Is The US Creating A Central Bank Digital Currency?

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FOREWORD

The US government has been exploring the creation of a Central Bank Digital Currency (henceforth, CBDC), something that other central banks across the globe have also been considering. However, there is no timeline and/or certainty that it will actually decide to move in this direction. With this and all of the noise earlier this year regarding the future of the US dollar in mind, we have decided to write about the potential creation of a CBDC. But before discussing whether this is a good idea, let's discuss what the functions of money are and try to figure out if there is any value in the creation/implementation of a CBDC by the US government.

WHAT ARE THE FUNCTIONS OF MONEY?

The United States dollar (USD) was partially backed by gold under the Bretton Woods Agreement until 1971, when President Richard Nixon ended the convertibility of the USD into gold. From this moment forward, the USD became a fiat currency, a legal tender whose value is not directly tied to a physical asset but relies on the faith and acceptance of individuals and institutions. There is no currency in the world that is backed by gold today. However, there are currencies across the global economy that are pegged to the US dollar and other strong currencies.

Money contributes to an economy by facilitating trade, investments, and economic growth. Money has, fundamentally, three functions:

KEY TAKEAWAYS

The US dollar was backed partially by gold through 1971, when it became a fiat currency. Now there is talk of a 'digital dollar'—a Central Bank Digital Currency (CBDC)

Wild fears abound that the US government may misuse a CBDC to confiscate or manipulate private wealth. We believe these fears are unfounded.

If the US decides to create a CBDC, it will enhance and complement, rather than go against, the current characteristics of the US dollar.

Concerns that a Chinese digital renminbi will overtake the US dollar (digital or otherwise) are overblown, as the dollar remains the world's premier reserve currency. The US dollar fulfills all the functions of money better than any other currency of the world.

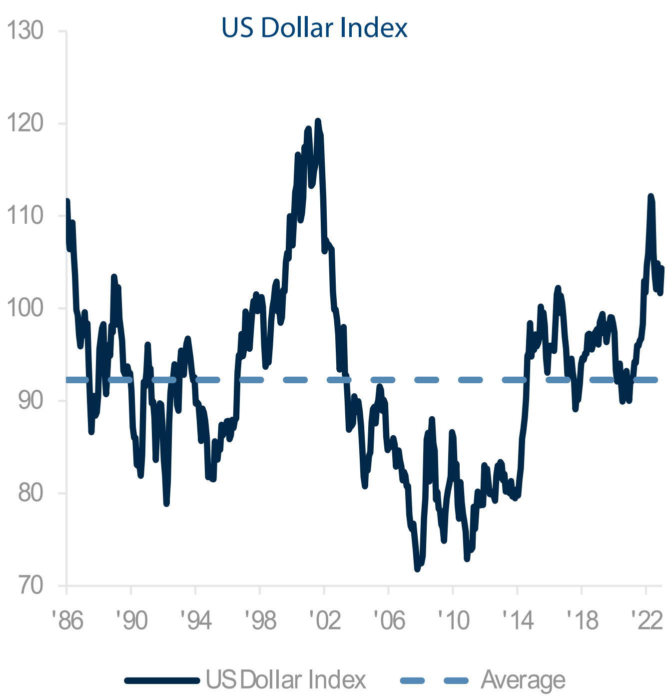
An American CBDC is still a long way from reality. Congress must approve creation of a CBDC and it would likely function as an extension of our already digitized financial system, rather than a new and sinister government tool.

1) as a unit of account: a uniform measure or a way to measure or value goods and services in an economy.

2) as a medium of exchange: it serves as an intermediary to facilitate an exchange between different parties to a transaction.

3) as a store of value: this means that money is expected to hold its value over time.

Although the three functions of money are important, the last one is the most important of all and it is what makes the dollar what it is today: the most important currency in the world.



Source: FactSet as of 06/2023

The fundamental reason the US dollar is the most important currency in the world economy is because its value is relatively stable over time, and individuals, firms, and countries trust that the US institutions in charge of the US dollar will protect the characteristics that make it so. The US dollar fulfills all the functions of money better than any other currency of the world. There is nothing in the potential development of a CBDC that would change any of the above-mentioned functions or even threaten them. Furthermore, the US financial system is already almost completely digitalized, so completing the digitalization of the system by introducing a central bank digital currency would in no way, shape, or form alter the characteristics of the US dollar. Perhaps the most important question to ask is: what does the US gain by creating or implementing a CBDC?

