U.S. Central Bank Digital Currency

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Impact Assessment

- The Fed has made no CBDC decision and will take its time making one, likely confronting Congressional demands for faster action and/or market developments that may force a CBDC construct not to the Fed's liking.
- The Fed's initial CBDC preferences preserve the intermediation role of banks but may add considerable nonbank competition.
- Neither monetary-policy nor financial-stability concerns appear to be insuperable challenges to a U.S. CBDC.
- Although the dollar's reserve-currency status is a Fed objective, the central bank does not appear concerned that the absence of a CBDC would endanger it.

Overview

Months after initially promising to release a discussion draft on central bank digital currency (CBDC), the Federal Reserve is now seeking comment on whether and how it might create one. Reflecting the hesitancy of several FRB leaders, Chairman Powell included, the draft emphatically states that the Board has made no decision to issue a CBDC and, should it do so, it will seek at least tacit approval from both Congress and whichever Administration is in charge at the time. However, despite this highly-conditional approach, the discussion draft also emphasizes several initial decisions the Fed appears to have made. These would preserve the role of cash and private-sector financial intermediation as well as establish goals for other policy objectives (i.e., privacy protection, illicit-finance prevention, reserve-currency preservation).

Even if the Fed overcomes its hesitancies and decides on a U.S. CBDC, the deliberative and outreach process by which it has decided to make a decision ensures that a U.S. CBDC would not be provided – should it be provided – within a year or two at the very earliest. By that time, international CBDC advances and/or competing private offerings may change the construct the Fed may come to prefer, perhaps mooting aspects of it and raising an array of new risks if relevant rules are only considered in the wake of the Fed's CBDC decision. The fate of the U.S. dollar as the globe's reserve currency may also be affected by delay, although the Fed is secure in its belief that this cannot occur.

Impact

While the Fed considers its options, other nations are moving quickly to adopt CBDC and global bodies are announcing success with an array of cross-border settlement projects. Indeed, the Bank for International Settlements has laid out and essentially endorsed a "two-tier" CBDC framework.[1] The BIS policy's details are often less definitive than its over-arching statements might suggest on issues such as privacy protection and financial stability, but its conclusions nonetheless suggest that the efforts dozens of central banks are undertaking to launch CBDC could leave the U.S. isolated if it fails to decide on a CBDC and marginalized by other CBDCs on which global finance and trade come increasingly to rely.

However, most other national financial systems are differently structured and regulated than that in the U.S., making it possible that – no matter how well CBDC suits others – it is inappropriate for the United States. The Board is indeed open to "better" options and it is possible that some of these might preserve the largely-private nature of U.S. financial intermediation and that of some aspects of the payment system, also furthering innovation and inclusion in ways that might prove challenging to the U.S. central bank by virtue of its mandate, limited regulatory reach under current law, enormous size, and complex decision-making process.

The Fed's discussion draft is carefully ambivalent about the benefits and risks it details for CBDC configurations within the broad parameters on which it has at least conditionally decided. However, perhaps none of these initial calls is as critical to financial institutions as the extent to which the FRB would supplant their role as deposit-takers, lenders, payment providers or all three. As discussed below, the tone of the Fed's CBDC premises is that the central bank would not serve as a financial intermediator, thus not replacing private institutions.

Even so, the private institutions with which it chooses to provide CBDC services would be as critical to the future U.S. financial system as the extent to which the Fed reverses its current decision to allow non-banking organizations and credit unions access to its payment system.[2] The draft suggests change, building on a pending Fed proposal dealing with access to the current payment system which might grant "regulated" nonbanks access akin to that now afforded to banks.[3] The discussion draft indicates that this might also be the case for CBDC.

Should CBDC open the payment system to nonbanks, the type of regulation the Board decides justifies eligibility would determine the relative competitiveness of banking organizations. However, even if the regulatory threshold is high, banks would lose one source of franchise value long considered key to their charters

[1] See *Client Report* **CBDC6**, June 24, 2021.

