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## Public Money: Digital Dollars? Fed Acccounts? Postal Banking?

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### Prompt for Discussion

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The recently enacted CARES Act has exposed glaring problems in the U.S. system of money and payments. Delayed stimulus payments are costly for struggling families and for the economy as a whole. Unfortunately, the United States has one of the slowest payment systems in the developed world. On top of that, millions of Americans don't have bank accounts. They must receive their stimulus dollars as physical checks, which are slow to arrive and often costly to convert into cash.

Growing awareness of these systemic defects has stimulated renewed interest in public sector solutions. When Democrats in the U.S. House of Representatives released their proposed stimulus legislation in March, they included a provision giving people the option to receive their stimulus as "Digital Dollars" through a new system of "FedAccounts" maintained at the Federal Reserve. While this provision didn't make it into the ultimate legislation, Senator Sherrod Brown, ranking member on the Senate Banking Committee, later introduced separate legislation "to allow everyone to set up a digital dollar wallet, called a FedAccount." Maxine Waters, chair of the House Financial Services Committee, did the same. And Representatives Rashida Tlaib and Pramila Jayapal included similar language in recently proposed legislation.

These proposals intersect with and complement proposals to implement postal banking as a way of serving un- and underbanked households. As these debates unfold in the United States, other central banks, including the Bank of China, are preparing to release their own central bank digital currencies (CBDCs) in the coming months.

In this roundtable, we invite participants to comment on these public-sector initiatives and what they mean for the future of money. Should the Federal Reserve issue a digital dollar, available to the general public? What problem would it solve or mitigate, and what new problems and risks would it create? Should central bank digital currencies take the form of "accounts" or should they try to emulate digital "tokens"? Can and should a FedAccount program be linked to or even merged with a postal banking initiative? Does maintaining the U.S. dollar's status as the dominant global currency hinge on launching a digital dollar?

## Contributions

November 19, 2020
**The Other Half of the FedAccounts Plan: What Happens on the Asset Side of the Fed's Ledger?**
Saule T. Omarova, Cornell Law School

October 16, 2020
**Central Bank Digital Currency: the hidden agenda**
Leonidas Zelmanovitz, Liberty Fund
Bruno Meyerhof Salama, UC Berkeley Law School

October 7, 2020
**On Equity within Public-Sector Banking Initiatives**

Abbye Atkinson, Berkeley Law

September 28, 2020
**The Inclusive Value Ledger: A Public Platform for Digital Dollars, Digital Payments, and Digital Public Banking**
Robert Hockett, Cornell Law School

September 1, 2020
**Designing Financial Services for People with Low and Uncertain Income**
James McAndrews, TNB USA Inc., and the Wharton Financial Institutions Center

August 27, 2020
**What to Do While Waiting for Fed Accounts**
Sarah Bloom Raskin, Duke University

August 18, 2020
**How to Fix the Covid Stimulus Payment Problem: Accounts, Information, and Infrastructure**
Aaron Klein, Brookings Institution

August 10, 2020
**FedAccounts: Digital Dollars**
Morgan Ricks, Vanderbilt University
John Crawford, University of California Hastings College of the Law
Lev Menand, Columbia Law School

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# L. Zelmanovitz and B.

# Meyerhof Salama, Central Bank Digital Currency: the Hidden Agenda

October 16, 2020

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Calls for the Federal Reserve (Fed) to consider a Central Bank Digital Currency (CBDC) gained steam after the release last year of a white paper by Facebook and associates proposing to create a stablecoin called Libra. The Fed has obliged, having now partnered with MIT to research technological and policy implications of a CBDC. But, create a CBDC with what purpose?

The creation of a CBDC by the Fed is most often portrayed as an *ad hoc* reaction to a proposal for a privately issued digital currency. Some also view it as a response to other central banks which are considering pursuing the same path. While the ideas of improving monetary policy and enhancing financial stability and competition are widespread as well, the focus has been on the Fed's need to catch up with the technological frontier and the challenges posed by geopolitical contenders.