ROLE OF THE GOVERNMENT

An important issue for the Federal Reserve (Fed) in the creation of a CBDC is its role versus the role of the private sector—the banking and financial industry. There are concerns that the creation of a CBDC would give the US government the ability to 'know' everything about everybody in the system and have access to very specific information about citizens. That is, if the government, or a government institution, is tasked with managing this CBDC, all of our information will be in the hands of the US government.

There is further speculation that if the government creates a CBDC it will have the power of to 'turn it off' and make wealth disappear. The last part of this argument, that the government will have the power to 'turn it off,' makes absolutely no sense. The fact that one of money's most important functions is as a 'store of value' makes the discussion of this point meaningless.

Arguably, the ability of the US to freeze foreign countries' or foreign individual's assets could lead to some mistrust over having a CBDC. However, this also makes no sense because nobody pushes anybody outside the US to hold US dollars. Every US dollar note (bill) says "this note is legal tender for all debts, public and private."[1] That is, the US dollar is legal tender only in the US and its territories, and not in any other country of the world. So, the question is: why would anyone else in the world, be it foreign individual, foreign company, and/or foreign government, hold US dollars? The answer is very simple: because they trust in the value of the US dollar over time and this trust extends to doing what is necessary to defend the value of the US dollar.

What is preventing, today and in the future, the government from knowing almost everything about its citizens? Nothing, even if the government does not implement a CBDC! The government may have to go through the judicial system to be able to gather information about its citizens, but it can know everything about them, if necessary. The point is, the US government doesn't gain anything more in terms of potentially 'knowing its citizens' by creating a CBDC.

In fact, one of the biggest problems for the government—as well as those institutions with which people do business on a daily basis—is probably information overload rather than too little information. At the same time, the government information system is highly fragmented, as some of this information is in the hands of the federal government, state governments, or private businesses rather than just all in the hands of the federal government. For those concerned about the government or private institutions knowing too much, this characteristic of fragmented information is probably good and will probably remain so in the future.

[1] This phrase is taken from a US dollar bill (note)

For those who believe that the Chinese yuan or RMB (the Chinese currency, the renminbi), with its own digital RMB, is going to take over the world and displace the US dollar in international markets, it is important to note that the Chinese government is actually creating this digital RMB to know more and to have complete information on who transacts, what they transact, why they transact, etc. The Chinese government wants to know everything about everybody because that is how it keeps a tight control on the Chinese economy as well as on its citizens and firms doing business in China.[2] This is not true for the US even if there are ideologically driven sectors who believe otherwise.

So far, the US dollar's preeminence as the currency of choice as a unit of account, for transactions (i.e., as a medium of exchange) as well as a conduit of stable value (i.e., as a store of value), is what has determined the US dollar's superiority across the globe. We have to remember that the US dollar is only a unit of account, a medium of exchange, and a store of value by legal tender within US borders. However, the fact that everybody accepts the US dollar for transactions outside of its borders is an indication that the US dollar has been accepted throughout the world due to its characteristics. Of course, that is also true of the euro, the Japanese yen, and other currencies across the global economy, but the US dollar's preeminence stands out. This means that any changes made to the characteristics of the US dollar will only be considered if they reinforce the importance of these functions, not if they subtract from them. And we are convinced that if, in the end, the US decides to go forward with the creation of a CBDC, the CBDC will enhance and complement, rather than go against, the current characteristics of the US dollar.

FROM PAPER TO DIGITAL, LARGE TRANSACTIONS WITHOUT A TRACE: ENTER CRYPTOCURRENCIES[3]

In this day and age anonymity has become a pseudo-function of money, or at least a characteristic some people holding large amounts of money desire. Cryptocurrencies seem to be targeting large transactions under anonymity. They are trying to fulfill the 'paper' dollar's (or any other strong currency, like the euro) ability to allow individuals to transact without being identified. This is especially true for very large transactions, just because carrying large amounts of US dollar bills to conduct very large transactions is cumbersome, inefficient, risky, and at the same time it increases the probability of identifying those conducting these transactions, especially if they don't want to be identified. Thus, from this point of view, cryptocurrencies may achieve some usefulness in the future. However, the fact that much of the interest in large and anonymous transactions is geared toward illegal/criminal transactions may continue to put the future value of cryptocurrencies in doubt. Furthermore, cryptocurrencies have a serious issue with the concept of 'stable value' or being a currency that is used as a store of value over time as shown in the graph below.

