIC-insured accounts and/or short-term low-risk dollar-denominated debt are not inherently risky.

Brainard contends a Fed digital dollar would boost private-sector innovation. To the contrary, it would almost certainly suppress it. No bank wants to compete with the central bank, which enjoys unlimited resources and is the financial system's paramount regulator.

Paper money has been used since the 7th century. New money technology has risks. E-dollars would be easier to withdraw from banks, reducing their lending base. However, in a world of positive real interest rates and FDIC insurance, the risk would be modest.

Cash is distributed by banks, not the Fed. Former Commodity Futures Trading Commission chair, Digital Dollar Foundation founder, and CBDC evangelist Chris Giancarlo argues a Fed e-dollar should also rely on banks for distribution.

Not everyone agrees.

With a view to increasing government's role at the expense of banks, Senate Banking Committee Chairman Sherrod Brown and House Financial Services Committee Chair Maxine Waters have supported the position that the Fed should provide retail accounts, letting consumers transact directly in central bank money. The Fed, however, is ill-equipped to manage retail banking. Even if it could, it should not compete with thousands of commercial banks and credit unions. That would further politicize and reduce the quality and supply of financial services.

Americans treasure their privacy, or at least their right to privacy. In practice, many are cavalier in what they share. While a Fed e-dollar likely would have more privacy than the digital yuan, no CBDC will be anonymous like cash.

If Congress authorizes a CBDC, it should be technology-agnostic, use banks and licensed financial intermediaries for distribution, and ensure the Fed does not inhibit competing regulated private-sector e-dollars.

Money has been evolving for thousands of years. It's still early for digital currencies. Policymakers should let the best and most ruthless regulator of value, the market, guide their development. Nobel Prize-winning economist and philosopher Friedrich Hayek argued in the *Denationalization of Money* for free trade and competition in currencies. Making private and Fed digital dollars compete with physical greenbacks, existing electronic payment systems, foreign currencies, and cryptocurrencies would be a step toward a more Hayekian world.

The CFPB director should stop imposing politics on payments and stick to his remit.

Rohit Chopra, director of the Consumer Financial Protection Bureau, in March shared his conjured alternative-payments universe with politically simpatico CNBC. Relishing his celebrity, Chopra held forth on inflation, payment-system competition and fees, and cryptocurrency risk.

The network's assumed framework for the interview was an uncompetitive payments industry chockful of villains, with consumers as victims and the Bureau as an enlightened and beneficent regulatory knight. It nicely captured our current financial regulators' anti-private-sector zeitgeist.

CNBC pressed Chopra on what his office was doing to help beleaguered consumers with payment fees in a time of "very high inflation," and suggested that increases by both Mastercard and Visa in their interchange fees would be a problem. Chopra ran with that idea, declaring a hike would be adding “insult to injury.”

To be sure, U.S. interchange rates have been high relative to many countries for more than half a century, but that has been true both during periods of raging inflation and periods of low inflation. The leading retail-payment networks aren’t driving inflation. Moreover, when interchange rises for merchants, cardholder fees typically decline and benefits increase. And issuer innovation flourishes—all of which is deflationary.

With two-sided payment systems, holistic value is what matters. Pricing set by competing payment networks, processors, and financial institutions—informed by the choices of millions of consumers and merchants, not by the preferences of regulatory poohbahs—is the best way to maximize total value.

Remember, inflation is caused by too much money chasing too few goods. The present administration may be blaming Big Oil, Big Food, and Russian despot Vladimir Putin, but it’s massive deficit spending, binge money-printing, negative real interest rates, a tight labor market, and production-suppressing regulation that make up the cocktail fueling our current raging inflation.

And by the way, it’s the Federal Reserve, not the CFPB, that’s charged by Congress with maintaining “stable prices.” If there were a competition problem, the Department of Justice and the Federal Trade Commission are tasked with enforcing antitrust laws.

An ‘Orwellian’ View

The CFPB director, nevertheless, eagerly declared that the United States doesn’t have “a competitive payment system” and that “we’re far behind many other countries.”

Chopra’s characterization was Orwellian. The U.S. payments industry is far more competitive and innovative than that of virtually all other countries.

Look at the retail-payment networks Visa, Mastercard, PayPal, American Express, Discover, Star, NYCE. Or at BNPL systems like Affirm and Afterpay, and at proprietary cards provided by Synchrony, Citi, and Bread (formerly Alliance Data Systems). These all compete fiercely, delivering ever-increasing value. That's because the most ruthless and unforgiving regulator on the planet—the market—polices them.

Indeed, merchant acquiring and processing and credit-card issuance are all ferociously competitive. As a result, merchants and consumers enjoy enormous choice from a trove of constantly improving services and products.

For example, person-to-person payment systems, many of which are fee-free, include Zelle, Venmo, Square Cash, Apple Cash, Google Pay, Western Union, MoneyGram, and Wise. They offer consumers a surfeit of options to pay anyone, anywhere, any time.

Then there are systems provided by FIS, Fiserv, ACI Worldwide, Paymentus, and Mastercard, all of which make paying bills convenient—and, for consumers, generally free.

In the realm of interbank payments, the ACH systems from the bank association The Clearing House and from the Fed provide low-cost and reliable credits and debits. Increasingly, they're same-day, though not instant, which is more than adequate for tens of billions of payroll and bill payments.

To be sure, policymakers worldwide tout the benefits of real-time interbank payments. Keen to be on the bandwagon, Chopra declared "We [the U.S.] need a fast, real-time payment system that is frictionless and low-cost," alluding to the Fed's FedNow service, slated to launch in 2023. In ChopraWorld, private-sector solutions clearly don't count. Yet, the U.S. today has multiple competing low-friction, low-cost, private-sector real-time payment systems including not only TCH's RTP, launched in 2017, but also Visa Direct, Mastercard Send, Zelle, FIS's RealNet, Fiserv's PopMoney, and Discover's Deliver.

On the edge of the mainstream payments world, there's creative ferment going on with cryptocurrencies and stablecoins. Perhaps some will find paths to payment-network critical mass and relevancy.

'Fevered Imagination'

Chopra enthusiastically disparaged “junk fees,” such as late, overdraft, and NSF fees, as “nickel and diming” consumers. Nobody likes to pay these fees, but consumers have agency. Fees for borrowers not honoring their obligations are entirely reasonable, and encourage better behavior.

Punishing creditors by curbing fees when borrowers don’t honor their commitments is unjust, and will reduce the supply of credit. Paying late and bouncing checks should be stigmatized, not incentivized.

The CFPB director worries about new payment technologies leveraging tech platforms to scale. For a moment, with Diem and social-media colossus Facebook, that seemed a real possibility. While existing payment systems are well-established and work well, a challenger at scale—say, stablecoins supported by digital wallets from Facebook, Google, Apple, Amazon, and PayPal—would be a good problem for policymakers to contemplate.

Further, Chopra noted consumers using cryptocurrencies often don’t enjoy the protections baked into card payments. Fair enough. Law and enforcement are evolving based on real-world experience. But legislators, not regulators, should take the lead in establishing the regulatory framework.

Only in Chopra’s fevered imagination is the U.S. payment system uncompetitive. The Bureau’s director should take pains to be apolitical while narrowly enforcing existing consumer-finance law. It is not regulators’ prerogative to make policy—or to impose their political preferences on the payments industry.

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