US Daily: What the Fed Has Said About Stablecoins and a Central Bank Digital Currency (Mericle)

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- In today's note we discuss early comments on stablecoins and a possible US central bank digital currency (CBDC) from FOMC participants and Fed staff economists. Fed officials plan to release reports on these issues later this summer, though final decisions are likely to take a while and any future introduction of a CBDC would require support from Congress and the White House.

- Fed officials appear motivated mainly by the possibility that a CBDC platform could improve the payments system. They are examining whether it could make payment clearing faster, reduce fees, handle a higher volume of transactions than the current payments infrastructure, be more resilient to failure or attack, and facilitate innovation in payments technology. A CBDC might be an effective way to achieve some of these goals, though some can be achieved in other ways.

- Much of the recent discussion among Fed officials centers on whether to introduce a CBDC or to instead leave digital payments innovation to the private sector and simply ensure that private stablecoins are well regulated. The debate centers on three issues: financial stability concerns related to the risk of runs, the impact on commercial banks' deposit base, and whether the private or public sector should control the digital payments platform. Fed officials hold a range of views, and we expect to learn more when the Fed releases its reports later this summer.

What the Fed Has Said About Stablecoins and a Central Bank Digital Currency

In two recent reports on central bank digital currencies (CBDCs), we discussed what introducing a CBDC in the US might mean for the financial system and for monetary and fiscal policy, and provided a status report on CBDCs around the world covering early design choices and approaches to managing key risks.

In today's note we discuss early comments on CBDCs from FOMC participants and Fed staff economists.[1] We discuss the timeline for future decisions, the motivations for a possible US CBDC, and the key issues in an emerging debate about whether to introduce a CBDC or to simply regulate private stablecoins.

Fed officials plan to release reports on both the policy and technical aspects of CBDCs, and Chair Powell said this week that a report on digital payments in early September will cover CBDCs and stablecoins. A team at the Boston Fed is also already working on developing the technology for a potential CBDC. Any final decisions are likely to take a while, however. Fed officials might want to defer decisions until after they introduce FedNow, a real-time interbank settlement service that will provide some of the same improvements to the payments system as a CBDC might, in 2023. Chair Powell has said that Fed officials would also need support from Congress and the White House, ideally in the form of an authorizing law.

Fed officials have offered some early hints of what a CBDC could look like. They have emphasized that it would coexist with currency and would be designed not to replace bank deposits. The user experience could be similar to phone-based payments apps, or the CBDC could appear as an additional account in an individual's commercial bank account alongside checking or savings accounts.

Fed officials appear motivated primarily by the possibility that a CBDC platform could improve the payments system. First, it could make payment clearing faster, though as Fed officials often note, FedNow will also achieve this. Second, by increasing competition it could make payments cheaper, especially on credit card transactions and cross-border transfers, though here too alternative approaches might achieve the same goal. Third, it might be able to process a higher volume of transactions than the existing payments infrastructure, which might be necessary if digital dollar payments become available to people abroad who currently transact in physical dollars, or if much lower fees open the door to a vast volume of micropayments. Fourth, it could be more resilient to failure or attack, though this remains an open technological question. Fifth, it could facilitate innovation in payments technology and allow for programmable money that enables features such as delivery versus payment.

[1] Recent comments include Randal Quarles, "Parachute Pants and Central Bank Money"; Lael Brainard, "Private Money and Central Bank Money as Payments Go Digital: an Update on CBDCs"; Eric Rosengren, "Remarks at the Panel Discussion, 'Central Bank Perspectives on Central Bank Digital Currencies'"; Jerome Powell, "Message on Developments in the U.S. Payments System"; Matthew Malloy and David Lowe, "Global Stablecoins: Monetary Policy Implementation Considerations from the U.S. Perspective"; Tobias Adrian et al., "Central Banks and Digital Currencies"; Alexander Lee, "What is programmable money?"; and Fed staff, "Proposed guidelines to evaluate requests for accounts and services at Federal Reserve Banks."

Much of the recent discussion among Fed officials centers on whether to introduce a CBDC or to instead leave digital payments innovation to the private sector and simply ensure that private stablecoins are well regulated. The debate centers on three issues: 1) financial stability concerns related to the risk of runs; 2) the impact on the existing commercial banking system's deposit base; and 3) whether the private or public sector should control a dominant future digital payments platform.

