Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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

This week, we conclude our series on CBDC with market ramifications.

Ramifications

Money is a seminal good. As our metaphysical discussion examined, economics has tended to avoid forays into the *being* of money.[1] Accordingly, for the past 150 years, there have been steady changes to the use of money, from a gold standard, to a dollar standard, to full fiat currencies, and floating exchange rates. We have seen credit money dwarf state and commodity money. There have been discrete changes; the failure of the gold standard to hold in the interwar years was one, while Nixon's closing of the gold window, effectively ending the Bretton Woods Agreement, was another. Most of the other changes were less dramatic. The development of the Eurodollar market undermined the Great Depression regulatory regime, as did the creation of the money market fund. The steady expansion of derivatives and the non-bank financial system played a role as well.

CBDC would also be a significant event on a global scale. And, any time there is a change in how money works, the potential for unexpected outcomes is high.

One way to develop a framework about CBDC and the challenges it brings is to use a Johari Window. A Johari Window is a psychological concept to compare what we know to what is known by others. We adapt it for our use by not having two "players" and instead use it to describe the risks of introducing CBDC.[2]

	Known to self	Not known to self
Known to others	Arena	Blind Spot
Not Known to Others	Façade	Unknown

(Source: [UxDesign])

The issues we have discussed tend to be in the "known/known" or "arena" box. These are characteristics such as token versus account. The "blind spot" includes things we know but we don't know the impact. For example, if we introduce CBDC, how will firms and households use paper money? These sorts of questions tend to be empirical; they will be answered in time, but, as market participants, we want to try to predict the outcomes for investing opportunities. The "unknown" quadrant is the one most people fear the most. It implies the things that we don't even know we don't comprehend. This area is where

[1] For a deeper dive into this topic, we recommend: Bjerg, Ole. (2014). *Making Money: The Philosophy of Crisis Capitalism*. London, U.K.: Verso Publishers.

[2] The Johari Window is the basis for Donald Rumsfeld's famous "known/unknown" comment.

"black swans[3]" reside. This quadrant is important but is essentially unknowable. Great care must be exercised because whatever "lives" here can cause problems. Nevertheless, perhaps the most worrisome area is the "façade" quadrant, which includes factors we think we know that we really don't. This is where ideology leads us astray. For example, ending fractional reserve banking may appear to be a good way to reduce market risk; however, it may lead to new problems that we don't anticipate. A classic example of this occurred when economists predicted that QE would trigger higher inflation. This call was dead wrong; in fact, QE mostly supported financial assets. But for those who adhere to monetarist theories of the economy, the rise in the money supply brought by QE would "inevitably" bring inflation.[4]

The "façade" quadrant is where policymakers are likely to make the biggest mistakes because they think they "know" the outcome and thus will be blinded by an unexpected result. Given their belief systems, they will tend to continue to hold onto the belief even in the face of being wrong. This is the quadrant where belief systems go to die, and great care and humility must be exercised.

So, using that background, what should investors expect? Here are our views:

1. The move to CBDC is inevitable. It will be framed as the simple act of moving on the long continuum of monetary evolution. We would disagree; the fact that CBDC sits in the middle of the Venn diagram we discussed in Part II suggests that it is revolutionary. It could give households and firms access to the Fed's balance sheet…or not. It could give foreigners access as well. Central bankers seem to feel compelled to create these instruments. As a result, we think it is likely to occur.
2. The banking system is facing a major risk. If the "Chicago plan" is introduced, banks will no longer be able to create money; only the central bank will have that power. Given the history of financial crises we have seen since the 1970s, this may be a good idea. But there is nothing to suggest that central bankers will do a better job. Shareholders in banks should watch carefully. The entire business model could be upended.
3. Cybersecurity firms could see demand for their products soar. If there are no large denomination bills available at banks, then it probably doesn't make sense to rob them. However, hacking could be lucrative.
4. Cash-handling businesses could go the way of the typewriter. So, coin counters, bill counters, armored cars, ATMs, etc. could become extinct.
5. Cryptocurrencies could become the venue of criminals. That is already happening to some extent (ransomware attacks usually ask for bitcoin). But if cash becomes the vehicle for conducting illicit activity, the mere presence of it would suggest a criminal operation.
6. Electricity and the security of its supply would become even more important. Imagine the situation recently in Texas if there had been no ability to use cash to conduct purchases. Thus, utilities and energy security firms (e.g., backup generators, batteries) could benefit.
7. Payment systems could be at risk. Credit card companies would still have a place (central banks may be reluctant to

[3] Taleb, Nassim Nicholas. (2007). *The Black Swan: The Impact of the Highly Improbable*. New York, NY: Random House.

[4] Monetarism tends to be a commodity money theory.

provide credit), but the presence of a lower cost payment system could put pressure on swipe fees. Merchants, on the other hand, could benefit.

8. Tech firms that assist in the development of CBDC could also benefit simply by being "in the room where it happened." They could provide services on an ongoing basis to central banks that would support their dominance.
9. If China is able to leverage CBDC to address the economic deficiencies of central control, it could become globally dominant. Not only would it improve its domestic economy, but it would provide an alternative economic and political system that other nations might find attractive. We would expect this development to be bullish for Chinese assets.
10. We expect that some central banks, including the Federal Reserve, will allow CBDC accounts to be held by foreigners. A potential side effect could be that it will increase exchange rate volatility and affect policy decisions. Currently, in many developed markets, exchange rates have only a peripheral impact on households. And, even in households that are affected, there is precious little that small investors can do to protect themselves from foreign influence or the effects of domestic policy and exchange rates. But, in a world where a household or firm may hold several CBDC accounts from different nations, it is not inconceivable that a change in monetary policy would lead to flows into and out of foreign CBDC accounts. For example, if U.S. monetary policy was deemed to be "overly accommodative," it could be quite simple for a relatively small investor to move cash to a euro or yuan CBDC account. Early research suggests that one consequence to CBDC could be higher exchange rate sensitivity.
11. At the same time, a successful U.S. dollar CBDC would fend off a potential challenge from Europe and China and maintain the dollar's reserve status, which would be bullish for U.S. financial assets.

So, in conclusion, the creation and dissemination of CBDC is probably bearish for payment systems, banks, and cash handling firms, whereas it is bullish for cybersecurity, electric utilities and electricity backup systems, and tech firms.

To reiterate, these calls are preliminary. We will be watching how the introduction of CBDC evolves. Investors will need to take precautions to avoid bias errors (lower left quadrant) because CBDC will tend to cause profound changes to the very nature of money.

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