There is, however, a subtler but more relevant interpretation: the effort to develop a CBDC represents one more step in the direction of enlarging the role of "sovereign money."

*The hidden agenda*

The proposals for creating digital currencies by central banks have taken the form either of “electronic tokens” or “accounts.” Electronic tokens are designed to mimic paper money. They are similar to electronic pre-paid debit cards or gift cards. For example, the Bank of Lithuania has just released commemorative digital tokens, the “world’s first digital collector coins.”

Account-based CBDCs are basically universal central bank accounts. They are designed to give retail customers access to online bank accounts directly with the Fed. Like electronic tokens – but unlike bank deposits or e-money stored in prepaid cards – these accounts are liabilities of the central bank. They are reserve balances held at the central bank, except that they are available to everyone, and not only to designated financial institutions.

Whether as a token or a bank account, a CBDC will be a form of money created by the US Federal Government through its monetary authority. It will be as much as “sovereign money” as you can get.

It follows that proposals to create CBDCs should be accounted for in practice for what they are in theory: an attempt to crowd out privately created money – and, therefore, an invitation for a greater degree of government-directed credit, money creation, and financial repression than what we already have today.

*Money as a joint creature of government and markets*

At least for the last three hundred years, in Western societies money has been supplied partly by the state and partly by the market. The state-supplied money first took the form of coins and later of paper money with legal tender. The other part of the money supply has been provided by commercial banks: first, in the form of banknotes redeemable in government–issued coins, and later in the form of bank credit payable in government issued paper money, which is why these assets are referred to as money "substitutes."

The supply of money by the government first depended on the availability of precious metals. The sovereign was forced to use real resources to invest in the mining of silver and gold or to purchase bullion from which it could mint coins. Except for the old trick of debasing the coinage and reducing its purchasing power, supplying money was costly.

The quantity of coins with the previously expected purchasing power that a sovereign could mint was therefore dependent of the allocation of real wealth. It was only much later that sovereign money was made possible solely on the will of the government (fiat money). The point, however, is that, in any of these cases the amount of the money supplied by the government is determined "outside" the market. In this sense, "sovereign money" is also "external" money.

At the same time, banks give credit. In doing that, they create banknotes or credit bank account balances for their borrowers – but only when borrowers come with investment propositions that are likely to allow for a profit. Because the amount of money substitutes created by banks depends on the existence of profitable opportunities for lending in the market, that part of the money supply is called "inside money." The beauty of this system is the supply of money adjusts "naturally" to the ever-changing demand for money.

Thus, came about what is now known as "modern finances" – that is, fractional reserve banking. This system came about in 1694 with the creation of the Bank of England. Instead of using real metal as a medium of exchange, people started to use the Bank's promise to pay gold and silver as the instrument for their private exchanges. This promise was represented on the Bank of England's balance sheet and took the form of banknotes.

*The fragility of private money*

Over time, the English commercial banks started to create *more* money substitutes than the counterpart of the amount of money originally borrowed by the UK Crown or the amount of reserves they kept in their vaults. The banks started to finance credit to commerce and, later, farming and industry. These arrangements with "fractional" reserves usually worked well when prudently managed under the rules of their creation. However, in situations of emergency, usually as a result of armed conflicts, said arrangements would end up being shattered: then came inflationary war finance.

The lesson is as follows: where banks are organized under a constitution that allows the sovereign to exercise its monetary prerogatives, banks are forced to lend to the government in emergency cases.

Military crises and other emergency situations therefore reveal the "inherent" fragility of the arrangements under which banks issue more promises to pay in "base/external" money than the amount of base money in existence. Inflationary war finance, in particular, lays bare the fragility that is inbuilt in fractional reserve banking.

A focus on this fragility should not obfuscate an under-appreciated benefit of this system: it is geared towards directing funding to the most promising investment opportunities. This improves overall economic efficiency: in improving the allocation of funds, as is plain to see; and also (and less obvious but equally important), in giving confidence for depositors and creditors to entrust their savings to the bank.

