The Coming Currency War: Digital Money vs. the Dollar

Central banks are getting closer to issuing their own digital currency. If they do, the dollar might finally face real competition as the world's dominant currency

By Dave Michaels and Paul Vigna Sept. 22, 2019 10:09 pm ET

Such a future, of course, might be a disappointment to many libertarians and tech-savvy investors who are pinning their hopes (and in some cases their money) on private cryptocurrencies such as bitcoin.

Instead, central bankers and governments—the entities that cryptocurrencies' backers hoped to render obsolete—are increasingly warming to the idea of "digitizing" their own national currencies. That is, they would issue money that would exist only virtually, without a paper or coin equivalent, and be universally accepted as a form of payment.

Central banks such as the Federal Reserve in essence already issue digital money, via the commercial banks that have accounts with them. Commercial banks then lend money electronically to households and businesses, and enable customers to make and receive payments digitally without exchanging cash. But a central-bank digital currency would be a leap beyond that.

Instead of working only through commercial banks, central banks might issue digital currency directly to the public that could be used as legal tender in the same way cash is today.

How it might work remains unclear, but countries are experimenting with it, and the implications could be profound for everything from commerce to interest rates to privacy. For instance, right now, most financial transactions —whether paying a credit-card bill or mortgage, sending money to a relative, or buying something online—involve settling payments over a patchwork of systems, meaning money can take two or three days to move between accounts.

A national digital currency managed on a single network could allow money to change hands almost instantly. Most bitcoin transactions, for instance, settle within 10 minutes. With a digital currency, transactions could happen in real time, and fees would be lower or nonexistent.

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What’s more, putting the central bank in charge of a digital currency could undermine the role that commercial banks play. It would open the door to politically thorny questions such as what the Fed should do with the new electronic deposits it would hold from consumers, including whether it should pay interest on them or make loans.

In addition, national digital currencies could make it harder for private cryptocurrencies to catch on. Because government e-cash would be operated, backed and controlled directly by central banks, it likely would be viewed as more reliable than privately created cryptocurrencies, which operate on decentralized networks of users and fluctuate wildly in value.

Perhaps most significantly, a world of competing national digital currencies could set up a new kind of currency war. The U.S. dollar has been the world’s dominant currency since the 1920s. But if national digital currencies allow for faster, cheaper money transfers across borders, viable alternatives to the U.S. dollar could emerge, embraced by nations and monetary officials concerned about the dollar’s outsize influence on the global economy.

“Technological developments provide the potential for such a world to emerge,” Mark Carney, the governor of the Bank of England, said in an August speech at the Federal Reserve’s annual symposium in Jackson Hole, Wyo. He highlighted the risks of the current dollar-dominant system, and sketched out an alternative where a new digital currency backed by a large group of nations, or even multiple currencies, vied with the dollar.

