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May 12, 2022

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Central Bank Digital Currency (CBDC) Feedback Form

To Whom It May Concern:

My name is Nicholas Anthony. I am a policy analyst at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to provide input to assist the Federal Reserve (Fed) in its effort to better understand central bank digital currencies (CBDCs).[1] The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary monetary and financial regulatory systems. The opinions I express here are my own.

****Editor's Note: Each response is limited in length to conform to the constraints of the Federal Reserve's comment form.****

1. What additional potential benefits, policy considerations, or risks of a CBDC may exist that have not been raised in this paper?

The Federal Reserve's January 2022 discussion paper touched on a number of potential benefits, risks, and policy considerations relevant to a central bank digital currency (CBDC).[2] However, the list of potential risks was particularly understated: only two paragraphs considered the balance of protecting financial privacy and preventing financial crimes.[3]

As noted in the discussion paper, financial institutions are already required to report large sweeps of financial activity in compliance with the government's attempt to combat money laundering

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[1] Board of Governors of the Federal Reserve System, "Central Bank Digital Currency (CBDC) Feedback Form," https://www.federalreserve.gov/apps/forms/CBDC.
[2] Board of Governors of the Federal Reserve System, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation," January 2022, https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf.
[3] Board of Governors of the Federal Reserve System, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation," January 2022, https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf. Pages 17-20.

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and terrorist financing.[4] In doing so, the paper appears to be suggesting that a CBDC would not be different from existing digital money. While it may be true that a CBDC could be *largely* identical to existing digital money, there would be a significant difference in that a CBDC would provide the opportunity to establish a direct line between the government and the public's financial activity. In doing so, a CBDC would erase what little financial privacy still exists in the United States.[5]

In fact, the threat to financial privacy may be the single greatest risk of a CBDC. And it's due to the significance of this risk that it is particularly disappointing that the discussion paper devoted so little time to the issue. The "intermediated CBDC model"—something which largely appears to be a retail CBDC with extra steps—described in the discussion paper *may* be able to be designed sufficiently to prevent a direct line between the government and the public by using third parties (i.e., banks and other financial institutions) to interrupt the flow of information. But even here, financial privacy is still at risk. One of the few constraints on the third-party doctrine is whether the information revealed was in the ordinary course of business. While financial institutions do not track down the journey of each dollar bill in the ordinary course of business, a CBDC would likely have a record of its transactions and make that data available to financial institutions. Therefore, that newly available data would likely be added to the existing reporting requirements and thus create a much larger data pool for law enforcement to pull from during investigations. Worse yet, even if that newly available data is not added to reporting requirements initially, it still creates a much larger data pool.

So whether it is done directly or in an "intermediated" fashion, a CBDC poses a significant risk to Americans' financial privacy. And it's not just a risk of quiet observance. The use of the Emergencies Act in Canada to freeze the bank accounts of protestors earlier this year showed that Americans should be aware of the extent the government can go to exert control.[6] A CBDC would dramatically increase that risk.

2. Could some or all of the potential benefits of a CBDC be better achieved in a different way?

In a report titled, "Central Bank Digital Currencies: Six Policy Mistakes to Avoid," Douglas Elliott and Larissa de Lima warn that officials should be careful not to ignore other policy tools when thinking about the design of a central bank digital currency (CBDC).[7] At the moment, it appears almost all of the potential "benefits" of a CBDC would be better left to existing efforts.

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[4] Board of Governors of the Federal Reserve System, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation," January 2022, https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf. Page 19.
[5] Nicholas Anthony, "Why Don't Americans Have Stronger Financial Privacy Rights?," Cato Institute, October 28, 2021, https://www.cato.org/blog/why-dont-americans-have-stronger-financial-privacy-rights.
[6] Nicholas Anthony, "How Canada Made the Case for Cryptocurrency, Not CBDCs," Cato Institute, March 2, 2022, https://www.cato.org/blog/how-canada-made-case-cryptocurrency-not-cbdcs.
[7] Douglas J. Elliott and Larissa de Lima, "Central Bank Digital Currencies: Six Policy Mistakes to Avoid," Oliver Wyman, May 27, 2021, https://www.oliverwyman.com/our-expertise/insights/2021/jun/central-bank-digital-currency-and-the-policy-mistakes-to-avoid.html.

