

WHICH TYPE OF DIGITAL CURRENCY FOR FINANCIAL INCLUSION?

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When the Libra Association first announced its plan to launch a private digital currency for domestic and cross-border payments—then consisting of a single token backed by a mix of stable fiat currencies—financial inclusion was a big part of its business case. With 1.7 billion people globally lacking a bank or mobile money account, Libra thought it was imperative for some of the world’s largest companies, including the leading social media platform, to join forces and bring cheap payments to the world’s “unbanked.” And while this project has faced a rocky reception from central bankers and regulators—for reasons good and bad—even they often frame the case for their own, public digital currencies (CBDCs) in terms of bringing cheap and fast electronic payments to the greatest possible number of people, as cash use and cash acceptance decline.

Neither Libra’s promoters nor central bankers are wrong. With smartphone penetration having long outpaced bank account ownership in many countries, digital wallets offer greater promise for bringing people into the mainstream financial system than analog approaches such as postal banking or a Canada-style public mandate. But to appeal to unbanked households, digital wallets must address the reasons why the unbanked are so. Ubiquity and minimal fees are

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important—as CBDC proponents suggest in making their case—but so are privacy, reputation, and simple interfaces that help customers understand their financial position and solve their questions and complaints without jargon or bureaucracy.

In what follows, I will define financial inclusion as more than just giving everyone a bank account. I will then examine public and private digital currencies according to their ability to foster inclusion in this deeper sense. Because many central banks—including the Federal Reserve Board—are seriously considering CBDCs in the medium term, I will outline some principles that should guide the development of public digital currencies, if the goal is not simply to give people a bank account, but to give them an account they want to use. These principles should generally also apply to private initiatives. I will conclude with some comments regarding whether “peaceful cohabitation” might be achieved between CBDCs and private digital currencies.

Defining Financial Inclusion

America’s financial inclusion problem is usually expressed as the percentage of households—5.4 percent at last count, according to the Federal Deposit Insurance Corporation (FDIC 2020: 1)—who lack a bank account. This percentage is considerably higher than those of other rich countries, such as Britain, Canada, and Germany, where account ownership is near universal. The absolute number of unbanked U.S. households is staggering, at 7.1 million, and while the FDIC’s biennial surveys chart an encouraging trend of decline since 2011, the pace of that decline is unsatisfying to many people, myself included.

But I am also unhappy with the conventional definition of financial inclusion. It assumes that, were someone to open an account on behalf of each unbanked household, the problem would be solved. Some experts whose commitment to help the unbanked I do not doubt advocate just that: a mandate for the Federal Reserve to create retail deposit accounts—“FedAccounts”—on demand (Ricks, Crawford, and Menand 2021). But I think the merits of this intervention as a financial inclusion policy are questionable, as there is no assurance that the unbanked want such accounts.

When the FDIC last asked the unbanked why they are so, just over a third cited minimum balance requirements and high fees as

the main reason. If “FedAccounts” carried no such fees, one might expect these households to welcome them and move from cash to electronic money. But that leaves two-thirds of the unbanked who might still eschew FedAccounts. Why? Because their chief reasons for being unbanked did not involve cost but privacy, trust, and the lack of a credit history or adequate documentation to open an account. Besides, 56 percent of the unbanked told the FDIC that they are “not at all interested” in having a bank account.

Two reasons come to mind for why so many unbanked would rather remain so than get a conventional bank account. The first is that financial services providers often described as “non-mainstream”—check cashers, pawnbrokers, payday lenders—serve the unbanked better than many of us think. They have convenient locations that are open most of the time, their fees are transparent if high, and the people who work there look like the unbanked: young, minority, immigrant, often Spanish speaking. The second reason is that bank accounts have become commoditized, their offerings indistinguishable from each other, and innovation minimal in comparison with other consumer financial products. Given the available alternatives, bank accounts just do not appeal to a majority of the unbanked.

The challenge of financial inclusion policy is to encourage the growth of bank account substitutes that do appeal to the unbanked. With that in mind, the definition of financial inclusion that I would propose is “access to deposit, credit, and payment options that meet consumers’ diverse needs and reflect their varied economic circumstances and life plans.” Only by taking account of the specific needs of unbanked consumers, and how these needs might change as they grow older and more affluent, can policymakers help to change the regulatory environment to better serve the unbanked. I believe digital currencies belong in the solution set.