Sweeping change

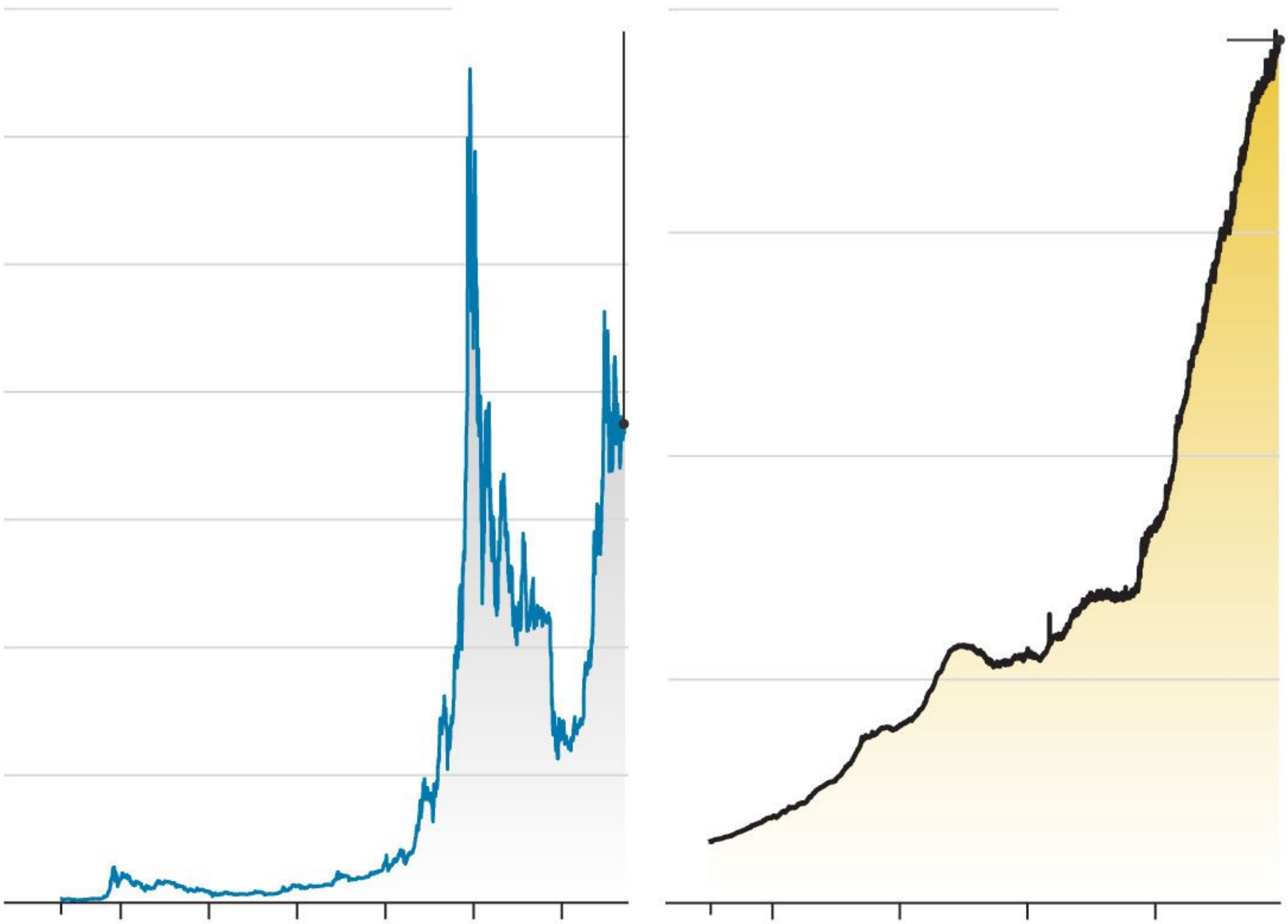
Mr. Carney's speech came at a time when currencies around the world are falling to multiyear lows against the U.S. dollar, and after authorities in the U.S. and abroad said they would closely scrutinize an effort by Facebook Inc. to launch a cryptocurrency pegged to multiple sovereign currencies. But the current rancor only highlights what are long-term changes in the global economy.

The speech also was the most pointed sign yet that the revolution ushered in by bitcoin nearly 11 years ago is taking root. Mr. Carney and Christine Lagarde, the incoming president of the European Central Bank, have both talked about the advent of digital currencies. France, which opposes Facebook's project, says a "public digital currency" along the lines of what Mr. Carney proposed should be considered. Central banks in Sweden, Canada, Switzerland and the Eastern Caribbean have experimented with or are exploring the technology.

The one that might beat them all to the punch is the People's Bank of China. The PBOC is expected to launch a digital version of China's national currency, the yuan, later this year or early in 2020. If it does, it would be the first major global currency to become digitized.

The benefits of digitization could be myriad. In addition to faster and cheaper money transfers across borders, a survey conducted by the International Monetary Fund found that central banks are looking at benefits like lower costs, more efficient monetary policy, blunting competition from bitcoin and its peers, and offering a risk-free payment network to the public.

Currency Comparison



The total market capitalization of bitcoin, the most popular form of digital currency, has grown dramatically since its creation in 2009, but still lags far behind the total value of U.S. dollars in circulation.

U.S. cash in circulation continues to grow apace, as seen in the expansion of M1, a basic money supply gauge that measures funds that are readily available for spending, including checking accounts that pay interest and those that don't, and currency.

Bitcoin total value

9/18/19

$183.5 B

Sources: U.S. Federal Reserve; Blockchain.com

The result could be a sweeping change in the international financial system, affecting, among other things, how nations trade.

The country that is first to introduce a digital currency that is more easily stored and used abroad than its physical counterpart will have “a first-mover advantage to greater currency use, though not necessarily to reserve currency use,” says Tommaso Mancini Griffoli, deputy division chief of the IMF’s central bank operations division.

The increasing interest in national digital currencies dovetails with a changing marketplace. Developing nations increasingly make up a larger percentage of global gross domestic product while the U.S. share shrinks.