The Payments System

Improving the payments system in the United States is an effort that is long overdue,[8] but a CBDC would pose little benefit given the existing developments in both the public and private sectors. First, the Fed itself expects to launch FedNow in 2023—an effort that is specifically designed to improve the payments system. Though to achieve this goal, FedNow could even be shut down today and the Fed could simply expand its operating hours to improve payments speeds.[9] Second, before the FedNow initiative interrupted the private sector's progress, the RTP Network was well on its way to successfully introducing real time payments across the country.[10] Third, stablecoins have offered another private-sector solution to payment delays by making transactions possible 24 hours a day.[11] So between the Fed's own efforts and the innovations in the private sector, it appears that a CBDC would do little to uniquely improve the payments system.

Financial Inclusion

Financial inclusion is a worthy goal, but a CBDC is not a worthwhile solution. As far as what a CBDC might offer that is not already available, it's unclear what unique benefit it might offer precisely because there is so much private-sector competition taking place. The Bank On initiative and adoption of mobile banking are giving underserved communities greater access to the financial system.[12] The Federal Deposit Insurance Corporation's (FDIC's) 2019 survey on banking and financial services seems to suggest these services are making a real improvement in the space considering the unbanked households in the United States have steadily decreased from 8.2 percent in 2011 to 5.4 percent in 2019.[13] By the time a CBDC is released, that number might be nearly zero. And best of all, options like cryptocurrencies, cheaper check cashing, and prepaid cards continue to reduce the burden of being unbanked.

The World Reserve Currency

Preserving the dollar's world reserve status is also described as a potential benefit of a CBDC, but this too falls short. Put simply, any improvement to the dollar is likely to help support its international status. For instance, improving financial privacy protections, payments speeds, and

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[8] George Selgin and Aaron Klein, "We Shouldn't Have to Wait for FedNow to Have Faster Payments," American Banker, February 28, 2020, https://www.cato.org/publications/commentary/we-shouldnt-have-wait-fednow-have-faster-payments.

[9] George Selgin, "Facilitating Faster Payments in the U.S.," Cato Institute, September 25, 2019, https://www.cato.org/testimony/facilitating-faster-payments-us.

[10] Norbert Michel, "The Federal Reserve Should Not Compete with Private Firms," Forbes, December 16, 2018, https://www.forbes.com/sites/norbertmichel/2018/12/16/the-federal-reserve-should-not-compete-with-private-firms.

[11] Nicholas Anthony, "Congress Should Welcome Cryptocurrency Competition," Cato Institute, May 2, 2022, https://www.cato.org/briefing-paper/congress-should-welcome-cryptocurrency-competition.

[12] Federal Reserve Bank of St. Louis, "Bank On National Data Hub: Findings from 2020," December 22, 2021, https://www.stlouisfed.org/news-releases/2021/12/22/st-louis-fed-releases-the-bank-on-national-data-hub-findings-from-2020.

[13] Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.

transparency in monetary governance would likely benefit the dollar's international status.[14] It's hard to imagine how a CBDC is unique in any other way than in terms of getting the United States a seat in the "digital currency race." And even then, it's not clear that this race is one the United States needs to win. "Going digital" may be an improvement for some foreign currencies, but those currencies still have many other problems that prevent them from being used on an international scale. China's own CBDC may be the best example of this problem: China may be leading in the digital currency race, but few people are flocking to it considering the country's history of human rights and privacy violations.

3. Could a CBDC affect financial inclusion? Would the net effect be positive or negative for inclusion?

A central bank digital currency (CBDC) is unlikely to affect financial inclusion substantially. Not only have the number of unbanked individuals been steadily decreasing over time, but the reasons people give for being unbanked are unlikely to be assuaged by a program from the federal government.