[2] See **PAYMENT20**, *Financial Services Management*, August 13, 2020.

[3] See **PAYMENT22**, *Financial Services Management*, May 10, 2021.

especially if the full body of rules applicable to them remains and "regulated" nonbanks are still not covered by all of this comprehensive, costly construct. Combined with the other ways in which nonbanks and tech-platform companies compete with insured depository institutions and/or own them, CBDC access for even just some nonbanks could be an inflection point for the U.S. financial system.

From a macroeconomic perspective, no question is as critical as another the Fed explores in the discussion draft: the extent to which CBDC affects monetary-policy transmission. The Board's initial view is ambivalent; it cites numerous ways in which CBDC works for and against efficient policy transmission, appearing to conclude that most of the risks can be mitigated by CBDC design. The Fed's most important concern as a central bank may thus not prove the CBDC impediment some anticipated.

CBDC's financial-stability questions are at least as structural as those germane to monetary policy. The Board's discussion here is even more ambivalent than that related to monetary policy and it provides no inkling as to its conclusion in the questions posed for comment. However, the brief discussion of design remedies for heightened instability suggests that the Fed is also not unduly concerned by this CBDC consideration.

However, with regard to the discussion of financial-sector impact, the draft implies that CBDC is at the least preferable to stablecoin and other private-sector alternatives. The Fed may thus well come to conclude that its dominance of a new form of central-bank money is preferable to any other new forms of bank or nonbank money.

Among the most compelling potential benefits of CBDC is its likely reduction in cross-border payment costs to individuals and small businesses. This is a top priority for global regulators which have already advanced a comprehensive improvement program anticipating widespread CBDC adoption.[4] The Fed's CBDC report notes that the average remittance costs fund-senders 5.4 percent of principal, adversely affecting both immigrants and small businesses obtaining foreign supplies. It does not go on from this to discuss how a U.S. CBDC would reduce remittance costs or what the U.S. will do if most other nations have CBDCs through which cross-border payments are transmitted but the U.S. continues to rely on bank and nonbank forms of money.

The Fed does acknowledge that asymmetries between the U.S. and global payment system might adversely affect the dollar's reserve currency status, but it does not lay out pros and cons of various options beyond stating that preserving reserve currency is another Fed objective with or without CBDC. Bipartisan Members of the House are far more concerned than the Fed about the possible dominance of China and loss of reserve-currency status,[5] and issue also frequently addressed in Congressional hearings.[6]

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4 See **PAYMENT23,** *Financial Services Management*, June 7, 2021.

5 See **CBDC4**, *Financial Services Management*, June 2, 2021.

6 See **CBDC2**, *Financial Services Management*, October 1, 2020.

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Another increasingly important Fed objective pertains to financial inclusion. Again, the draft is ambivalent; it suggests numerous financial-inclusion benefits derived from CBDC but notes that these might well be achieved via other forms of innovation. The report does not acknowledge issues of concern in other CBDC discussions – e.g., the continuing "digital divide" limiting low-income community broadband access and/or access obstacles to the disabled or elderly individuals. It does, however, solicit comment on inclusion which may well spark consideration of these concerns.

What's Next

The discussion draft was released on January 20. Signaling that the Fed is in no hurry to make CBDC decisions, comments on it are not due until May 20. Although this is not a formal administrative matter, all comments will be made public. The Board also plans extensive public outreach and hearings, none of which have yet been scheduled.

All of this outreach is apparently required before any decision is made that would lead to a specific CBDC proposal that would then be submitted to Congress and the Administration. If the Fed then awaits Congressional direction, CBDC could be considerably delayed and its legal-tender status perhaps endangered. The discussion draft says that the Fed would prefer express statutory authorization – i.e., new law that would likely take still longer to finalize and thus postpone CBDC for at the least one more year after the Fed describes its preferred approach. Whether it could also get that approach if Congress weighs in is also uncertain – for example, Democrats appear to favor an approach in which the Fed would offer "FedAccounts" and thus play a far larger role than this paper believes appropriate.[7] The Fed has, however, left open the possibility that it might act without express authorization, a step it would presumably take if it decides to offer a CBDC and fears undue delay or undesirable change.

