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## CENTRAL BANK DIGITAL CURRENCIES INQUIRY

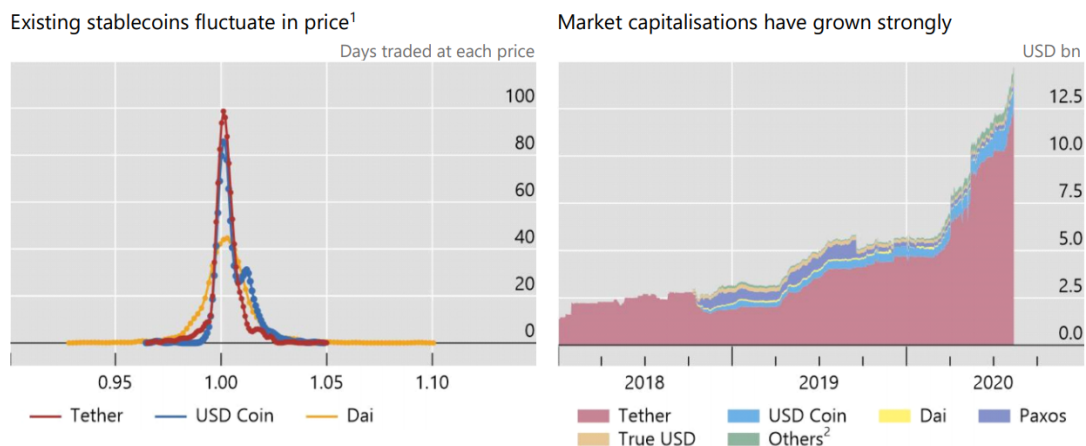
The payments system is changing. But it may not be changing for the better.

### The emergence of private currencies

The so-called 'fiat cryptocurrencies'<sup>1</sup> such as Bitcoin, Ethereum and Dogecoin have failed to gain any significant use for payments.<sup>2</sup> (The exception which proves the rule is in El Salvador where the government has passed laws compelling the acceptance of Bitcoin.) But the creation of 'stablecoins', which at least *claim* to be backed by true currencies, have much more potential, for good or bad.

Currently the largest such entities are Tether (with a market valuation of around US\$ 70 billion), USD Coin (\$30 billion) and Binance USD (\$10 billion). They have been growing strongly and have (so far) held their value very close to 1:1 with the currency to which they are pegged (Graph 1).

**Graph 1: Stablecoin market developments**



<sup>1</sup> Histogram of daily trading prices in USD. The sample includes Tether (2 Jan 2018–14 Aug 2020), USD Coin (9 Oct 2018–14 Aug 2020), Dai (2 Jan 2018–14 Aug 2020), Paxos (28 Sep 2018–14 Aug 2020) and TrueUSD (6 Mar 2018–14 Aug 2020).

Source: [The stablecoin index, Messari](#).

Source: Arner, Auer and Frost (2020, p 8)

Stablecoins have been likened to 'currency boards' which issued paper currency fully backed by safe assets in the backing currency.<sup>3</sup> These were popular in British colonies and were also used by Argentina and Estonia. The most prominent example today is Hong Kong.

So far none of these stablecoins are significantly used for payments. But on the horizon is a stablecoin with more potential. A consortium led by Facebook has

<sup>1</sup> Gorton and Zhang (2021, p 3).

<sup>2</sup> As BIS (2019, p 67) put it, they 'are speculative assets rather than money' with 'few redeeming public interest attributes when also considering the wasteful energy footprint'.

<sup>3</sup> Hawkins (2019a).

been developing a group of stablecoins under the name Diem. Despite Facebook's deep pockets, the project has been quite troubled. The consortium has lost many of its prominent members, such as eBay, PayPal, Vodafone, Visa and Mastercard. The launch has been pushed back from 2020 to 2021 (and looks likely to be further deferred). The name has been changed from Libra to Diem. The name of the associated wallets has changed from Calibra to Novi. The headquarters has been moved from Switzerland to the US. And the proposal has gone from being a single coin pegged to a basket of currencies to being a suite of coins (including the pound), each pegged to an individual currency, in addition to a multi-currency coin. It is struggling to get regulatory approval. But given Facebook's deep pockets and over 2 billion users, it is too soon to dismiss it.