Private Digital Currencies vs. CBDCs

It is no secret that—with the possible exception of the People’s Bank of China—central banks’ interest in issuing digital liabilities directly to households and nonfinancial firms was spurred by the Libra project. Many of them found the original Libra white paper half baked and the prospect of several large multinational firms releasing a private currency potentially dangerous and destabilizing.

Some also worried that Libra could push central banks to the sidelines by displacing national currencies, thereby blunting the effects of monetary and credit cycle policy. But, while Libra might compete with the currencies of small and unstable jurisdictions, it would have been highly unlikely ever to challenge the U.S. dollar, the euro, or the pound sterling—not least because all of these formed part of the original hybrid Libra “basket.”

Yet, just 18 months after Libra was first proposed, the pace at which major central banks have made public their intention to launch CBDCs in the medium term is impressive. In March, the Bank of England (2020) published a discussion paper on the topic. The European Central Bank (2020) followed suit in October. The Bank for International Settlements, which brings together the world’s central banks, is both monitoring and assisting its members in this endeavor (Auer, Cornelli, and Frost 2020). And while the Federal Reserve has not yet publicly outlined its CBDC plans, the Boston Fed is running an experiment with MIT’s Digital Currency Initiative, which senior Fed executives such as Governor Lael Brainard consider serious enough to merit mention in their speeches (McSweeney 2020).

These CBDC developments have somewhat taken the wind out of the sails of private digital currency projects. Global financial institutions such as the International Monetary Fund and the Financial Stability Board have continued to issue guidelines for the effective regulation of what they call “global stablecoins” (GSCs), but it is CBDCs and not private digital currency projects that have recently caught the imagination of policymakers and many private-sector players in the payments ecosystem. This is not entirely surprising: central bank-issued instruments have characteristics—ubiquity, risklessness, legal tender—that most private-sector competitors could not quite match. But some private-sector players do have the scale, reputation, and financial resources to elicit broad acceptance by households and businesses. What is more, these private multinational projects might achieve cross-border interoperability, whereas domestically focused central banks have failed to do so in the past.

But it is not just the international character of private digital currency projects that makes them competitive with CBDCs. Read any of the central bank publications I listed earlier, and you will find that they discuss in some detail the implications of CBDCs for monetary policy and financial stability but spend comparably little time on their

customer-facing features. Yet, far from a trivial sideshow, this aspect of CBDC development is all-important, if CBDCs are indeed to promote financial inclusion. And in this regard, private-sector players have a leg up on central banks because many of them interact with customers daily, online and offline. Some even operate their own digital wallets.

It is not enough for central banks to declare—as, for example, the ECB has done—that they favor an “intermediated” CBDC model in which they would run the core infrastructure and stand behind every CBDC unit, with private-sector firms competitively supplying the platforms through which customers would manage their CBDC balances, make payments, and transfer relevant data. The slow progress of FedNow, despite relying on well-established real-time gross settlement (RTGS) technology that other central banks have had for years, shows that even limited-access innovations can challenge a large bureaucracy. Because of their novelty and retail features, CBDCs would pose additional challenges of interoperability with third-party applications, cross-border exchange, and cybersecurity, issues with which central banks are largely unfamiliar.

Principles for Digital Currency Development

Whether public or private, digital currencies should be built with several principles in mind, if their goal is to reach households that currently lack a bank account. The first principle is to avoid fixed fees as much as possible, as they fall disproportionately on low-income households that keep low balances and regularly overdraw their accounts. Banks used to minimize fees by cross-subsidizing low-balance accounts with debit interchange fee income, until the 2010 Durbin Amendment capped these fees (Sarin and Mukharlyamov 2019). Libra proposed to avoid them by relying on interest income from the short-term government securities in which it would invest customer funds. Central banks have suggested that they too will refrain from charging fixed fees, though quite how they could finance the CBDC infrastructure and running costs, while also paying interest on CBDC balances like they currently do on bank reserves, remains unclear (Zuluaga 2020).