The dollar’s hegemony made sense after World War II, when the U.S. accounted for 28% of global exports. Now, the figure is just 8.8%, according to the IMF. Yet the dollar still dominates international trade. Around 40% of world trade is invoiced in dollars, roughly four times the U.S. share of world trade, according to data from Gita Gopinath, a Harvard University professor who is now the IMF’s chief economist. And the dollar is used in 88% of all foreign-exchange trades world-wide, according to the Bank for International Settlements.

Lawmakers Are Spooked by Facebook’s Libra Cryptocurrency. Here's Why

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Lawmakers Are Spooked by Facebook's Libra Cryptocurrency. Here's Why

Facebook's plan to release its own currency, called Libra, has sparked a range of concerns among lawmakers. WSJ's Paul Vigna explains. Photo: Andrew Harrer/Bloomberg News

The dollar isn't going to lose its position overnight, Mr. Carney said at the August gathering. But bankers should be thinking about a post-dollar world now, he added, rather than waiting for the next crisis to force change.

The dollar's status as the lingua franca of international business provides benefits: Companies in places like Argentina can export goods to Turkey, and get paid in dollars. Because those dollars are deposited in local banks, they can be lent to companies. In fact, because there are so many dollar deposits, it's actually cheaper for overseas businesses to borrow in the U.S. currency, creating a feedback loop that maintains the greenback's pre-eminence.

But as Mr. Carney noted last month, this convenience has a downside: When the dollar appreciates, debt denominated in dollars becomes more expensive for foreign businesses. At the same time, the price of those countries' imports rises, which can feed inflation.

Because of the dollar's status and the fact that economies are more interconnected than ever, dozens of countries are essentially beholden to U.S. fiscal and monetary policy. Fluctuations in the dollar's value feed through credit markets, causing surges and withdrawals of capital that can cause financial crises in emerging markets.

"U.S. developments have significant spillovers onto both the trade performance and financial conditions of countries with even relatively limited direct exposure to the U.S. economy," Mr. Carney said.

One countermeasure to that dynamic could be a "synthetic hegemonic currency," as Mr. Carney called it, a fancier term for a global public cryptocurrency. The currency he proposed would be based on a basket of reliable currencies, including the dollar and China's renminbi.

Facing pressure

Not all policy makers like the idea of a global digital currency to rival the dollar.

The U.S. has been wary about the growth of cryptocurrencies. Federal Reserve Chairman Jerome Powell said this month that consumers have many payment options already. Moreover, he added, the cybersecurity risks involved with a digital currency are "quite daunting," pointing out that if hackers gained access to the system, they could siphon off money from the electronic vault.

But the growth of online payments—from cryptocurrencies to Apple Pay and Venmo—raises the question of when the Fed will give people the same electronic access to cash that it gives banks, which earn interest on funds they deposit with the central bank.

Facebook's proposal for a cryptocurrency, dubbed Libra, underscores how Silicon Valley is pressuring central banks to adapt. Unlike other private cryptocurrencies, Facebook already has a network—two billion users on social networks that double as marketplaces—to support the consumer demand that would drive use of a private currency.

“Central-bank digital currency, even if it were created by major countries, would likely have far fewer users and would not spread over this social-media platform,” says Tobias Adrian, director of the monetary and capital markets department at the IMF. “So there is something that intrinsically could be more disruptive about proposals such as Libra.”

