Confluence Investment Management

Weekly Geopolitical Report

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The Geopolitics of Central Bank Digital Currencies (CBDC): Part III

(Due to the Easter holiday, the next report will be published on April 12.)

This week, we continue our series with an examination of the geopolitics of CBDC.

The Geopolitics

As we noted in Part I, there has been strong interest among the central banks to introduce digital currencies. We would expect each country that decides to establish a CBDC regime will do so based on its domestic situation. But these new currencies won't exist in a vacuum; the establishment of CBDC in one country will likely affect what occurs in other nations as well.

Therefore, this week's report examines the likely structure of CBDC in the U.S., China, and the Eurozone. We will project what a CBDC will look like in each region by establishing the priorities of each one, a likely CBDC structure based on those priorities, and current progress. Obviously, the world is more than these three entities, but for our purposes, the introduction of CBDC by these three powers will tend to determine what other nations decide on this issue.

U.S. CBDC

Priorities:

1. Protection of monetary sovereignty
2. Protection of the reserve currency status
3. Maintain technical edge in fintech
4. Reform the financial system
5. Enhance policy tools
6. Reduce crime/tax evasion

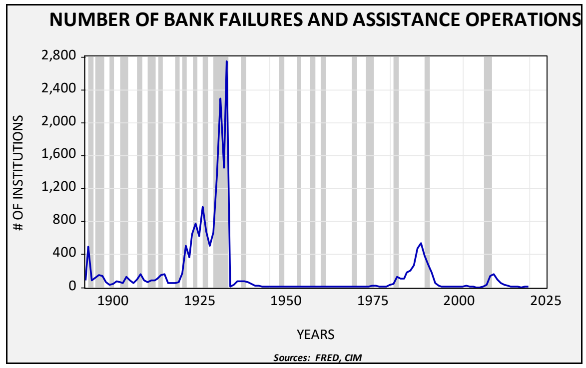
#1: Sovereignty: The Fed's concern over digital money began when Facebook (FB, USD, 264.28) unveiled the LIBRA project. Until that point, officials seemed to treat cryptocurrencies as a fad or oddity…with good reason. The distributed ledger/ blockchain is clunky and isn't really a threat to payment systems. But, large technology companies with global footprints have the potential to become something of a monetary pseudo-state that could undermine the sovereign nature of the current monetary system. The existing system is at least nominally democratic; the Federal Reserve is a private bank, but it operates with congressional oversight. A technology company's currency would be completely private. Managing the money supply would be conducted by a board of directors of a profit-seeking company, and this board may not have an interest in supporting a failed bank. In fact, technology companies have been looking to enter the financial industry; issuing their own currencies would be a bit of a throwback to the monetary system before the establishment of the Federal Reserve and would clearly have an impact.

The social media platforms would already have a platform for distribution and usage. Facebook's mistake was probably unveiling the project before it was ready to roll it out. Now that the Fed is moving on this issue, we suspect regulators will prevent the technology firms from making much progress. We would not be surprised to see the Fed work with the technology platforms for distribution but, in the end, the Fed and the government want to protect their power to issue and control money.

#2: Reserve currency status: The U.S. dollar remains the dominant reserve currency. The SWIFT network estimates [that nearly 87% of trade finance is denominated in U.S. dollars](). The U.S. dollar's reserve currency status gives American policymakers a [potent tool for sanctioning foreign governments](). Thus, it makes perfect sense that U.S. policymakers want to maintain the dollar's attractiveness and having a digital dollar is probably a minimum requirement. But, as we will note in their respective sections below, reducing the reserve currency power of the U.S. is a goal of both China and the Eurozone. Given the openness of the American financial system, we would expect the Fed to allow foreigners the ability to open U.S. dollar CBDC accounts, with the caveat that the citizen distinction is documented (a key issue for priority #5).

#3: Maintain a technical edge: If the world is moving toward digital currencies, the U.S. would be remiss if it allowed itself to fall behind. We would expect the Fed to actively seek participation from the major technology firms to assist in the creation and distribution of the digital dollar.

