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Libra: Regulatory intervention is called for !

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From the point of view of the Chief Economists of the Savings Bank Finance Group, the public hype about the macroeconomic significance of "Libra," Facebook's potential new accounting unit, needs to be followed up by a level-headed attempt to put it into economic perspective:

→ Libra is to be backed by a reserve basket containing existing currencies and is therefore to be viewed, in the first instance, as a unit of account. It could, however, evolve in future into a digital currency, i.e. a monetary unit, which raises fundamental questions about monetary systems and financial stability.

→ If money is to be created with Libra, the question arises as to whether Libra can morph into a sustainable, intrinsically valuable asset if users utilise the smart-contract templates provided for lending purposes. We consider that it would be highly problematic if Libra were to be allowed to move on into the stage of being a fully-fledged currency enabling autonomous credit money creation.

→ It remains imperative that central banks and supervisory authorities closely monitor the way cryptotokens develop. For no stone must be left unturned in the effort to avert dangers to financial stability.

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Libra: Regulatory intervention is called for !

Libra - the starting-points of the debate

The authors of the Libra white paper published this June have sparked a heated debate on the future of money - a debate which has also been picked up and continued by Germany's Bundestag. Discussions about the implications for supervisory bodies and central banks are now reaching fever pitch as well.

In the mission statement provided by Facebook and its 28 partners in the white paper, it is emphasised that 1.7 billion people have no access to financial services and that especially "people with less money" are compelled to pay too much for their transactions. Accordingly, a central reason for the envisaged introduction of Libra is to speed up and simplify payment transactions. In this connection, Facebook has pointed out that it is planning to set up an independent non-profit organisation called Libra Association, based in Switzerland, whose task it will be to accomplish these goals. What is left unanswered here, though, is the question of how the promise that people, especially in less developed countries, will be able to transfer Libra everywhere and at any time into euros or US dollars via "authorized resellers" can be honoured.

At this point, we would like to draw attention to the fact that neither Facebook nor almost all its associates are non-profit organisations. In our opinion, the Libra initiative is not a not-for-profit project but rather a profit-oriented venture. In the long run, the plan is presumably to generate earnings from the link-up between advertising business and e-commerce, from operating a payments system, from using a currency and from utilising the data gathered in the process - even though the latter is explicitly ruled out in the white paper. Although first-stage Libra is to be a derivative "complementary currency" (currency-board regime) without an autonomous monetary policy, it could - depending on the potential size of this new payment system - have disruptive effects on the financial system.

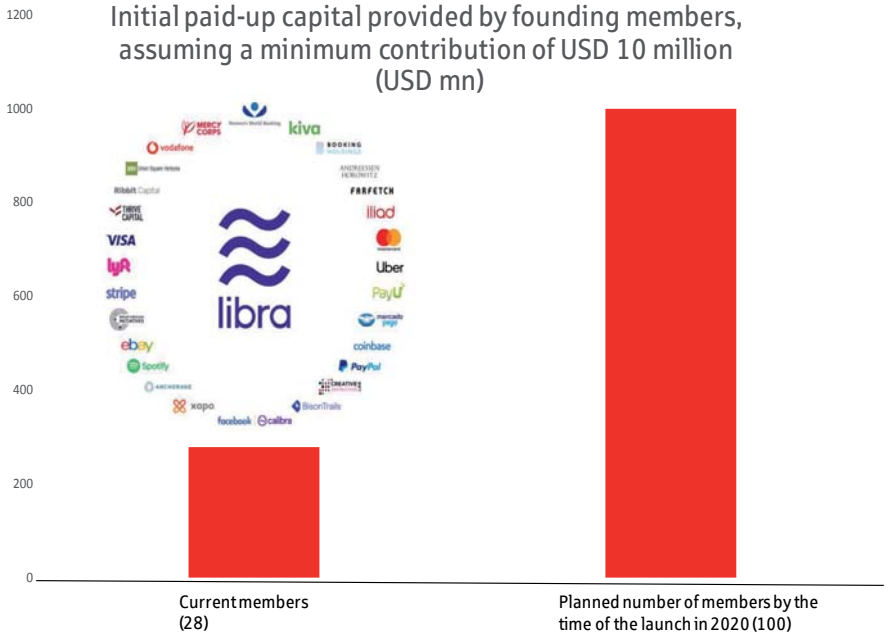
Libra Inititaitve is not a not-for-profit project