Before diving into these issues, it is important to clarify the difference between a CBDC and private stablecoins. A CBDC is a liability of the Fed, similar to bank reserves but available to the broader public. A stablecoin would be operated by a private company or consortium that sells coins to the public and uses the funds raised as the asset backing for the coin. The stablecoin operator could place these assets in an account at a commercial bank, which might have to hold a higher percentage of high-quality liquid assets if regulators judged the risk of a run on the stablecoin to be high. Alternatively, the operator could place its assets in a "narrow" bank that functions solely as a custodian for the operator and holds the assets as reserves at the Fed, but does not lend, if the Fed allowed a narrow bank to have an account. Finally, the operator could directly hold its assets in a reserve account at the Fed without the formality of the narrow bank intermediary, if the Fed permitted. Recent papers and blog posts by Fed economists have discussed each of these scenarios.

We now turn to the three issues raised above in the Fed's discussion of stablecoins and a potential CBDC:

Financial stability

The first key question is how stablecoins or a CBDC would affect financial stability. Stablecoins with insufficient backing could be subject to runs, especially in times of market distress, and Fed officials have therefore emphasized the need for additional regulation similar to that for money market funds. Governor Quarles has argued that the Fed can easily address this risk, while Governor Brainard has instead emphasized that an earlier period of US history when private monies predominated was "notorious for inefficiency, fraud, and instability." That might argue for introducing a CBDC to crowd out private stablecoins and cryptocurrencies, a point Powell sympathized with in comments this week.

To limit the risk of runs on stablecoins, the Fed could impose tight requirements on the asset backing for stablecoin operators or their custodian banks, though it might need additional regulatory powers. In the limit case where the Fed required or allowed a stablecoin to be either directly or indirectly backed 100% by reserves at the Fed, it becomes a conduit for individuals to hold a Fed liability that is functionally similar to a CBDC and—like a CBDC—it creates a risk of a run toward it and away from other assets in times of distress. Fed officials have taken a skeptical view of narrow banking in the past because of this risk. In short, there is a tradeoff between making stablecoins less runnable and making everything else more runnable through the introduction of a fully-backed stablecoin or a CBDC. How these risks compare is difficult to judge.

Impact on the banking system's deposit base

The second key question is how stablecoins or a CBDC would affect the commercial banking system's deposit base. If stablecoins or a CBDC mainly displace demand for cash, then the impact would be modest. But if they substantially reduce demand for bank deposits, then what the stablecoin operator or the Fed does with the funds raised from selling the stablecoin or CBDC is important. A recent Fed paper envisions the operator making a deposit in a commercial bank account, effectively recycling deposit funding back to the banking system. Even this scenario raises some concerns: deposits might become more concentrated at the operator's bank; net interest margins might shrink if the operator seeks the best interest rate more actively than household depositors; and the commercial bank might need to hold more HQLA if the stablecoin is more subject to runs than regular household deposits. To the extent that the stablecoin becomes widely adopted and the operator's account becomes massive, its custodian bank might need to look more like a narrow bank than a commercial bank that lends.

The other two scenarios would have a larger impact on the commercial banking system's deposit base. Both a CBDC and a stablecoin whose operator stores its assets entirely in a narrow bank or a direct Fed account would have the same effect of removing deposits from the commercial banking system. We previously discussed arrangements in which a central bank could in theory recycle deposits by lending back to the commercial banking system, but this would likely face legal obstacles in practice. From this perspective then, the intermediate outcome of a stablecoin operator whose asset backing is well regulated but not entirely held in reserves at the Fed might be the least disruptive to commercial banks.

Public vs. private control of the digital payments platform

The third key question is whether the private or public sector should control a future digital payments platform. Quarles has argued that the Fed should focus on supporting private sector innovation in payments technology and set a "high bar" for introducing a CBDC. In contrast, Brainard has argued that the private sector could innovate on top of the foundation provided by a CBDC, and that the Fed should be wary of competing private currencies that could fragment the payments system or raise costs for households and businesses if a payments system operator became dominant due to network externalities. The public versus private sector question depends in part on the type of innovation one hopes to achieve with digital currencies. If the desired innovation is related to public policy goals—such as boosting financial inclusion or empowering monetary and fiscal policy—then it might be more natural for the public sector to control the platform so that it can impose platform-wide rules on transactions.

These are some of the main issues that Fed officials will discuss as they continue to debate the case for a CBDC. We expect to learn more when the Fed releases its reports later this summer.

David Mericle

Disclosure Appendix

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