Source: FactSet as of 06/26/2023

Furthermore, governments across the global economy could render cryptocurrencies illegal or, at least, regulate them, which could make them even less desirable, and/or marginalize them so they remain on the margins of economic activity, used only for conducting illegal/illicit transactions. In the US, as well as in each of the countries that issue their own currency, that currency is the legal tender for transactions in that country and thus countries across the world will continue to be opposed to cryptocurrencies, especially if they infringe against the sovereignty of those countries.

Even if the Fed or the US Treasury does not acknowledge it, paper currency is the easiest instrument to use in order to avoid identification and thus it is an important instrument in economic transactions if the individual/firm/agent does not want to be identified. Both the criminal world and those who accumulate US dollars (or any other currency) in order to protect themselves from their own countries' fiscal authorities or shield themselves from bad monetary policies, (i.e., high inflation, hyperinflation, and large devaluations of domestic currencies), use paper currency as the US dollar's ability to retain its value has been second to none over the decades.

This is, perhaps, the biggest reason for the Federal Reserve, and the US government, to fear the growth of cryptocurrencies.

[2] See our "Thoughts of the Week" for April 5, 2023, where we discuss the US dollar as a reserve currency and the challenge from the Chinese RMB: "Dollar vs. Speculators: Don't Bet Against the Dollar"

[3] Cryptocurrencies have other issues like security of transactions due to fraud or theft while at the same time they are very expensive to create in terms of the energy needed/used in its creation. We are not going to discuss these issues in this white paper but refer readers to specialized publications for more information.

However, a US digital currency is not going to compete against the US dollar note or cash across the global economy because a CBDC takes away what it is the most important characteristic of a bill or currency note, that is, the anonymity of those that hold it. What cryptocurrencies provide, other than anonymity, is that they can handle large transactions, which is very useful for large, and many times illegal, activities. We think cryptocurrencies are aiming to compete against the holding of US dollar notes.

However, we don't think cryptocurrencies are a good subsitute for those individuals across the globe that hoard US dollars, i.e., or what has been called currency substitution.

MONETARY POLICY: HOW DOES IT WORK?

The Fed conducts monetary policy through the banking/financial system by selling/buying US Treasurys in the open market. If the Fed sells Treasurys to the market, it is tightening monetary policy, i.e., increasing interest rates, as it is removing liquidity from the market. If, on the other hand, the Fed buys Treasurys, then the Fed is injecting cash into the system, i.e., decreasing interest rates, by using cash to buy those Treasurys from the market.