Despite the slow pace of high-level decisions, the FRB will continue to work with global counterparties to develop CBDC standards for cross-border payments. The draft does not also make clear if Federal Reserve Bank of Boston/MIT technology efforts germane to the U.S. will continue beyond describing them, but this appears to be the case.

Analysis

For purposes of this paper, the Fed follows the Bank for International Settlements' general CBDC construct.[8] As a result, CBDC is considered a widely-available digital liability denominated like physical fiat currency of the Federal Reserve. Much of the discussion assumes this widely-available construct, but a footnote indicates Fed's openness also to narrow-purpose CBDC for wholesale or other payment purposes. Comment on these narrow options is solicited.

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[7] See **CBDC**, *Financial Services Management*, May 16, 2020.

[8] See **CBDC6**, *Financial Services Management*, June 24, 2021.

A. Assumptions

Those on which the draft rests include:

- U.S. CBDC would be the equivalent of paper money in terms of wide availability. However, the paper also indicates that the Fed believes it would need to involve some form of digital identification akin to the way banks now ensure that their customers are who they or others represent them to be.
- CBDC should complement – not replace – current forms of money or private financial services.
- CBDC would need to be readily transferable among a wide range of customers and intermediaries.
- CBDC will need to satisfy the FRB and key officials that its benefits outweigh its risks, especially with regard to privacy protection and illicit-finance prevention. The Fed will also wish to see widespread public support.
- CBDC transactions would need to be real-time and final, serving as the payment medium for consumer purchases of even small-value goods and services and of government benefit, tax, or other payments.

B. Costs and Benefits

Benefits could include:

- a new foundation for the payment system that bridges old and new payment systems as well as for private-sector innovation;
- a level playing field for innovators of all sizes;
- new capabilities meeting the needs of a digitalizing economy (e.g., micro-payments);
- enhanced cross-border payments;
- support for the Dollar's international role;
- financial inclusion, with the Fed noting that this is a policy priority but also that further study is required to assess it. This is now under way at the Federal Reserve Bank of Cleveland; and
- greater public access to safe central-bank money.

Risks may include:

- fundamental changes to U.S. financial structure, adversely affecting financial intermediation and low-risk asset demand. However, CBDC design could remedy at least some of this risk;
- financial-system instability, with design features again key to the extent of the risk;

- monetary-policy transmission challenges, although the paper largely discounts these in addition to noting that – while the Fed's portfolio would surely grow larger with CBDC – it might not be greater than it is now if other liabilities run off. Further, if CBDC is a direct cash substitute, then there will be little monetary-policy impact. Interest-bearing CBDC is said to present greater systemic risks, but perhaps also better transmit monetary policy;
- Setting the appropriate balance between personal privacy and crime prevention. In the intermediate construct noted above, privacy management would remain the job of banks and, perhaps, also nonbanks. Financial institutions would also be responsible for anti-money laundering and related requirements. However, CBDC would need to be designed to limit both policy risks; and
- operational resilience and cybersecurity, although CBDC could enhance payment-system resilience if it includes offline capability (an issue being researched).

C. Request for Comment

The Fed seeks comment on matters including:

- better ways to achieve CBDC benefits;
- financial-inclusion impact;
- monetary-policy transmission;
- financial stability;
- potentially adverse financial-sector effects, especially in comparison to stablecoins and nonbank money, and ways to mitigate adverse impact;
- the extent to which, if cash use continues to decline, there remains a need for central-bank money;
- cross-border payment considerations;
- the importance of other national CBDC decisions;
- ways to provide privacy without complete anonymity;
- ways to enhance operational resilience and cybersecurity;
- whether CBDC should be legal tender;
- CBDC design, with questions posed on the extent to which interest should be paid, the need for CBDC-account thresholds, and the regulatory structure governing intermediaries;
- offline capability;
- transferability across many payment platforms; and
- the impact of future innovation.