#4: Reform the financial system: History has shown that fractional reserve banking is both efficient and fragile. It is efficient because banks can make loans easily and can scale up to meet loan demand. However, that efficiency comes at a high cost—bank failures are a persistent feature of fractional reserve banking.



This chart shows the number of bank failures in the U.S. from 1892 to 2020. As the chart shows, bank failures were common even after the Federal Reserve system was created. The regulatory structure that was implemented after the Great Depression was very effective in reducing financial stress. As the chart shows, frequency of bank failures plummeted, but this stability came at the cost of inefficiency. This inefficiency provided an incentive for regulatory arbitrage; the evolution of the Eurodollar deposit in the late 1960s and the money market fund in the late 1970s was a result. The Depression-era regulations were steadily eroded until they were effectively ended with the Gramm-Leach-Bliley Act of 1999.

The expansion of the non-bank financial system and the banking system's participation in it were behind a series of financial crises, from the LTCM event, to the Great Financial Crisis and the financial crisis that emerged last March. These three events are just the "high points" of instability. Minor problems within the repo markets or overseas crop up on a regular basis. For the most part, regulators have treated these problems in a manner akin to firefighters. They resolve the immediate problem (usually by monetary easing) but never fix the underlying problem. CBDC could create conditions that would allow for the implementation of the aforementioned "Chicago plan," discussed in [Part II](), that would likely reduce risk in the financial system by ending fractional reserve banking.

#5: Enhance policy tools: One of the problems that emerged during the pandemic was how to quickly distribute aid. Using CBDC to distribute funds in Fed accounts would resolve this issue. In addition, if the Fed wanted to program money—for example, implement negative interest rates, index CBDC to inflation, "time-stamp" money to encourage purchasing and investment, etc.—then digital currencies would provide this tool.

#6: Reduce crime/tax evasion: Moving to electronic money gives cash "memory" and makes it hard to conduct "off the books" business. This change would improve tax collection efforts.

Likely structure: Given these goals, what would a U.S. CBDC look like? First, we would expect physical cash to continue; the political costs of outlawing cash probably make its elimination impossible. The Fed has indicated the issuance of CBDC will require congressional approval and getting rid of cash would make that unlikely. But we would expect regulation and custom to make the use of cash more difficult. For example, we would anticipate the banning of large denomination bills. If the $20 bill was the largest one available, conducting illegal activities would become increasingly difficult. Second, we would expect the Fed to use a CBDC account system instead of a token. There would be great pains taken to preserve some level of privacy but not complete anonymity. After all, the "know your customer" rule in financial regulation has been in place for a long time. Extending that knowledge would make sense. In addition, transaction data is already captured by the payment companies, so Americans are already accustomed to this information being collected. Third, the temptation to end fractional reserve banking will be high, but it may not be implemented without a financial crisis. So, it probably won't be in the first iteration of the Fed's CBDC but it will become more likely when the next financial crisis emerges (and, if history is any guide, it will). Finally, we would expect foreigners to be able to open Fed CBDC accounts, although there will be great care exercised to designate them as such. This would avoid the problem of sending foreigners stimulus funds; foreign accounts could also face punitive policy actions (e.g., a more negative interest rate, no inflation indexing). Americans will likely be able to hold some national foreign CBDC, although we would not be surprised if countries like China and Russia were excluded.

Progress: Although not as far along as China, the Fed appears to be accelerating its creation of CBDC. It recently published a position paper on the topic and is collaborating with MIT to research various technologies for CBDC.