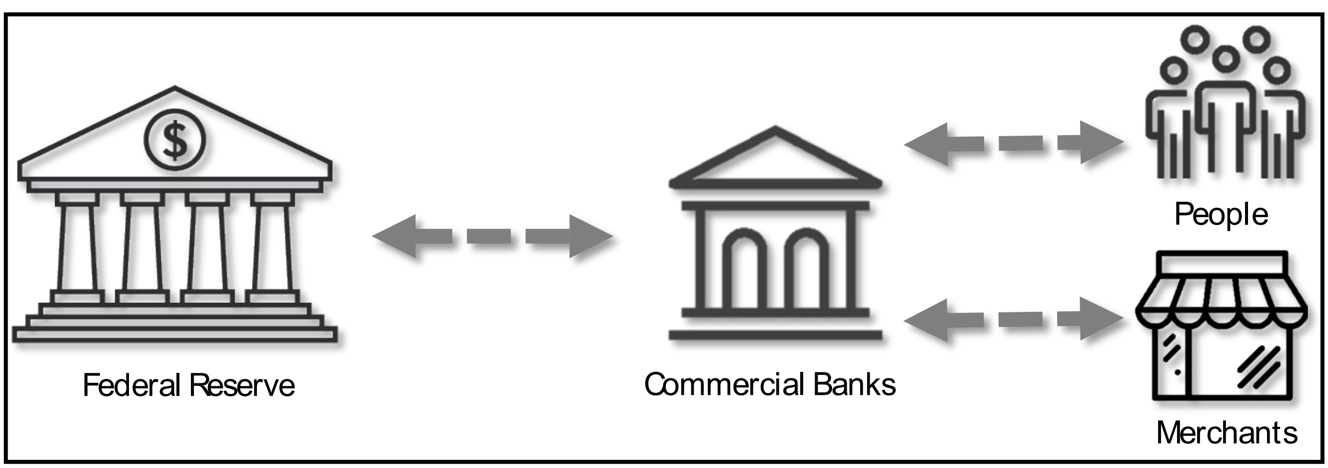
Banks then create new money through what is called the 'money multiplier' by lending to firms and the public in general. Since the Fed does not interact with the public and does not create money in the US economy, as this role is performed by the private financial sector, any potential decision on the creation of a CBDC will probably continue to rely on the private banking/financial system to perform the role of money creation in the US economy. It is highly improbable that the US government and the US Congress will change the role of the Fed if it goes forward with the creation of the CBDC. In its June 2023 Congressional hearing, the Chairman of the Federal Reserve, Jerome Powell, agreed with us, replying to a question from a US Representative that the Federal Reserve is not interested and will oppose any dealing with US individuals and that a potential CBDC will probably be implemented through the US financial system.

CBDC AS A FISCAL POLICY INSTRUMENT?

A potentially important role for a CBDC design in the US would be in the ability of the US government/US Congress to conduct fiscal policy by targeting those sectors of the country that actually need help during recessions or pandemic events like the one we had in 2020 with the COVID-19 pandemic. The effort to transfer income to Americans during the COVID-19 pandemic unmasked the serious inability of the US government/US Congress to target its fiscal policy efforts. The two checks issued by the Trump administration plus the PPP program to help firms to keep workers in their jobs during the pandemic, together with the check issued by the Biden administration showed how difficult it is for the US government to implement targeted fiscal policies in emergency situations like a pandemic, many times transferring money to those who did not need help while at the same time creating the opportunity for serious fraud, both increasing the cost as well as the inefficiency of these programs.

Perhaps the only efficient and targeted fiscal transfer mechanism used during the pandemic was the $600 dollars per week of extra unemployment insurance given during the pandemic to those workers who had lost their jobs. Of course, somebody may have concerns about the US Congress conducting this type of policies, but it was the only one that actually targeted those that needed help.

Furthermore, a well-designed CBDC could also help the US government reduce waste and fraud in conducting fiscal policy, which is not a small issue. However, we believe that there is very little interest in the US Congress to give the federal government or any particular federal government agency the ability to manage such a system at this time.



WHAT IS IMPLIED BY A DIGITAL CURRENCY?

We have addressed many questions from clients regarding the potential implementation of a CBDC by the US Department of the Treasury and the central bank, that is, the Fed. As we argued above, although the Treasury and the Fed have indicated that they are considering the potential benefits/costs of creating a CBDC, the project is still not completed, and any implementation of such a digital currency would need approval from Congress.