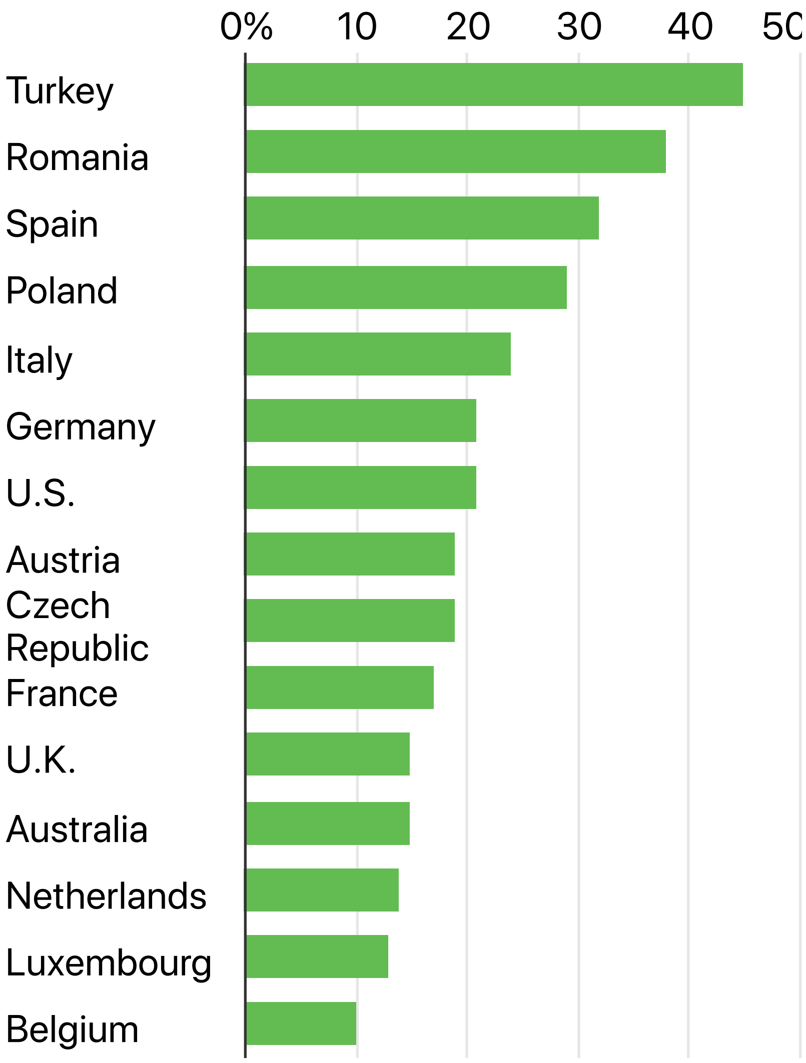
Crypto Ownership

Share of respondents in a 2018 survey of European, U.S. and Australian consumers who expect to own cryptocurrency in the future

That also makes it a potential threat to the Fed, which needs to control the money supply to modulate inflation and stimulate the economy.

“No central bank wants the currency to be something it doesn’t control,” says Jeremy Stein, a Harvard University economics professor who served as a Fed governor from 2012 to 2014. “In the extreme, if everything in the world is priced in Libra and not in dollars, the U.S. cannot set monetary policy—because setting interest rates in dollars, who cares?”

At the least, central-bank digital cash might raise interest rates. In a world where everyday consumers had accounts at the Fed or their country’s central bank, the supply of bank deposits would shrink, according to a November 2018 paper by economists at the IMF. Banks would have to pay



more to attract deposits, and they might not be able to pass on those costs by raising interest rates on loans.

That wouldn't be good for banks, Mr. Powell said in his news conference this month, underscoring how nervous the Fed is about upsetting the balance between the central bank and private business.

One way to reduce this threat: Central banks could have digital wallets for everyday people, but they wouldn't pay interest on the balance. Another avenue: Consumers could hold digital cash only at their bank, leaving central banks as remote from everyday savers as they are today.

Still, the growth of digital payment services is forcing central banks to explore these new technologies, says David Chaum, a cryptographer who himself built one of the first digital-money systems, called DigiCash, in the 1990s, and today is working on another one, called Elixxir.

Central banks will have no choice but to make sure the new monetary infrastructure is secure, he says, adding: "What if that system breaks down? Are people going to be able to buy bread?"

Testing ground

In China, where mobile money apps like Alipay are ubiquitous, much of domestic commerce already has moved into the digital world. That might be one reason the People's Bank of China appears to be moving faster than other central banks to digitize its currency, the renminbi. The bank hasn't publicly commented on the timing, but stories from the state-run China Daily, among others, suggest the digital renminbi could be unveiled this year or next.

The renminbi would be a significant testing ground. Its use in world markets has increased over the past decade, and China has surpassed the U.S. to become the world's leading trading nation.

