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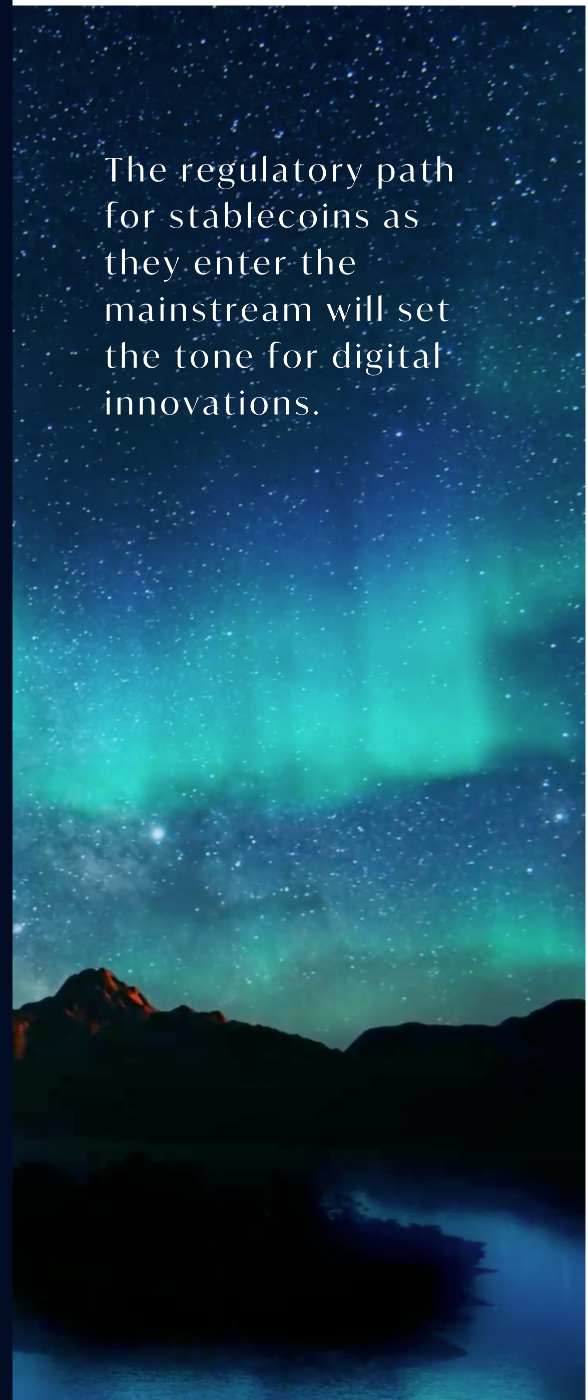

Market Notes

FED LOVES DIGITAL (CBDC…NOT SO MUCH)

It's complicated. That's the simple message from the long-awaited Fed report on a central bank digital currency. Policy is encouraging private US dollar stablecoins to lead the digital transformation of the global economy. And they will. Are financial stability risks a limit to scaling private stablecoins? No. Stability is a matter of regulatory design. The regulatory path for stablecoins as they enter the mainstream will set the tone for digital innovations.

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1. Let the games begin! China held true to its promise of showcasing its digital yuan on the eve of the Winter Olympics, providing marketing guidance in English to buy a cup of coffee (here). And the Federal Reserve delivered on its commitment to report on the forward path of a central bank digital currency (CBDC) in America (here). The Fed was careful to balance the pros and cons evenly to the envy of all two-handed economists, passing to Congress the responsibility to take the next steps. The report appears carefully designed with the intent to not convince anybody that a CBDC is necessary or even desired.

2. So, it is over to Congress. The search for relevant legislation takes you to H.R. 3506, a Bill introduced last year to support the US dollar as the world's reserve currency (here). The text is simple and clear – the Secretary of the Treasury is charged with the tasks of establishing a strategy around a digital dollar in a formal report and evaluating China's activities with its digital yuan. Special attention is given to the risk of China unseating the US dollar as the world's main reserve currency. Only the Bill, like others on the digital dollar before it, is not going anywhere. Machine learning analytics put a 4% chance of its passage (here).

3. It is tempting to make light of the currency competition with China. After all, the US dollar accounted for 40.5% of all cross-border payments in December 2021 with China at only 2.7% (here). However, China's share has risen sharply in recent months and surpassed Japan for the first time in December. Further, the year-old joint venture between China's digital currency research institute and the world's largest international payments infrastructure provider is indicative of broader ambitions (here). The competitive nature is different from past cycles. The last major transition away from a reserve currency, the British pound, occurred with international cooperation. It was coordinated. The US-China dynamic is competitive, and it centers on digital.