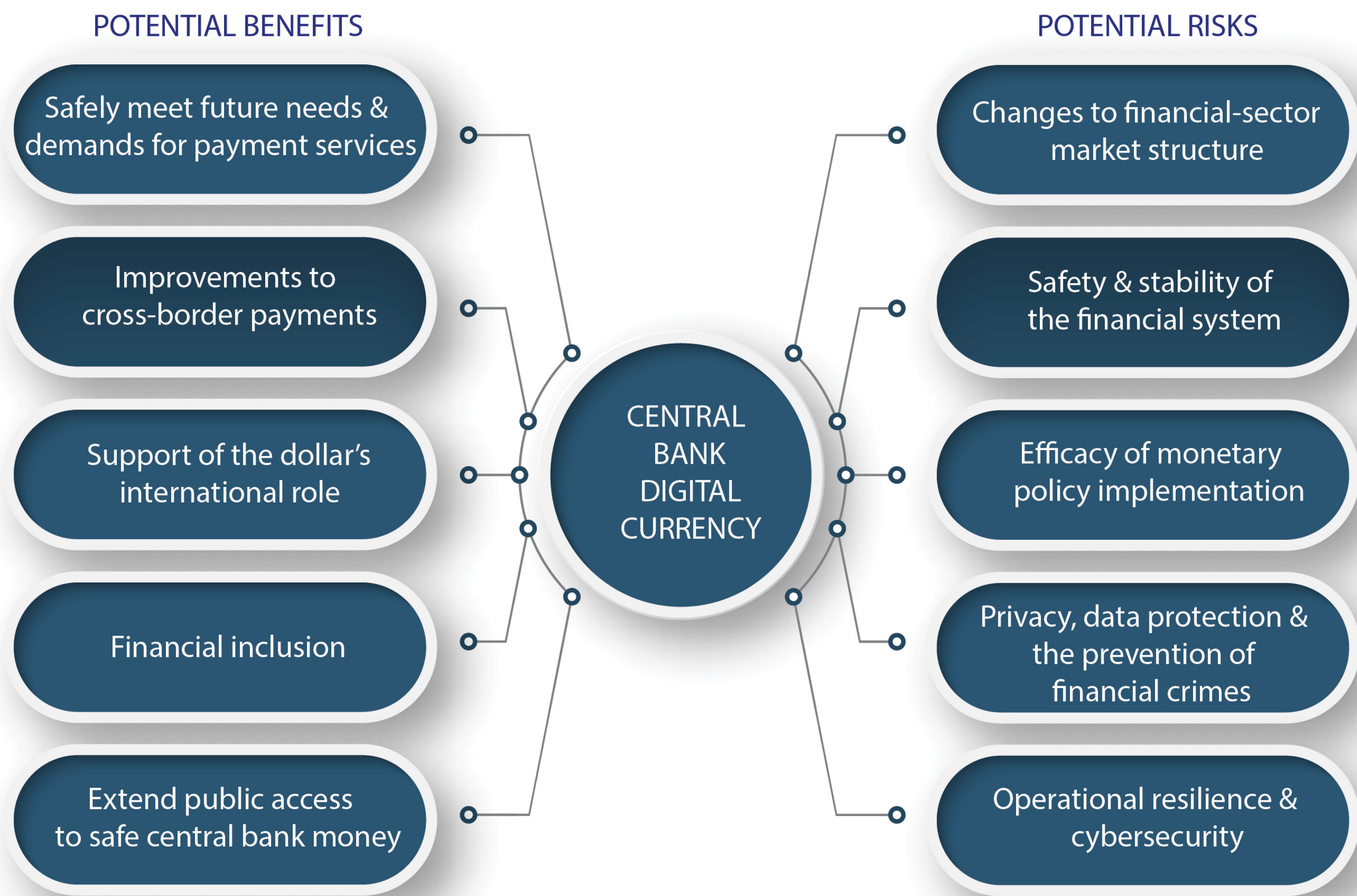
Furthermore, they indicate that if a digital currency is ultimately implemented, it will tend to complement the current system rather than replace it, as there are still plenty of individuals who continue to use paper currency even in today's already highly digitalized economy and monetary system.

One of the biggest issues for the Fed is that its mandate does not include dealing directly with individuals but dealing with financial institutions, as they are the ones that 'create' the money that is used by economic agents. That is, the Fed's customers are financial institutions, not individuals. Thus, any introduction of a CBDC would probably be implemented through the Fed's intermediaries, that is, financial institutions, i.e., banks.

A recent paper by the Fed called "Money and Payments: The US Dollar in the Age of Digital Transformation"[4] enumerates the potential benefits of a CBDC as well as potential risks and policy considerations. These range from public access to safe central bank money (potential benefit) to privacy concerns (potential risk—see more below).

What would a CBDC mean for markets?

Federal Reserve needs to carefully weigh the pros and cons
of digital currency in a heavily digitized financial system



[4] See "Money and Payments: The US Dollar in the Age of Digital Transformation," Board of Governors of the Federal Reserve System, Research & Analysis, January 2022.