China CBDC

Priorities:

1. State security and economic stability
2. Power projection

#1: State security and economic stability: Over the past half millennia, nation-states have faced the following choice. They can opt for societal stability by restricting economic innovation and political freedom at the cost of economic stagnation, or they can accept a degree of societal instability by allowing economic innovation and political freedom and benefit from prosperity.[1] The choice is clearly stark, and geography and

[1] For an excellent exposition of this idea, see: Shvets, Viktor. (2020). *The Great Rupture: Do We Need to be Free? Three Empires, Four Turning Points, and the Future of Humanity*. Zanesville, OH: Boyle & Dalton.

geopolitics plays a role. For example, the U.S. faces no immediate geopolitical threats; Canada and Mexico are both weak powers and the other borders are oceans that are long distances from more potent threats. Accepting instability for prosperity is a reasonable choice. Other nations are not as blessed. When a nation faces persistent threats, the temptation for authoritarianism is strong. The cost is economic stagnation. For example, China endured a long period of colonialization, called the "Great Humiliation," which was supported by internal dissention. China is attempting to create a new model of authoritarianism that is both stable and provides high levels of growth. Since Deng, Western governments have assumed that as China developed, it would eventually liberalize and become more democratic. That has been the path of other Asian nations.

China, especially under General Secretary Xi, is trying to forge a different path. One of the reasons that containing freedom leads to stagnation is because the practice of restraint leads to economic centralization. As Hayek noted, markets work because information is diffused and can be used by the most relevant economic actor. A central planner simply can't acquire enough information and process it efficiently compared to markets.

China is making the wager that artificial intelligence (AI) will give it the power to mimic markets in its economy and still allow it to constrain political freedom. Beijing hopes to allow for some degree of innovation, guided by the state, and use the information gathered by AI to efficiently distribute goods and services. AI tends to improve the more data it processes; in an authoritarian regime, there are no real limits to how much information can be gathered, giving China a "leg up" on democracies, which are more concerned about privacy.

A CBDC from the Peoples Bank of China (PBOC) is another tool in this process. By making an increasing level of transactions occur on digital platforms, the ability to collect and process data increases. And, as we have noted above, the ability to monitor purchases is a feature of CBDC. The CBDC would contribute to China's social scoring system. It is conceivable that it could be adjusted to increase social score by purchase choice; for example, buying healthy food could increase the social score. In sum, China would likely use CBDC to enhance social stability and control. In other words, CBDC would be a tool of social control. We would expect China to replace all physical currency with CBDC over time.

Finally, we note that in the latest budget, there was a discussion of direct allocation of governments, hinting at the use of CBDC to accomplish this goal.[2]

#2: Power projection: China is clearly worried about U.S. financial sanctions. One of the ways it can dilute this power is to make the yuan a reserve currency. Beijing's efforts in this area, so far, have not been effective. The dollar still dominates the global financial system. Some of this ineffectiveness is due to the closed nature of China's financial system. China has traditionally restricted its capital account, making it difficult for foreigners to use yuan for trade and investment.

China seems to be trying to use CBDC as a way to internationalize the yuan. For example, it has joined a pact with Thailand, the UAE, and the Bank of International Settlements to investigate a distributed ledger platform to trade digital currencies.

[2] See page 16 of the budget report.

This may mean China is considering a token CBDC (with likely ties to allow tracking). It remains unclear if China would be open to allowing foreigners to hold yuan CBDC accounts; a token system might mitigate that issue. It has also set up a partnership with SWIFT, which may allow it to bypass sanctions on that system. The speed at which China is moving suggests it sees financial sanctions as a threat.

Likely structure: What would a yuan CBDC look like? We expect it to be quickly implemented with a rapid withdrawal of currency to occur shortly after it is unveiled. There will be no real privacy protections; the goal is to generate as much data as possible to feed into the AI process. Although we expect China to encourage foreigners to hold yuan CBDC accounts or tokens, we don't expect that will be reciprocal. China will not want its citizens to have alternative currencies that might precipitate capital flight.

Progress: China is moving rapidly to build a CBDC system. It is in the process of creating digital "wallets" that would allow users to transact without a smartphone. It is co-opting China's fintech industry to distribute tests of CBDC. It conducted trial runs over the recent Lunar New Year holiday.