This trust-based system can be broken in three situations: when the sovereign thinks that it is politically expedient to force the banks to lend money to the state (as in times of war); when banks are perceived to have created more money substitutes than the amount of money people want to hold (leading to bank runs); or when bank lending is politically driven and systematically forgoes the most profitable opportunities. The ensuing evils include bank failures, inflation, capital misallocation, and so forth.

It is because Western societies have been plagued by these three evils for centuries that some politicians, central bankers and academics have considered reducing or abolishing inside money. The reasoning is that the benefits from the circulation of money substitutes are counterbalanced by the costs of financial stabilization; and those costs are borne by taxpayers.

While typically falling short of openly proposing the abolition of inside money, the fact is a good number of CBDC proponents see those costs as excessively high. A progressive reduction in the role of inside money is then advocated. Increasing levels of financial repression are nothing but the logical consequence.

*The expected turn to financial repression*

Despite private money's fragility, governments promote its creation. For instance, governments worldwide offer "deposit insurance" and "lender of last resort" facilities to entice people to surrender money in exchange for deposits, propping up private bank deposits by covering it with a public "umbrella." An older example was the authorization granted to banks to suspend the redemption of banknotes in coins. Typically, the other side of the bargain is that banks finance the government directly or offer subsidized loans to protected segments.

CBDCs offer a more radical solution to the problem of fractional "fragility": curbing the capacity of banks to creat e money or further regulating its quantity, depending on the particularities of each CBDC scheme. It is a kind of "devolution" to the government of (inside) money creation powers that, starting in the late 17th century England, were assigned to the private sector. But to return power to the government for what purpose? This is the biggest irony of all: the idea is to create CBDCs to allow the government to continue doing the exact same thing it does today – that is, to gain access to real goods without imposing greater taxation in the present.

What then? Then allocation of credit could be directed to those projects that the political process deems more worthy of receiving the funds even further than what is done today. The name of that is financial repression. CBDC is a tech-based variant of previous attacks on inside money, such as the "Chicago Plan" in the 1930s or recent proposals for "narrow banking." It is one more stance in which it is advocated that the liquid funds of the community should be politically allocated.

Under current arrangements, government issuance of paper money comprises only a fraction of the total stock of money, and the credit creation by the private banks serves to allocate resources to productive endeavors. By creating a CBDC through a mechanism like a "Fed account," under which all bank deposits are in real time transferred to the Fed, the government would force private banks to allocate resources to a single asset – bank reserves with the Fed – that is, public debt. That is funding for ends decided politically, not by the market.

*The mechanics*

Let us see how any of that can be accomplished. For the sake of simplicity, let us use the Chicago Plan model to illustrate the mechanics of Fed Accounts. Suppose the Fed creates a ledger for all bank accounts in the country directly in its balance sheets. It then announces that depositors can choose between opening new accounts directly with the Fed or keeping their deposit accounts with their current commercial banks – but, in the latter case, under the caveat that each commercial bank must transfer one hundred percent of its deposits in real time to corresponding accounts held with the Fed by their customers.

Under such arrangements, the banks will, in practice, be put in a regime of 100% reserve requirement and will not have money to lend to private borrowers from the floating of their deposits. In turn, the Fed will have as base money (bank reserves with the Fed) the entire liquidity of the country, except for the other component of base money, paper currency – assuming, of course, that paper currency will continue to exist, something that some proposals for CBDC do not permit.

Thus, all the demand for "cash" (paper money and bank deposits) becomes "Fed-accounts". The money supply becomes a Fed liability, all of it. The counterpart of those liabilities on the asset side of the Fed's balance sheet is Treasury notes. And if the banks wish to lend money, they first need to borrow from the Fed or borrow in the capital markets like any other business. Then, of course, banks will cease from being commercial banks and will no longer be able to create inside money through credit creation.

In fact, we talk about a "hidden" agenda precisely because we speculate that the entire exercise with the creation of a CBDC can end in the demise of modern finances premised on inside and outside money creation.

