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The Future of Digital Currency Is Arriving Fast. Can the Fed Catch Up?

COMMENTARY By Eswar Prasad Feb. 2, 2022 4:00 am ET

The U.S. Federal Reserve waded into the debate about a central-bank digital currency with a new paper.
Mark Wilson/Getty Images

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When was the last time you used dollar bills rather than a swipe of a card or your phone to pay for your groceries or coffee? If you still use cash, you (and I) are part of a dying breed. Digital payments are becoming the norm around the world as the era of cash rapidly draws to an end. Central banks are therefore scrambling to keep the money they issue relevant for retail transactions.

Some central banks have already taken the plunge in experimenting with central bank digital currencies. China, Japan, and Sweden are leading the charge among major central banks. Meanwhile, the Bahamas and Nigeria have already rolled out their CBDCs.

The U.S. Federal Reserve, by any measure the world's most influential central bank, has finally waded into the debate with a paper clearly and concisely delineating the pros and cons of a digital dollar. The paper may have disappointed those who wanted the Fed to stake out a clear position or signal urgency on the issue.

The Fed's paper articulates some crucial questions and hints at two overarching ones that surpass technical considerations.

First, is there a compelling user case for a digital dollar?

Some central banks contemplating CBDCs seem to view them as a pathway to broadening financial inclusion by providing everyone in an economy easy access to a low-cost digital payment system. Others such as Sweden's Riksbank view a CBDC as providing a backstop to a private payments infrastructure that might be subject to failures of technology or confidence. Then there is China, where the government seems to view a digital yuan as a tool to rein in Alipay and WeChat Pay, whose dominance is limiting competition.

Second, is there broad political and public support for such a move?

CDBCs pose a variety of risks. They could stifle private sector innovations in payments—after all, what company can directly compete with a government-backed agency? CBDCs might also lead to a disintermediation of banks if CBDC accounts are seen as safer than commercial bank deposits, especially in times of financial volatility. Moreover, digital money inevitably leaves a digital trace, making it hard to preserve the confidentiality and anonymity afforded by cash. In short, a CBDC could make a central bank more intrusive into the economy and the lives of its citizens.

These two considerations are central and cut to the heart of the Fed's role. Its job is to manage monetary policy and ensure financial stability. No central bank should take on the direct provision of financial products and services; that is best left to the private sector. With all these risks, why bother with a digital dollar at all?

There are in fact good reasons for the Fed to move forward, some of which the paper acknowledges explicitly. A digital dollar would provide a convenient and cheap means of digital payments that would benefit small businesses and consumers, including the many low-income households that are unbanked or underbanked. Moreover, it would bring cash-based economic activity out of the shadows and into the tax net, and also crimp illicit activities such as drug trafficking and terrorism financing fueled by cash.

A CBDC provides some tools for implementing monetary policy in perilous times. If cash gave way to a CBDC, it would be easier to implement negative nominal interest rates, incentivizing consumers to spend and businesses to invest rather than save. The government could use CBDC digital wallets to make direct transfers, such as coronavirus stimulus payments, to households. These are not tools to be used lightly but could be handy at times of great economic peril.

Other reasons have been proposed for urgency on this issue, including the costs of being a late mover. The concern in particular is that other countries' CBDCs could displace the dollar as the dominant global currency should the Fed not act quickly.

These are not compelling reasons. There are in fact some advantages to being a late (but not too late) mover on CBDCs. Experiments in other countries are showing how conceptual and technical design choices can mitigate risks from a CBDC. China and Sweden are setting up a two-tier system, with their central banks creating a payment infrastructure on top of which private payment providers can compete and innovate in providing front-end services to consumers and businesses. The Bahamas has shown that putting a cap on CBDC digital wallet balances mitigates the risk of deposit flight from commercial banks. New technologies are paving the way to provide some transactional privacy for at least low-value digital payments.

As for the digital yuan, it might, at the margin, expand the Chinese currency's role as an international payment currency. But foreign investors, including other central banks, are hardly likely to ditch the dollar and rush into the yuan as a reserve currency.

The biggest risk a digital dollar poses is to the Fed itself. If digital money results in the Fed being seen as an agent of the government in matters of law enforcement or even the implementation of fiscal policy, then the Fed puts its independence and credibility at risk. This in turn could hurt the institution's legitimacy and effectiveness, a deeply concerning prospect.

The Fed is right to open up the debate on a digital dollar, wise to pose the right questions that deserve careful consideration that preclude any hasty judgments, and correct that the decision is one about societal and institutional considerations not just technocratic ones.

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