The Bank On initiative, mobile banking, and cryptocurrencies are all giving underserved communities unprecedented access to the financial system.[15] For instance, the Federal Reserve Bank of St. Louis found that nearly 4 million accounts were opened in 2020 due to the Bank On initiative—an initiative designed to increase the availability of low-cost deposit accounts.[16] Mobile banking has experienced similar success: it was the main way to access one's bank account for only 9.5 percent of households in 2015, but it rose to 34 percent by 2019.[17] The Federal Deposit Insurance Corporation's (FDIC's) 2019 survey on banking and financial services seems to suggest these services are making a real improvement in the space considering their growth has coincided with unbanked households in the United States steadily decreasing from 8.2 percent in 2011 to 5.4 percent in 2019.[18]

With those factors set aside, it is unlikely that a CBDC would win wide support among the un- and under-banked population unless it offers credible privacy protections and intermediary-free services. The 2019 FDIC survey found that trust and privacy were cited as two of the top three

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[14] Nicholas Anthony, "Congress Should Welcome Cryptocurrency Competition," Cato Institute, May 2, 2022, https://www.cato.org/briefing-paper/congress-should-welcome-cryptocurrency-competition.

[15] Federal Reserve Bank of St. Louis, "Bank On National Data Hub: Findings from 2020," December 22, 2021, https://www.stlouisfed.org/news-releases/2021/12/22/st-louis-fed-releases-the-bank-on-national-data-hub-findings-from-2020; Paul Calem and Yasmeen Abdul-Razeq, "What Drives Household Financial Inclusion? Analysis of Data Exposes Myths and Identifies Opportunities," Bank Policy Institute, May 3, 2022, https://bpi.com/what-drives-household-financial-inclusion-analysis-of-data-exposes-myths-and-identifies-opportunities/; and Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.

[16] Federal Reserve Bank of St. Louis.

[17] Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.

[18] Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.

reasons for not having a bank account.[19] A "government bank account" is likely to be an even less appealing prospect for the respondents—even if it is merely a digital wallet.[20]

6. Could a CBDC adversely affect the financial sector? How might a CBDC affect the financial sector differently from stablecoins or other nonbank money?

Where stablecoins and other nonbank moneys (e.g., cryptocurrency) complement and build off of the financial sector,[21] a central bank digital currency (CBDC) could undermine it. It appears to be likely that a CBDC would have a negative impact on financial stability. A CBDC offered at the retail level poses substantial disintermediation risks.[22] In short, by offering an option that is safer than the average deposit account, a CBDC would increase the risk of bank runs in times of stress. Both the Fed[23]and the Bank of International Settlements (BIS) have recognized this risk in the past,

> Depending on the design and adoption of a CBDC, there may be broad market structure effects. There is a risk of disintermediating banks or enabling destabilizing runs into central bank money, thereby undermining financial stability. Today, the public can (and have in the past) run into central bank money by holding more cash, but such runs are very rare, given the existence of deposit insurance and bank resolution frameworks that protect retail depositors. [A] widely available CBDC could make such events more frequent and severe, by enabling "digital runs" towards the central bank with unprecedented speed and scale … [If] banks begin to lose deposits to CBDC over time they may come to rely more on wholesale funding, and possibly restrict credit supply in the economy with potential impacts on economic growth.[24]

As should be clear from BIS's account, the Fed's entry into the digital currency landscape differs significantly from the private sector initiatives (e.g., cryptocurrencies, stablecoins, etc.) in that the Fed's entry would risk an unprecedented tilting of the playing field.

10. How should decisions by other large economy nations to issue CBDCs influence the decision whether the United States should do so?

