Should CBDCs Be the Next Big Thing?

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Governments are moving closer to issuing digital money. That could introduce some benefits—but also many risks and complications.

Central bank digital currencies (CBDCs) are coming, slowly but inevitably. They can be retail (for use by consumers and businesses), wholesale (for use between financial institutions), or both. Evangelists enthuse they'll improve money and domestic and cross-border payments. At this juncture, however, such compelling use cases are unclear.

Federal Reserve notes (cash) and reserves at the Fed are central-bank money, in other words, Fed liabilities. Banks already transact in central-bank money among themselves. The public primarily uses commercial-bank money.

Retail CBDCs enable consumers and businesses to hold, and transact in, electronic payment instruments—but in national unit accounts that are central-bank rather than commercial-bank labilities.

Launched in 2014, the first CBDC, Ecuador's central bank's digital dollar, was shuttered in 2018. The dinero electrónico failed because of its reliance on the state mobile network operator for distribution and because of distrust of the central bank.

Notwithstanding the dinero electrónico's demise, central banks are increasingly keen on CBDCs. Their interest in the matter has been accelerated by such factors as the rise of cryptocurrencies, Facebook's 2019 announcement of the stablecoin Libra (rebranded Diem), and the People's Bank of China's commitment to developing an e-yuan.

Debuting in October 2020, the Bahamas' digital sand dollar was the second CBDC out of the gate. The Caribbean Central Bank's digital dollar has been introduced in seven out of eight served island countries and territories. And Nigeria’s central bank has started issuing e-Naira.

What About the Fed?

Most of the world’s major central banks will follow suit. The highest-profile CBDC pilot these days is the PBOC’s e-yuan. It reports more than 140 million digital-wallets for managing e-yuan have been downloaded, 10 million acceptance-ready merchants, and 150 million transactions to date, totaling almost $10 billion.

To be sure, China’s central bank says it wants to improve payments efficiency beyond what Alipay, China Union Pay, and WeChat Pay have achieved. But an e-yuan could provide additional benefits for Beijing. In a Financial Times interview, the UK’s spy chief, Sir Jeremy Fleming, warned that the digital renminbi could be a tool to surveil users and exert control over global currency transactions.

The Fed has been studying the development of an electronic greenback. But the Fed is a creature of Congress. Fed chairman Jay Powell declared, “We would not proceed” adopting a digital dollar “without support from Congress … ideally … in the form of an authorizing law.”

Washington can ban private digital currencies or use regulation to tilt the playing field, either of which would suppress money-and-payments innovation.

Milton Friedman’s counsel a quarter century ago that the future of e-cash would depend on the private sector’s “flexibility to experiment, without broad interference by government” should inform Congressional policymakers. Ideally, CBDC legislation would provide legal and regulatory clarity, be technology-agnostic, and prohibit regulators from handicapping private digital currencies.

But the Fed isn’t of one mind. Powell remains undecided. Vice chair nominee Lael Brainard is a CBDC proponent. Governor Christopher Waller and former vice chair of supervision Randal Quarles are skeptical there’s a compelling need, noting the U.S payment system is already substantially digital and works well.

Waller and Quarles also argue that the pro forma arguments trotted out in a Fed e-dollar's favor—that it's necessary to promote financial inclusion and to defend King Dollar against a digital yuan—don't bear scrutiny.

The percentage of unbanked American households has been falling, going from 8.2% in 2011 to 5.4% in 2019. Significantly, 75% of these households say they don't want a bank account. Almost 10,000 banks and credit unions compete to serve Americans. Neobanks like Chime and Green Dot, and de facto banking from Square and PayPal, continue to make it ever easier to bank.

Design Choices

But if Washington wants to do more than recite financial-inclusion pieties, it would lower barriers to entry in financial services and repeal debit-interchange price controls. These moves would more effectively expand financial-services access than a Fed e-dollar.

Design choices will affect CBDCs' utility and impact. CBDCs can be account- or token-based. Account-based systems would be easier to implement, whereas token-based systems should enjoy greater flexibility.

The banking and money system is a two-tier one. The Fed serves banks, and banks serve consumers and businesses. Champions of the idea that government should take a greater role in banking advocate the Fed should provide bank services to consumers and businesses directly, competing with commercial banks. Alternatively, as with physical cash, the Fed could rely on banks to distribute e-dollars.