In an earlier, US Department of the Treasury report called "The Future of Money and Payments"[5] the Treasury made four recommendations:

Recommendation 1: Advance work on a possible US CBDC, in case one is determined to be in the national interest.

Recommendation 2: Encourage use of instant payment systems to support a more competitive, efficient, and inclusive US payment landscape.

Recommendation 3: Establish a federal framework for payments regulation to protect users and the financial system, while supporting responsible innovations in payments.

Recommendation 4: Prioritize efforts to improve cross-border payments, both to enhance payment system efficiency and protect national security.

With regard to Recommendation 1, the research document, in section "III. Potential US CBDC design Choices," argues that "A CBDC is a digital form of a country's sovereign currency. In the United States, the existing forms of sovereign currency are deposits held by banks and selected financial institutions at the Federal Reserve (reserve balances) and Federal Reserve Notes (paper currency). A CBDC would have three core features. First, CBDC would be a legal tender. Second, CBDC would be convertible one-for-one into reserve balances or paper currency. And third, similar to transfers of reserve balances over Fedwire or the FedNow Service, or payments with paper currency, CBDC would clear and settle with finality nearly instantly."[6]

Although this paper argues that there may be two alternatives for intermediaries, that is "(1) a single-tier (i.e., direct) CBDC with the central bank, and (2) a two-tier CBDC where intermediaries (potentially banks or nonbank financial intermediaries) would onboard and manage payments while the central bank records account balances," we reiterate that it is highly unlikely that the US Congress will use the direct route, that is, to give the responsibility of the CBDC to the US central bank and will probably use the second alternative, that is, a "two-tier CBDC where intermediaries" with banks or nonbank financial intermediaries.

FEDNOW

The Fed has recently improved its financial institution's payment system by introducing a new service/system called FedNow. We have already heard grumblings that this system is one of those attempts by the federal government to encroach on individuals' lives. However, there is nothing sinister about FedNow, it is just a new service, as the Fed explains on its website, and is part of Recommendation 2 above:

> "The FedNow Service is a new instant payment infrastructure developed by the Federal Reserve that allows financial institutions of every size across the US to provide safe and efficient instant payment services.
>
> Through financial institutions participating in the FedNow Service, businesses and individuals can send and receive instant payments in real time, around the clock, every day of the year. Financial institutions and their service providers can use the service to provide innovative instant payment services to customers, and recipients will have full access to funds immediately, allowing for greater financial flexibility when making time-sensitive payments.
>
> The FedNow Service will be deployed in phases, with the initial launch taking place July 2023."[7]

CONCLUSION

We don't know if the US Treasury Department and the Federal Reserve are going to create a CBDC but if they decide to go forward, they would need authorization from the US Congress. Furthermore, if they decide to go forward with the plan, it will probably be just an extension of what we currently have, which is an almost completely digitalized financial and monetary system. The truth is that the US probably doesn't gain much from further digitalizing the system because the system is actually almost completely digitalized. Furthermore, there is still a big appetite for holding the US dollar in the US as well as in the rest of the world. Some of this demand for US dollar notes is due to the trust the US dollar has established across the global economy, as a medium of exchange but supported, fundamentally, by being a stable 'store of value.'

Some of this demand, especially in the US, is from people who don't trust the system and will always be reticent to participate in it. And since we believe that if created, the system will continue to have its 'cash' component, these people will remain on the sidelines, using cash for their daily lives.

But we do see value in the full digitalization of the system, as it will make it more efficient and, in the long term, probably cheaper than today. To that end, the Fed has created FedNow and is probably going to continue to move in the full digitalization direction, even if it stops short of creating a CBDC.

[5] See "The Future of Money and Payments," Report Pursuant to Section 4(b) of Executive Order 14067, US Department of the Treasury, September 2022.
[6] Ibid, page 19.
[7] See "About the FedNowSM Service," in https://www.frbservices.org/financial-services/fednow/about.html.
[8] As an example, real estate pricing as well as real estate transactions in Argentina are posted and conducted in US dollars due to the instability and ever changing, i.e., depreciating value of the Argentine peso.

All content written and assembled by Raymond James Investment Strategy.

ADDITIONAL DISCLOSURES

U.S. Dollar Index | The U.S. Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies.

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