Privacy is the second principle that should guide digital currency projects. The fear of losing it is the second-biggest reason why the unbanked prefer not to open a bank account. Central banks have vowed to protect privacy in a CBDC system, but durable protection

can only be achieved by deliberately designing CBDCs to be private. This is why some experts have called for CBDCs to take the form of digital bearer tokens, which anyone who held them could use, rather than intermediated accounts, to which central banks or third parties could bar access (Green and Van Valkenburgh 2020). A bearer token would most closely resemble the properties of physical cash and is therefore the most appropriate substitute as cash use declines. Private digital currencies could also be designed to protect user privacy, but as regulated financial intermediaries, issuers and hosted wallet providers could not easily refuse to make transaction data available to government authorities. Therefore, the extent to which digital currencies, whether publicly or privately sponsored, protect privacy will ultimately be up to policymakers.

The third principle that digital currency projects should follow is competitive provision. Card networks and other multisided markets have successfully implemented the model of “coopetition,” whereby market participants set common standards for interoperability and mutual acceptance, while also distinguishing their individual offerings in order to attract customers to their products. The Libra project would follow a similar model. Central banks have likewise expressed a preference for competition between customer-facing private-sector providers, even as they would remain the exclusive guardians of the core CBDC infrastructure. But, at the same time, central banks should tolerate competition from private digital currency ecosystems like Libra. Not only will competition prevent future abuses by any one gatekeeper, but it is also more likely to bring about a range of digital account options that cater to the needs of the unbanked.

Prospects for “Peaceful Cohabitation”

Will central banks allow competition on equal terms from private-sector projects? Their swift and overwhelming response to Libra might cause some people to think they will not. After all, many central bankers thought digital currencies an irrelevant sideshow before the prospect of a real competitive threat materialized. Nor did their objections to Libra always rest on well-founded concerns about monetary and financial stability. But if their goal is to promote financial inclusion domestically and abroad, central banks should tolerate competing ecosystems, as these could help to enfranchise groups whom central banks are particularly ill-equipped to serve.

Immigrants are one example. Policymakers often point out that, even as the cost and speed of domestic payments have recently improved in many countries, senders of small remittances continue to pay high prices. And while central banks pay lip service to cross-border interoperability, they have still not achieved it, and the commercial banks they regulate tend to be among the more expensive suppliers of foreign-exchange services. Auspiciously, much private-sector digital currency innovation has focused on the remittance market, although these efforts are largely yet to bear fruit and domestic regulation has sometimes acted as a barrier to their growth.

Young consumers, who account for a disproportionate share of the unbanked, are another group private-sector providers might be better placed to serve, as these consumers are “digital natives,” active on social media, and more trusting of new brands than they are of legacy institutions like the U.S. Postal Service (Morning Consult 2020). To be sure, private user interfaces on the CBDC infrastructure might manage to entice many young consumers just as well, but why rely on just one payments system when private firms are happy to supply another?

While the primary focus of financial inclusion policy will rightly be on the domestic population that is presently unbanked, policymakers and central banks should also consider the welfare of foreign underserved consumers, as policy in the leading economies—the United States, Europe, and the United Kingdom—is likely to have spillovers for less developed countries. Allowing private digital currency projects to flourish could even benefit the leading central banks, by shifting foreign demand for stable exchange media from CBDCs to private digital currencies, thereby letting central banks focus on their domestic policy objectives.

Conclusion

I think it likely that, within the next five years, many major central banks will either launch or begin the process for launching retail CBDCs. In justifying their decision, these central banks will undoubtedly cite financial inclusion. And rightly so: CBDCs designed to address the chief concerns of the unbanked—high fees and privacy—could hold strong appeal to them, especially if central banks rely on private firms to competitively deliver user interfaces such as digital wallets, mobile applications, and customer service.

But even if CBDCs prove attractive to many unbanked households, there will be some groups whose needs CBDCs cannot satisfy. For example, those who make heavy use of cross-border money transfers may find CBDCs to be of little help, as central banks have struggled to achieve interoperability with each other. For those groups, private digital currencies may be a helpful supplement. Private options would also put competitive pressure on CBDCs to meet consumer needs, just like foreign and private currencies already discourage central banks from behaving recklessly with the money supply.

Technology is helping to bring down the number of unbanked households around the world. But this progress is not automatic. If financial inclusion is a priority for policymakers deciding digital currency policy, they should encourage as many competing projects as possible.

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