Every nation in the world could adopt a central bank digital currency (CBDC), but that alone would not be a justification for the United States to follow suit. Both lawmakers and regulators must be careful to distinguish between keeping up with the Joneses and learning from the

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[19] Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.
[20] Nicholas Anthony, "Only Six People Used the Postal Banking Pilot Program," Cato Institute, March 30, 2022, https://www.cato.org/blog/only-six-people-used-postal-banking-pilot-program.
[21] Nicholas Anthony, "Congress Should Welcome Cryptocurrency Competition," Cato Institute, May 2, 2022, https://www.cato.org/briefing-paper/congress-should-welcome-cryptocurrency-competition.
[22] George Selgin, "Central Bank Digital Currency as a Potential Source of Financial Instability," Cato Journal, Spring/Summer 2021, www.cato.org/cato-journal/spring/summer-2021/central-bank-digital-currency-potential-source-financial-instability.
[23] Board of Governors of the Federal Reserve System, "Regulation D: Reserve Requirements of Depository Institutions, 12 CFR Part 204," Federal Register 84, No. 48 (March 12, 2019, www.govinfo.gov/content/pkg/FR-2019–03-12/pdf/2019–04348.pdf.
[24] Bank for International Settlements, "Central Bank Digital Currencies: Foundational Principles and Core Features," https://www.bis.org/publ/othp33.pdf.

experience of others. Decisions by other nations should inform the decisions made by the U.S. government regardless of the subject area so long as the relative conditions are considered, and no decision is considered a panacea.

To that end, lawmakers should shift their focus away from trying to win the "digital currency race" and towards strengthening the dollar.[25] It is unlikely that the majority of people who rely on the U.S. dollar will switch to the Chinese yuan, Russian ruble, or Nigerian naira simply because those countries offer a CBDC—especially considering the U.S. dollar system is already largely digital.

15. Should a CBDC pay interest? If so, why and how? If not, why not?

Aside from the many potential practical problems, interest payments on a central bank digital currency (CBDC) could risk exposing the Fed to a new wave of politicization—especially when officials try to use negative interest rates and above-market rates to spur spending and saving, respectfully. In fact, determining the appropriate level of competition with private financial firms will likely be difficult. First, it's unclear what market failure the Fed would be stepping in to solve by paying interest on a CBDC when there are numerous available interest-bearing alternatives in the private sector. And second, it's unclear how effective interest payments would be considering the policy will have to decide whether the upper bound on interest paid to CBDC holders will take the rate paid to reserve accounts into account. Failure to do so (i.e., exceeding private-sector interest rates) would likely increase both disintermediation risks[26] and political risks as industries and the public vie for one policy over another.

16. Should the amount of CBDC held by a single end-user be subject to quantity limits?

If a central bank digital currency (CBDC) were to be created in the United States, it should not be subject to quantity limits at any stage. Although China's CBDC uses a model in which users must relinquish increasing levels of privacy in return for higher account balance limits and others have argued account limits can protect consumers from losses, the United States should allow consumers to choose what amount best fits their needs regardless of how high or low that amount is. More so, there should not be reporting thresholds where users are allowed to exceed certain levels, but are, in turn, reported for doing so. In that sense, the United States would simply be mirroring China's model—albeit, in a more roundabout fashion.

It might not be most productive or even the safest choice to hold one's money in one account over another, but it should ultimately be up to each individual person, nonetheless. Much like with the case against using negative interest rates on a CBDC to spur spending, it is not the federal government's role to decide how individuals use their money.

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[25] Nicholas Anthony, "Congress Should Welcome Cryptocurrency Competition," Cato Institute, May 2, 2022, https://www.cato.org/briefing-paper/congress-should-welcome-cryptocurrency-competition.
[26] George Selgin, "Central Bank Digital Currency as a Potential Source of Financial Instability," Cato Journal, Spring/Summer 2021, www.cato.org/cato-journal/spring/summer-2021/central-bank-digital-currency-potential-source-financial-instability.

21. How might future technological innovations affect design and policy choices related to CBDC?

The current trend of technological innovation seems to suggest that a central bank digital currency will soon be unnecessary. The number of unbanked households continues to fall each year due partly to the rising adoption of mobile banking;[27] innovations within stablecoins and cryptocurrency more broadly have presented unprecedented access to the financial system; and fintech companies continue to make new advances in financial services. In looking to the future to see what place a CBDC might have, it seems most likely that it has no place at all.

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Sincerely,

Nicholas Anthony
Policy Analyst
Center for Monetary and Financial Alternatives
Cato Institute

[27] Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.