

## Letter 31

### **What is the future for the international monetary system, central banks and cryptocurrencies?**

*"When the past no longer illuminates the future, the spirit walks in darkness" Tocqueville.*

Regardless of the political, sociological and economic consequences of the global pandemic, should we not consider the monetary consequences of this pandemic and Tocqueville's word that serves as a reminder of the uncertainties surrounding the future? Is there a boom in private cryptocurrencies? Will they not be supplanted by national digital currencies? Finally, what key role will the \$ play in the international monetary system in the next decade? The question is open for two reasons. One economic, the other monetary. The first because, with the catch-up of emerging countries and China in the lead, the relative economic weight of the United States in the world is declining, the second because the hegemony of the \$, as a transaction currency, but even more so as a monetary weapon used for financial sanctions, has been strengthened, thus irritating many powerless countries, not just Iran or Russia but China and the European Union.

Less economic domination but increased monetary domination – these are the seeds of an evolution to come.

The emergence of digital currencies could accelerate the evolution, making it possible to bypass SWIFT, to avoid the constraints of the use of the principle of extraterritoriality and therefore circumvent the use of sanctions, fines or prohibition of trade.

Three trends can be anticipated: an evolution towards a more multipolar monetary system with a greater role played by the Euro, or even the SDR and eventually the Yuan; again, an increased role for central banks with the launch of digital currencies and actions in favor of green finance; private cryptocurrencies, which, in the future, will be competing with public digital currencies as a means of payment and will therefore be confined to a diversification role in the investment sphere.

#### ***An evolution of the international monetary system?***

Since the end of the convertibility of the dollar into gold in August 1971, the dollar has been the sole currency of international trade and is used for more than two-thirds of international transactions. Will the dollar remain at the heart of the international monetary system in the long term? Can a national currency be an instrument of unilateral domination with the application of the principle of extraterritoriality? To answer these questions, let's evaluate the alternatives.

**The Euro:** Since its creation in 1999, the € is the second most important international currency. It represents, depending on the year, between 22% and 27% of international transactions and 20% to 27% of the world's foreign exchange reserves. The € is far behind the \$, by more than 60%, but far ahead of the Yen, the £, the Yuan or the Swiss Franc – none of these currencies represent more than 4% of international transactions.

While the € is associated with the commercial transactions of the 19 countries in the Euro area and some 20 countries in neighboring or de facto African countries indexed to the Euro, commodities remain financed in \$.

The role of the € is most evident as the reference currency of about 40% of international bonds issued by countries outside the Eurozone.

To sum up, while some might have had doubts about the sustainability of the Eurozone a few years ago, today the Commission's stated ambition to promote the € on the international stage and the adoption of the €750 billion recovery plan in mid-2020 have silenced the advocates of an exit from the Euro.

**The SDR:** Defined using a basket of currencies, the Special Drawing Rights could initially be promoted as a complement to, and eventually a substitute for, the \$ and play a role as a synthetic multilateral currency. The International Monetary Fund could be recognized as a lender of last resort. Such a development would require the acceptance by Western countries, who currently hold a majority in the decision-making process, of an IMF reform with a view to develop the role of SDRs and SDR allocations by country. Emerging countries should be able to finance themselves in SDRs and not be obliged to take on debt in \$. Their exposure to movements in the \$, to capital outflows, would thus be reduced.

Americans hold the key because they have a blocking minority in the votes at the IMF.

**The Yuan:** The Yuan is not an international currency to date because the currency is not yet convertible and interest rates are not free. The bond market is large but is still dominated by large local banks and therefore does not offer liquidity equivalent to that of Western markets. In 2019, foreign investors held no more than 3% of Chinese bonds, attesting to the lack of internationalization of this market. The Yuan represents only 2% of international foreign exchange reserves, less than 10% of the weight of the €.

Ultimately, the authorities' intention to promote the Yuan on the international stage is clear and, in 2016, it reached its first milestone with the inclusion of the Yuan in the composition of the SDR, the IMF's Special Drawing Rights, with a 10% weighting.

By announcing the launch of an electronic Yuan, the Central Bank of China can provide quick and easy access to those who do not have access to banking services. It can fight corruption more easily and can also circumvent U.S. sanctions against individuals, companies or states by making transactions that bypass the SWIFT network. With this system, it could be the end of the extraterritorial privilege linked to the \$ and an opportunity to accelerate the international use of the Yuan.

The digital currency is also a means of monitoring the population because all transactions are identified. This is quite the opposite of Bitcoin which was designed to ensure anonymity. Also, it faces competition from WeChat and Alipay but for the latter, this is only one service among others.