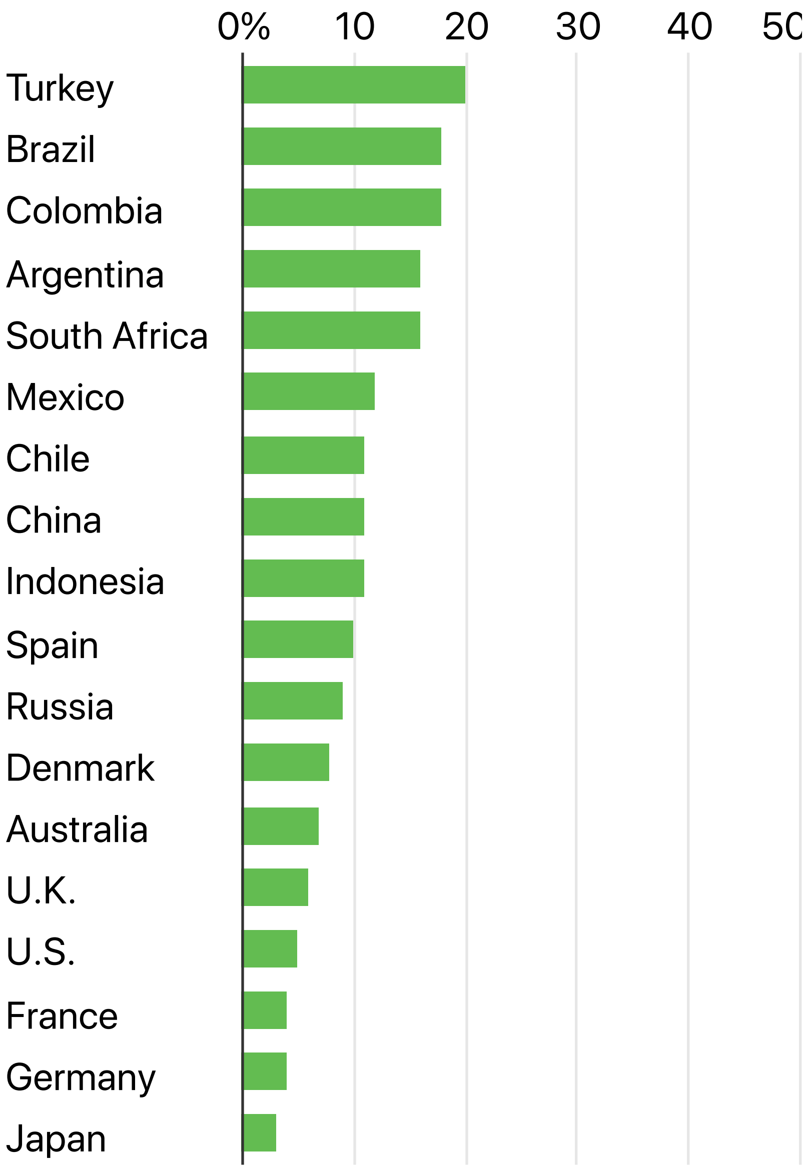
For the Chinese, digitizing the renminbi is a way to get out from under the U.S.'s thumb, says Eswar Prasad, an economics professor at Cornell University and former head of the IMF's China Division. China's goal isn't necessarily to overthrow the dollar, he says. But they want to give their allies an alternative to the dollar and create a system that couldn't be disrupted by the U.S.

"Would the Chinese like to be less vulnerable to American sanctions? Happier if they didn't have to use the dollar for their imports and exports? The answer to that is unambiguously yes," he says.

China's digital currency would differ significantly from the bitcoin model, with the central bank keeping control

Share of respondents in a 2019 global survey who reported using or owning cryptocurrency

Sources: ING International Survey Ipsos online pc most recent of 14,828 consumers across 15 cour with 500 respondents from Luxembourg and rou(1,000 respondents from all other countries conducted March 26-April 6, 2018 (expect to ow Statista Global Consumer Survey (own or use)



of the money supply and tracking users' identities.

The people and companies behind private cryptocurrencies believe their assets will still have value even if countries move to digitize their national currencies. People around the world won't want to give up the anonymity and privacy associated with cryptocurrency, they say, even if they are pushed into using solely electronic forms of cash.

"What you end up with is a situation where the government has potentially perfect surveillance into all the financial flows in the entire economy," says Travis Scher, vice president of investments at Digital Currency Group, owner of the digital-currency trading firm Genesis Trading. "In a world where a country like China issues its own digital currency and tries to move the entire economy onto that, it actually will increase demand for cryptocurrencies and digital currencies that are more private and create the potential for more autonomy."

Whatever happens, it could be chaotic, the Bank of England's Mr. Carney warned in Jackson Hole. When the dollar overtook sterling as the world's dominant reserve currency in the early 20th century, the backdrop was economic upheaval and a world war that decimated Europe.

"History teaches that the transition to a new global reserve currency may not proceed smoothly," he said.

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