Eurozone CBDC

Priorities:

1. Stability
2. Power projection

#1: Stability: The Eurozone project is part of Europe's postwar goal of avoiding being "ground zero" for the next world war. Due to its geography and geopolitics, no power has been able to successfully dominate continental Europe for very long. The southern regions are divided off by mountain ranges (Pyrenees, Alps, Carpathians). The Nordic nations are separated by the Baltic Sea. The British Isles are close enough for the British to interfere with the continent but far enough away to be safe from continental powers. And, Russia, with its goals of territorial expansion, is a persistent threat. After suffering through two world wars, European leaders were determined to avoid a similar fate. The general conclusion was that nationalism was the primary cause of European wars, so the cure was to replace national affinity with economic prosperity. It has worked, in part, because Europe outsourced its defense to the U.S. through NATO. As European militaries have atrophied, the risk of war among themselves has declined. In addition, the EU has worked to knit the continent together as a coherent economic whole. By increasing continental economic ties, the goal is to encourage a more "European," as opposed to national, vision. As noted earlier, the euro currency notes show generic images of people and places that appear, well, "European." In reality, none of these images are of any actual European or place.

Moving to a digital euro would further link the continent together economically. Accordingly, the creation of a euro CBDC is seen as a natural extension of the Eurozone project.

At the same time, due to the national states within the Eurozone, coordinating on issues like privacy control and allowing foreigners to have accounts will be more difficult. These issues tie into the overarching problem of trying to manage different nations within a bloc.

#2: Power projection: Europe used to run the world. Britain, the Netherlands, France, Spain, and Portugal all had, at one time or another, massive overseas colonial interests.

Other European nations participated on a smaller scale. Britain was the global hegemon from the early 1800s into the early 20th century, but that all fell apart in the 20th century. Two world wars devasted Europe, and the onset of American hegemony led to steady decolonialization.

It's difficult to fall from dominance to irrelevance. Although that statement is overstating the case, Europe isn't what it once was. However, that doesn't stop European leaders from trying to project power. The European economy remains formidable and Europe is heavily represented in international bodies.

Europeans have envied the dollar's dominance since the 1960s. It was the French who coined the term "exorbitant privilege" when describing the dollar's reserve status. Europeans hoped that the euro would have the heft in world markets to challenge the dollar's dominance. So far, that hasn't occurred. There are generally two reasons for the lack of power. First, the Eurozone, following the economic policies of Germany, are export promoters, meaning they support their economic growth via exports. The U.S. has proven that to provide ample supply of the reserve currency, the reserve currency nation needs to run a current account deficit (or have colonies that absorb the excess saving, allowing the host nation to run a current account surplus with the rest of the world). Second, the reserve currency nation needs to provide a risk-free asset for reserves to be held. Treasuries provide this instrument for the dollar. Until recently, the Eurozone had no such asset; a reserve manager needed to pick a Eurozone country's sovereign debt. Complete safety in German bonds offered a negative yield; capturing a positive yield required owning more risky nation debt. However, the pandemic bailout package did create a Eurobond and we think this will improve the odds that the euro will be a more acceptable reserve competitor. As with China, a digital euro could enhance the attractiveness of the currency.

To compete with the dollar, the Eurozone will at least need to match the efforts of the Fed in creating a CBDC. Therefore, we would look for the creation of a CBDC to have rising priority going forward.

Likely structure: What would a euro CBDC look like? We would expect it to look much like the dollar CBDC; it will be account-based. Foreigners will likely be able to hold CBDC accounts, although we would expect Europe to mimic the U.S. and make them different than domestic accounts. Given Germany's dominance of the Eurozone, we would not be surprised to see the CBDC indexed to inflation. That might make it especially attractive to foreigners if they receive indexing provisions. If so, it would tend to appreciate the euro and increase its attractiveness as a dollar alternative.

Progress: There is some early stage work being done on CBDC. Public discussion has started. Nevertheless, we expect progress in the Eurozone to be the slowest of the three regions mentioned in this report. It is quite possible that other non-Eurozone nations, notably Sweden, may issue CBDC well before the Eurozone and that may become a guide for the ECB.

Part IV

Next week, we will conclude this series with market ramifications.

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