If *the \$* were to lose its status, which General de Gaulle denounced in the mid-1960s stating the "exorbitant privilege of the \$," it would entail the abandonment of an international monetary system that allows for a national currency to be the international currency and the United States to run constant deficit in its foreign trade, in its current account, without ever having to worry about the worsening of its debt or its settlement because, other countries, have no choice but to accumulate the \$. Japan holds some \$1.3 trillion in U.S. Treasuries and China barely that. In fact, since the 1960s, but even more so since the end of the gold convertibility in 1971, the United States has been able, without risk, to consume more through the use of a portion of the world's savings surpluses. As John Bowden Connally, Nixon's advisor, told The Europeans in 1971, "The dollar is our currency, but it is your problem." In other words, it does not matter to an American if the \$ depreciates because he is indebted in \$ and the damage is borne by the foreign holder of debts in \$.

*A new extension of the role of central banks with digital currency?*

To this day, a country's central bank is the custodian of the sovereign currency. It manages public debt, which is counter-valuable to the country's assets, wealth and tax revenues. Managing public debt entails maintaining the confidence of international investors, avoiding a country's default, and tempering periods of stress through purchases, i.e., monetization to avoid pressure on rates.

Central banks are sometimes criticized, but they are always asked to do more. Should we not welcome their interventions, both in 2008 and 2020, to avoid or resolve two potentially systemic crises? Should we be concerned about a shift by central banks towards "modern monetary theory", with massive purchases of public debt, control of the yield curve, support for corporate finance and negative interest rates? In any case, on the current debate of a possible cancellation of public debt carried by central banks, one can only reiterate the opposition to this measure which was already mentioned in a previous Letter.

Today, there is strong pressure on central banks to address climate emergency, in terms of both supervision and buying of corporate bonds on the secondary market. Is not allowing banks, under the supervision of the central bank, to grant loans indiscriminately subsidizing pollution? Is that not ignoring the risk of global warming? The central bank can force banks to adjust their credit policies and adapt their "stress tests" to ESG requirements (environmental, social and governance standards). Similarly, in order to play their part in the fight against global warming, central banks can be selective in buying corporate bonds, renounce the purchase of bonds from fossil fuel companies and focus their purchases on "green bonds".

But should we blame central banks or deplore the weakness of policy? Should we denounce the prepotency of central banks or be alarmed by the political vacuum?

### ***What is the place for private cryptocurrencies?***

Will central banks remain the sole providers of liquidity for means of payment and the purpose of transactions? Will there be a shift from the current monetary system, anchored in the verticality of the central bank to the banks, to a private and decentralized system? Can there be an end of the state monopoly over monetary issuance and a substitution of a decentralized model of issuance? These are the questions.

The creation of blockchain technology, a chain of blocks in literal translation, offers transactions authentication, through the use of computers for mining, recording, certification and storage, of all transactions that are grouped in blocks and connected in chains by an encryption system.

In other words, computers around the world store transactions in an encrypted format in "blocks" but there is no central control body.

The apparent attraction of cryptocurrencies, without dependence on a central authority, is the anonymity of transactions. It is also the result of a distrust of the State, the consequence of a sharp drift in debt, the translation of fears about the emergence of speculative bubbles, the feeling that interest rates no longer reflect the reality of risk, a flight from excessive euphoria, the anticipation of a disaster or default, the fear of a return to inflation or monetary depreciation and the desire to protect assets.

Since the creation of Bitcoin in 2009, cryptocurrencies seem to be gaining status with investors and with some companies. In a world awash in cash, the scarcity of Bitcoin limited by supply, justifies a premium in the eyes of some. However, several points need to be made:

On the one hand, the capitalization of these cryptocurrencies, \$2,000 billion, is still modest. It can be compared to the global public debt of about \$100,000 billion, or the capitalization of GAFAM of \$8,000 billion. Bitcoin represents the bulk with a market value of \$1,100 billion, ahead of more than 1000 cryptocurrencies, the largest of which is Ethereum that accounts for 12%.

A sensitive point is that Bitcoin ownership is concentrated among the top 1000 addresses holding 28% of the value of the market.

Importantly, cryptocurrencies are to date essentially speculative assets because they are too volatile to fulfil the traditional functions of a currency, unit of account, means of payment and liquidity reserve instrument. As a unit of account, a currency with a limited supply cannot be managed. This is the case with Bitcoin. A maximum of 21 million units are planned with just over 18 in circulation and of this total, three appear to be lost. As a means of transaction, commercial use in the United States in November was less than \$300 million, a paltry figure compared to annual U.S. consumption that is about \$15,000 billion. A brake on the widespread use of crypto transactions lies in its validation time that requires around ten minutes.

What is more problematic is its energy consumption, using up to 800kWh while a Visa transaction uses less than 2Wh. To date, the use of bitcoin is low with just 150 million transactions per year against 400 billion for credit cards. Nevertheless, mining already consumes more than 400TWh, almost equivalent to the annual consumption of France, 500TWh. More than 50% of the miners are in China and are using fossil fuels. The more miners there are, the greater the computing power deployed, the more expensive the energy bill will be, and the more negative the energy footprint will be.