*Politics in the origin*

Imagine the Fed opens lines of credit, say, only to green energy projects, or for businesses with owners coming from minorities (or, more likely, majorities), or any other politically connected group. The system of market-driven allocation of capital is undone and with that the efficiency of wealth creation in society is reduced. Politicians signal virtue, while capital formation suffers. Yet, there is a lag until disposable income and consumption actually drops. In a generation or two we are all much poorer – but who is to blame?

Additionally, we must entertain the possibility of even more aggressive forms of CBDC. Foes of private money may dream of direct retail accounts with the Fed or a “postal bank” associated with the Fed, and lending done directly by the Federal government and some of its agencies. In this more radical scenario, the entire financial sector is nationalized, in one way or other. If the government decides that all the savings of the country should be funneled to finance public projects and none to finance private business, the deleveraging of private businesses ensues. Only well-capitalized firms survive – as is the case in underdeveloped countries with shallow financial systems and bloated public sectors.

Of course, not all proposals of CBDC are that extreme. Some of the proposals for digital token dollars, for instance, will only marginally (although no one can know for sure by how much) reduce private-banking intermediation by inducing a greater portion of the liquid holdings currently kept in cash, to be kept in digital form.

Motives matter, and the agenda of many of the CBDC proposals is therefore a dangerous one. The operational independence of central banks and the formal separation between monetary and fiscal policy has served Western societies well by insulating central banks and the monetary policy from political pressures. This is not to deny that this separation works best during peace than during war. The point, however, is that now there is a strong movement to undo this framework in times of peace (enthusiasm for CBDC predates the Covid19-triggered crisis).

Symptomatically, central bankers such as the President of the European Central Bank Christine Lagarde and Governor Andrew Bailey, of the Bank of England, have expressed enthusiasm for using the operations of their banks to fight climate change. It is easy to understand their motivations. They will get kudos from the media and from politicians not willing to undergo the regular budgetary process. The costly subsidies and mandates they want to impose could then benefit their favorite sectors and constituents. If politically–driven credit allocation already takes place under current arrangements, imagine what will happen if the central banks gained a new mandate – one to do precisely that?

And there is still one additional aspect to consider. How far down that road have we already traveled? Consider Money Market Mutual Funds (MMMFs). In a way, the financial institutions managing those funds are already off-balance sheet intermediaries between investors willing to hold “cash equivalent” instruments and the Federal government, the main supplier of assets to those funds (that is, the main borrower of those resources, in the form of Treasury notes).

This is already a way for the financial institutions to intermediate credit without leveraging their own balance sheets, without the creation of instruments commonly recognized as “money substitutes.” Now, of course, if one considers that the units of the MMMFs are themselves “money substitutes,” then the banks are already doing “narrow banking” with a substantial portion of the total liquidity of the economy.

*The importance of being earnest*

Professor Morgan Ricks in his testimony to Congress on the subject stated that “[u]nder the FedAccount proposal, Congress would direct the Federal Reserve to give the general public—individuals, businesses, and institutions—the option to hold accounts at the central bank.” Unlike other scholars, he is clear about the goal of increasing the weight of public money in the monetary base. His honesty should serve as a model for the kind of open discussion that should be taking place.

We are of the opinion that private financial intermediaries, whether commercial banks or not, still perform an essential role in monetary and financial systems. They extend credit to trustworthy private borrowers (even if, sometimes, only to issuers of short-term commercial papers that will be bundled together and purchased by MMMFs and other short–term fixed income mutual funds).

The moment that a CBDC is introduced, even under the least aggressive proposals, the space for standard intermediation will be drastically reduced. That seems to us to be at the heart of the agenda for introducing a CBDC if it comes to pass.

The banking system we have today, with all its problems, at least has been performing its role of creating inside money relatively well. With that, it continues to help the money supply to smoothly match an ever-changing demand for money. If that is true, it is incumbent on the proponents of CBDC arrangements to explain why the implications of their proposals are not the ones we are pointing out here. Or, if they are, then an open conversation about financial repression should start immediately.