In many developing countries many families rely on remittances sent by family members working abroad. Globally these remittances were US\$ 720 billion in 2019.<sup>4</sup> There are valid concerns that banks impose large charges to make these transfers (and that they are needlessly slow). Avoiding these charges is regarded as one of the driving forces behind use of cryptocurrencies in general and stablecoins in particular.

These private sector stablecoins, however, pose risks to both those holding them and to financial stability more broadly.

Holders of stablecoins must trust the issuing entity to maintain a fund of safe assets denominated in the link currency. Already court proceedings have revealed that Tether did not always maintain the backing it promised.<sup>5</sup>

Given there are doubts about the backing, stablecoins would be vulnerable to a run in the same way as unregulated banks without deposit insurance. If this were to happen to a large stablecoin issuer it could be very disruptive to financial markets as the stablecoin issuer was forced to liquidate assets.<sup>6</sup>

A multitude of private stablecoins with differing risks would also be a recipe for confusion.

Gorton and Zhang (2021) drew an apt analogy with the private currencies issued during the free banking era in the United States. This era was ended when their currencies were taxed out of existence in 1866.

As well as concerns around financial stability, there are concerns about privacy with the amount of information the issuer of a private stablecoin could amass about its users.

Another possible concern is that widespread use of a stablecoin denominated in a foreign currency could act much like the 'unofficial dollarisation' seen in economies like Zimbabwe where the domestic currency is displaced from much economic activity; Richards (2020b). This in turn would raise concerns that the central bank would then lose control over monetary conditions; Hawkins (2019b).

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<sup>4</sup> Bank for International Settlements (2021, p 85).

<sup>5</sup> Shubber and Venkataramakrishnan (2021).

<sup>6</sup> Cunliffe (2021) discusses these risks in a UK context.

## The emergence of central bank digital currencies

Central bank digital currencies (CBDCs) are now a reality of daily life in some countries. The 'sand dollar'<sup>7</sup> issued by the Central Bank of the Bahamas and DCash issued by the Eastern Caribbean Central Bank are already in widespread use. The latter is even being used for some international payments. Rather than new currencies they are digital representations of existing national currencies.

CBDCs have been defined as 'a form of digital money, denominated in the national unit of account, which is a direct liability of the central bank'.<sup>8</sup>

CBDCs could take different forms. A 'wholesale' CBDC could be restricted to use between financial intermediaries. A 'retail' CBDC, such as the sand dollar and DCash, would be available to the wider economy. A retail CBDC can be designed in two ways, as a token or account-based. The latter could be seen as extending the reserve accounts that banks have with the central bank to other customers. There are also hybrids between the two approaches, such as the e-CNY being trialled by the Peoples Bank of China.<sup>9</sup>

Just as central banks provide the historical trusted means of payment for the public (currency), so too may they be called on to provide the future trusted means of payment in the form of a retail CBDC.

Furthermore, an interest-bearing, or potentially interest-charging, CBDC could provide an additional instrument for monetary policy.<sup>10</sup>

Central banks are already working on multi-CBDCs that could operate across borders. This could be the answer to providing cheap and safe remittances. Already of 47 public retail CBDC projects, 11 include a cross-border dimension.<sup>11</sup>

## Conclusion

The UK has long punched above its weight in the global financial market (Table A). The City of London and the pound are valuable brands. To keep this status, the UK cannot afford to be left behind as the payments system evolves.

**Table A: Selected indicators (percentage share of global total)**

	Real gross national income (PPP basis); 2020	Foreign exchange turnover by location; April 2019	Currency	Foreign exchange turnover by currency; April 2019
United Kingdom	2	43	Pound	7
China	18	2	Renminbi	2
United States	16	17	US dollar	44
Euro area	13	7	Euro	16
Japan	4	5	Yen	9

<sup>7</sup> <https://www.sanddollar.bs/>

<sup>8</sup> Bank for International Settlements (2021, p 65).

<sup>9</sup> Bank for International Settlements (2021, p 79).

<sup>10</sup> These arguments are developed in Bordo and Levin (2017).

<sup>11</sup> Bank for International Settlements (2021, p 89).

Sources: World Bank website; BIS (2019). Foreign exchange turnover by currency shares halved to be comparable to other columns.

The issuance of a well-designed British CBDC, a digital pound, able to link with other countries' CBDCs to facilitate international payments, would be a force for good both for the UK and the global economy.

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