4. Of course, tedious issues like the rule of law and privacy rights slow the centralized US response to a digital dollar. But this is America's key advantage. Take a step back and consider the direction of digital-dollar policy over a short period of time: the Fed has proposed new rules for what it means to be a digital bank; the President's Working Group (PWG) embraced private stablecoins; the Treasury translated the initial PWG into detailed issues; and now the Fed has poured cold water on the immediate prospect for a CBDC. The door is wide open for the private sector to scale innovation at a time when the US dollar is already the base currency of choice in the digital ecosystem (here) Stablecoin users are giving the US a vote of confidence in issues such as property rights, more than macro policies.

5. Ironically, scaling a private digital dollar has more obstacles at home from legacy market participants than anywhere. The issue of scalability and stability have penetrated US policy direction. It is a point of emphasis for the Treasury: "if insured depository institutions lose retail deposits to stablecoins, and the reserve assets that back stablecoins do not support credit creation, the aggregate growth of stablecoins could increase borrowing costs and impair credit availability in the real economy. The perception of the safety of insured depository institutions relative to stablecoins could also shift during times of stress…." (here).

6. Are private stablecoins going to ruin bank credit creation? (It is a rhetorical question.) This is an issue of regulatory design, not an organic flaw to private stablecoins. The digital dollar is in high demand for a simple reason – it delivers a better user experience in all respects. CENTRE and Circle formed a consortium to create

USD Coin (USDC) with careful attention to governance and regulatory conditions. Its open-architecture and transparency are notable as is user-adoption – USDC is the most circulated stablecoin on the Ethereum blockchain, surpassing Tether last year. Could the JP Morgan Coin compete with USDC? Not in a closed environment to JP Morgan clients, no. This is a deeper tension between open and closed systems, between digital and traditional finance. Policy will take its direction from lawmakers, who, in turn, will heed the attention of voters and their user experience.

7. To be sure, a regulatory misstep could threaten financial stability. However, this is also quite unlikely given the care being taken on regulatory design. True, the PWG Report contemplated stablecoins moving into the banking system and being insured, an unorthodox position. It begged the question: Why insure a stablecoin that is 100% reserved by assets like Treasury bills and deposits at the central bank? Naturally, if this were to occur, stablecoin would be incredibly attractive when financial risks rise as they would have far more protection than ordinary bank deposits. Feedback to policymakers will include compelling logic from stablecoin issuers and users to avoid such regulatory design flaws. Nuances of policy are won on logic.

8. There are unavoidable disruptions with scaling private stablecoins. And those will be for the better. Think of stablecoins in the context of the evolution to just-in-time inventory in the global goods sector. Companies held less precautionary raw materials. And in the transition, those supplying inputs to production saw a decline in demand. However, companies were also able to free the balance sheet for more productive purposes – borrowing for long-term investment rather than copper in a shed – and reduce prices to consumers. In parallel, a scalable stablecoin means that cash inventory buffers can be much less, especially in the financial system. This will make the financial system more efficient – not riskier. The rise in the velocity of money means we need less money to generate the same outcomes. It is a positive innovation!

9. But aren't stablecoins going to take deposit funding away from the banks? The assets held by stablecoin issuers, such as Treasury bills, are already competing with bank deposits. It is important to distinguish transactional demand versus an investment holding. Alphabet has $142 billion in cash and equivalents because of an exceptional operational business. Free cash flow is projected to be $80 billion in 2022, more than 30% of revenue. That will add to cash assets and banks will compete for that capital. It is all about the use-case. A stablecoin is a tool for managing cash transactions more than cash investments. And if everyone uses stablecoins as their cash investment proxy, issuers will become financiers to the banking system.

10. Bringing private stablecoins into the banking system will allow it to scale. In turn, this will afford CBDC the luxury of time –an extended trial and could easily conclude by recognizing that it isn't needed at all. Stablecoins enter the banking system because they play a very different role than a money-market fund, even though both hold similar assets. To scale a stablecoin for wholesale payments, it is imperative that it not break the buck. And under Fed regulatory purview, stablecoin issuers will hold exactly the collateral that allows the Fed to play the role it was built to play in open markets – lender of last resort, providing liquidity against suitable collateral, ensuring that the buck is never broken. That's the key to avoiding stability risks when scaling private stablecoins.

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