FedFin Client Report

Tuesday, September 19, 2022

FedFin Analysis: Treasury Presses CBDC, Nonbank Payment Powers

Client Report: CBDC14

Executive Summary

In this in-depth report, we follow through as promised on our initial analysis of key sections in last Friday's Treasury report on CBDC and changes to the payment system. In this and subsequent in-depth reports, we go beyond our focus on Treasury's recommendations to analyze the rationale behind them and lay out our forecast for next steps. We noted last week that the Treasury report cannot force the Fed to adopt a CBDC but clearly seeks to press the U.S. central bank quickly to undertake the policy and technology action steps necessary to achieve the numerous benefits attributed to what Treasury would consider a well-designed CBDC. As discussed below, Treasury concludes that there is a "natural use case" for CBDC, contradicting those in the Federal Reserve – perhaps including Chairman Powell – who have yet to find one. This reflects the report's overall and – for Treasury – new focus on U.S. competition in response to another White House order (see *Client Report* **MERGER6**). Key to this are Treasury's steps that increase nonbank access and CBDC-intermediation powers, perhaps conditions on holding limits and other constraints. A new Treasury-led inter-agency working group will also press the Fed by considering issues such as national security and international coordination not now addressed by the central bank's discussion draft (see FSM Report **CBDC10**). As this report makes clear, the Administration sees CBDC as critical on several key concerns. This Treasury report also presses for rapid adoption of instant payments and nonbank access in part to ensure greater competition in payments sectors found to be ill-served by banks (remittances) or unduly concentrated. Treasury also wants the federal government to use instant payments for its many transactions, doubtless here signaling a new focus within Treasury in its fiscal-agent programs. The paper also reiterates the PWG's call for stringent stablecoin constraints (see *Client Report* **CRYPTO21**).

Analysis

As with its other analyses following the President's executive order on digital assets (see *Client Report* **CRYPTO26**), this section includes background analyses with interesting policy ramifications. Points of note here include:

- Although Treasury securities are not considered money for payment purposes, their role otherwise as money is increasingly indistinguishable from currency. The report does not discuss how this view may affect Treasury's focus on this market and its fragility, but does indicate that the SEC's central-clearing proposal is unlikely to be the last word.
- Settlement in central-bank money poses no risks, a sharp contrast to private money such as bank deposits. This assumption underlies much in the CBDC discussion and in some cases conflicts with in-depth assessments of CBDC vulnerabilities (e.g., cyber-risk).
- Instant payment inter-operability facilitates efficiency, but raises an array of fraud, AML, CFT, and other concerns. We infer from this and other points (see below) that the U.S. may move slowly to advance BIS and FSB cross-border payment pilots.

The report includes an extensive discussion of how a U.S. CBDC could work, noting that there is a "natural use case" for wholesale CBDC, perhaps with a specific focus on using this form of money for repos or securities purchases; this use case could be strengthened if nonbanks had access to it and digital-money clearing houses were established handling transactions in numerous forms of digital currency. Wholesale CBDC might also pay interest, substituting for bank reserves, crowding out tricky forms of digital money, although run-risk could be problematic. The report also describes various options and use cases for retail CBDC, noting it could also pay interest and thus facilitate monetary-policy transmission without substituting for bank deposits depending on retail-CBDC design. As Treasury outlines a CDBC, it:

- would need to support instant payments;
- has essential cyber-incident management capability and continuity under acute stress;
- deters money laundering and terrorist financing;
- could increase money functionality by, for example, automating payroll or government payments and micro or machine-to-machine payments. This programmability poses possible risks described in the report;
- facilitates nonbank access that would enhance instant payments and finality;
- likely need to be permission-based; and
- inter-operates with other CBDCs, significantly improving cross-border payments and establishing an "advanced cooperation" ensuring common technology and standards as well as posing numerous risks that include those to the economic sovereignty of participating nations.

Treasury anticipates retail CBDC as a two-tier system akin to that posited by the BIS (see FSM Report **CRYPTO29**). However, Treasury goes beyond this basic model to note that a hybrid structure is possible in which nonbanks can distribute CBDC working through banks for custody and wallet services. Holdings would reduce nonbank risk and be systemic buffers if they varied based on risk externalities including those in the Treasury market.

The report also finds that nonbank intermediation would increase financial inclusion, competition, payment-system efficiency and resilience, the foundation for U.S. innovation, AML/CFT compliance, and financial stability. The report also notes possible risk to credit availability unless nonbanks are allowed to intermediate CBDC in concert with banks.

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The Treasury report also concludes that CBDC would enhance the dollar's reserve-currency role if inter-operability and liquidity considerations are fully addressed. In the near term, reserve-currency status appears secure, but it could be threatened as stablecoins and other innovations advance. These innovations could also threaten national security in the absence of a dollar-based CBDC. The paper also notes how a U.S. CBDC could enhance democratic values and global freedom, a key objective of the President's order.

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