CBDCs can be supported by permissioned-distributed, hybrid, or central electronic ledgers. Central banks will weigh tradeoffs differently and employ different architectures. No CBDC will be unpermissioned.

While the digital sand dollar is limited to domestic use, electronic dollars, euros, and pounds, probably won't be. Most greenbacks circulate outside the United States. While an e-dollar won't be anonymous, its value would likely be greater abroad.

A Fed e-dollar's domestic impact likely would be modest. However, CBDCs could roil the cross-border payments market, making transfers faster, more convenient, and cheaper, thereby boosting demand.

A digital King Dollar may supplant weak national currencies and payment systems. If Venezuelans and Zimbabweans, using smart phones, can transact in e-dollars rather than bolivars and Zimbabwean dollars, respectively, many will, and will be better off for it.

Risky Business

Cheerleaders say central-bank money is less risky, but in countries like Venezuela and Zimbabwe, central-bank money is plenty risky. And, in the U.S., private digital currencies—backed one-to-one by dollars in FDIC-insured accounts and short-term, liquid securities—wouldn't be materially riskier than Fed e-dollars.

Libertarians love payments anonymity. No CBDC, however, will be anonymous in the way cash is. For governments, that's a plus. For consumers and businesses, not so much. Digital dollars and pounds, however, are likely to offer greater privacy protections than digital yuan.

CBDCs pose risks. They'll be easier for consumers and businesses to hold and transact in than cash, and, therefore, will reduce banks' assets and lending capacity. In a normal interest-rate environment, that wouldn't be a big risk. Additionally, in uncertain times, there's risk of capital flight from banks to CBDCs.

It's too early to know how they'll affect central banks' ability to implement monetary policy. Advocates contend policy tools could be enhanced. With the elimination of physical cash, CBDCs would enable negative interest rates. Congress should take care to prevent the possibility of negative rates being designed into a Fed e-dollar. Enabling negative interest rates, thus punishing savers and causing malinvestment, is a bug, not a benefit.

CBDCs may have different velocities than cash. And competing private payment systems self-correct. Public systems are quite another matter.

Indeed, the biggest CBDC risk is that they could pre-empt or crowd out the development of competing private digital currencies. The Fed is the financial system's paramount regulator and enjoys virtually unlimited resources. Commercial banks, fintechs, and payment networks will, consequently, be reluctant to compete against it.

Fed Governor Waller observes that "markets operate efficiently when private-sector firms compete to provide the highest-quality products to consumers and businesses at the lowest possible cost" and that "government should compete with the private sector only to address market failures." There's no obvious failure in payments and bank money.

Quarles, the former vice chair of supervision, warned "a Fed CBDC, or even plans for one, might deter private-sector innovation by effectively "occupying the field."

A Level Field

Historically innovation in money and payments has been driven by private initiative, not by the state. In the 7th century, Chinese merchants introduced the first paper currency. It was Scottish banks that invented overdrafts, and multicolored and double-sided banknotes.

Financier Frank McNamara launched the first general-purpose payment card network, Diners Club. Banker Dee Hock was the father of the global bank card network, Visa. Banks built the global cross-border payment-messaging network Swift.

Peter Thiel and Max Levchin founded PayPal. Cryptocurrency pioneers Chris Larsen, Jed McCaleb, Vitalik Buterin, and Anatoly Yakovenko, didn't work at the Treasury Department. Stablecoin development, too, has been spearheaded by private-sector capital and initiative from entrepreneurs like Circle's Jeremy Allaire, Paxos's Charles Cascarilla, Andrew Chang, and Richmond Two, and Tether co-founders and Mastercard Foundation alumni Brock Pierce and Craig Sellars, and entrepreneur Reeve Collins.

Leading CBDCs and stablecoins won't be national silos. Eventually, they'll interoperate, enabling instant cross-border value exchange through global clearinghouses, bilateral or multilateral connections, or both.

In “Denationalisation of Money: The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies,” Freidrich Hayek advocated free trade in money for private and national currencies to be able to freely compete, subject to market discipline. Fed e-dollars, Citi e-dollars, Diem, ECB digital euros, Circle’s USDC, Tether’s USDT, et. al., vying for pride of place in e-wallets and different use cases, would foster innovation, with the market guiding development and picking winners and losers.

Best case, competing private and public money and payment systems operating on a level legal and regulatory playing field, will evolve, delivering ever-greater value.

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