There will be coexistence between traditional and digital payments because the major central banks will be organizing for it, but the possible coexistence of public and private currencies is another issue. Competition, or even the substitution, of digital payment methods for currency and credit cards will take place, but not necessarily with private cryptos.

To switch to private crypto would be to sever a contract of trust and break a social bond. This is because until today, money is issued in return for credit – it is fiduciary and accepted by society, and the central bank, the apex institution and lender of last resort, provides liquidity and manages interbank balances. If money is an expression of state sovereignty, then Bitcoin and other cryptos are not currencies.

But will cryptocurrencies be able to offer this confidence? Will they be able to offer stability in their value to facilitate transactions? Are we willing to accept the risk of conversion? Is there not a risk of fraud?

Private cryptos should therefore remain a speculative investment instrument, not a hedge strictly speaking, because, like Gold, one cannot qualify, quantify, nor establish a symmetry between Bitcoin and any other investment. Price volatility is inherent in the narrowness of these markets. Value is a leap of faith and not a rational analysis as can be conducted on the assets of a listed company.

What about GAFAM? Today, Apple with ApplePay and Alibaba with Alipay offer credit cards, but the settlement goes through the banking systems, and also offer loans or investments, but in partnerships. Facebook, with its 2.4 billion users and the data collected on them, and with its economies of scale, wanted to launch "Libra", a multi-currency digital currency – a universal currency with reserve assets consisting of a basket of currencies. By the end of 2020, the Libra project was abandoned and Facebook is now working on "Diem", a digital currency linked to the \$. But if this succeeds, will it not lead to the fear of technology giants having a grip over a social network that is larger than any country? Should we accept granting private companies an oligopoly over means of payments? Yes, insofar as the payment settlement provided by Amazon or Alipay is ultimately guaranteed by central banks. Not necessarily, if

it is a cryptocurrency payment, with the use of a blockchain supported by ETFs or tokens. Should these companies not, as long as they are competing with banks, be subjected to the same regulations as banks? Is this not partly the reason behind the recent intervention of the Chinese authorities against the IPO of Alipay?

Let us anticipate that the states will regain control with the launch of digital currencies. In addition to current monetary policies, this would offer a capacity for direct action, a possibility of "helicopter money," i.e., direct credit to the accounts. Compared to traditional money transfers, the benefits for users would be lower transaction costs, no taxation of deposits as today in the Euro zone and Switzerland, and greater speed. Compared to current cryptos, the advantage would be an elimination of volatility and possible traceability in case of fraud. Would users accept the disappearance of payment with cash? Initially, there would be substitutability between liquid and digital assets, with the advantage of eliminating the harm caused by negative interest on the Euro or the Swiss franc.

The question for this national digital currency would be the direct or indirect link between users and the central bank, in other words, the role of the current banking systems. Either the digital currency would only be used for settlements between banks or it would be a currency available to everyone. If households were to have a digital account directly with the central bank, then this would lead to a shift towards disintermediation of credit. The traditional transmission channel of monetary policy, credits create deposits, would be altered and commercial banks would suffer the consequences on their intermediation revenues. The Central Bank would have to refinance banks to compensate for the reduction in banks' credit capacity caused by the transformation of part of the deposits into digital currency. The Central Bank would also bear the credit risk, and would have to be recapitalized in the event of default.

### ***Conclusion:***

The state-issued digital currencies will provide a solution to the 1.7 billion who, according to the World Bank, are deprived of bank accounts as an application on a mobile phone will suffice. One of the major advantages of cryptocurrencies is the low cost of intermediation, but for private cryptocurrencies, the savings are nothing compared to the price volatility and there seems to be a hindrance in its development:

It has often been said that the gold standard, with its erratic production in the face of growing trade, is unsuitable for being the international currency. What about a supply, like that of Bitcoin that is limited to 21 million units?

Can we be confident if there is no identified issuer, no counterparty, no property right of an asset? The value of a share on the stock exchange is the equivalent of the value of a company, its equity, its intangible assets. The value of a public bond is the equivalent of a country's existing wealth. Nothing like that for a private cryptocurrency.

Isn't the anonymity of transactions an open door to illicit transactions?

What about supervision, regulation of issuers, protection of users and risk of default? Under the current payments system, central banks are lenders of last resort but there is no equivalent with private cryptos. If tomorrow the Fed, the ECB, the Bank of China launch an e-currency, the risk will be non-existent since it will be a centralized system and there will be less costs than with traditional bank transfers. But what about Bitcoin and other cryptos?

How can the problem of volatility be solved to make these cryptos a means of payment?



Finally, at a time when everyone is concerned about global warming, we cannot ignore the huge impact of electronic transactions on global electricity consumption.

Let us stop here with these three fundamental but delicate topics of the evolution of the international monetary system, the role of central banks, and the relative place of future digital currencies and private cryptocurrencies. The purpose of this Letter was to raise some questions and provide some answers to these new topics but, let us be modest and conclude with *Chateaubriand*, "*Everyone looks at what I look at but no one sees what I see*".

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