Using a support structure encompassing a variety of enterprises that is unique for a digital company, Facebook, the initiator of the project, has created an institutional configuration which is designed to enhance the social acceptability of the company's business expansion into the financial sector. Whether such a consortium with many diverse interests is suited to the task of keeping a payment system running in the long run will have to be demonstrated by the field trial. At all events, the control options available to Facebook, the initiator, as well as to the other associates are extensive.
It is accentuated in the white paper that the association due to be founded in Switzerland is not supposed to operate a stand-alone monetary policy. At

the same time, though, we are informed that "top banking institutions" or "authorized resellers" classified on the basis of their top credit ratings will be able to put Libra coins into circulation. These institutions are to receive "incentives" to create Libras. Such "prices/incentives" invite a comparison to the role of interest rates in the existing monetary system. According to the white paper, Libra coins must invariably be backed by assets from the underlying reserve basket. The Libra currency will thus practically reflect the average monetary policy of the currencies in this reserve basket; the white paper also mentions that the reserve basket's composition may be adjusted over time, meaning that it is going to be subject to fluctuations in valuation for this reason alone. However, the white paper does not address/ answer any questions about financial-market stability.

Is Libra not a new kind of money?

The remarks in the white paper only permit the general conclusion that Libra is, in effect, going to be pegged to a basket of currencies dominated by the US dollar and the euro; more precise information on this score is lacking. All that can be inferred in quantitative terms is the size of the foundation's paid-up capital if all 28 sponsors listed transfer their USD 10 million minimum capital contribution; even if Libra achieves its objective of "approximately 100 members" by the time of the target launch in the first half of 2020, aggregate paid-up capital would only amount to a mere USD 1 billion. This initial capital is needed to set up and operate the association and will also perform the function of liable equity capital, thereby having claims on the association's possible profits. In addition, however, all Libras ordered by customers for transactions would be backed by a reserve of "real assets."



Source: Own figure

"Libra" will be digital book money to be obtained in exchange for established currencies, the currency unit being called "Libra coin". Transfers of such book money within the Libra network are supposed to be quicker, simpler and cheaper than in conventional payment systems. The technology involved is a variant of the distributed-ledger model. To that extent, the name used in the white paper, Libra Blockchain, can be regarded as a purely marketing-driven designation. In contrast to the Bitcoin or Etherum models, the proposed technology only outwardly resembles a blockchain - there are, however, essential differences. For example, access to the technology is not granted to all users but only to about 100 operators ("validator nodes"). We are talking, in effect, about a "private" blockchain.

Currency basket pegging with advantages and disadvantages

The operational capacity of the Libra network is therefore higher than in the case of Bitcoin (1,000 transactions per second instead of just seven). The technology beneath the bonnet of this "blockchain" is different as well. One ought perhaps therefore to speak rather of a decentralised data base with restricted access, in which all 100 operators are permitted to enter transactions. Less computing power is needed in this connection than in the case of Bitcoin, and energy consumption is accordingly lower. A key difference to existing cryptotokens is that the volume of Libra currency reserves created is to be backed by a basket of conventional currencies. Libra is therefore not limited from a volume point of view (unlike Bitcoin) but is, on the other hand, "backed" by paper money (which, conversely, is not "backed"). The utility deriving from this is that fluctuations in the Libra's value relative to conventional currencies can be smoothed out (so-called stablecoin): in the event of a pronounced sell-off in the Libra relative, say, to the US dollar, a Libra operator ("validator node") can decide to buy Libra coins from the pool of currency reserves at a price he or she determines, thereby stabilising the exchange rate. Given, however, the frequent bouts of heavy exchange-rate volatility between global currencies, the Libra will - depending on the composition of the underlying reserve basket - be exposed to a possibly considerable exchange-rate risk vis-à-vis the respective domestic currency.

Whether - and, if so, to what extent - private partners were prepared to satisfactorily stave off possible speculative attacks in order to stabilise a new Libra currency is, admittedly, a cardinal question. Yet the currency reserves available to the Libra Association ought, in principle, to suffice. Such exchange-rate smoothing, along with the obligation to convert the new unit back into hard currency, would be a core pledge, the violation of which would presumably soon lead to Libra's demise. One way in which Libra would differ from state-sponsored currencies is that money creation and money destruction would be steered purely passively in line with market requirements (so-called currency-board regime). There would be no "monetary policy." No money creation would take place through the extension of loans by banks. On the other hand, all these passive features could

be jettisoned at some point if Libra became established, if Facebook were to apply for a banking licence and if this were to be allowed by the regulatory authorities. Ultimately, it really ought to be clarified prior to the Libra Association's launch in the first half of 2020 why none of the association's members has, as yet, applied for a banking licence. For the Libra Association is a "narrow bank:" it has shareholders, administers assets and earns interest. The advent of the Libra Association could see the dream of liberal economists coming true: there would finally be a private currency competing with established state-controlled currencies.

Competition from private currencies would mean that - rather like in the TV industry after private television had gained regulatory approval - the public sector would only be in a position to offer one out of several possible options. To enable more rapid dissemination of its Libra system, Facebook could, for example, offer traders participating in its network financial incentives to use the new currency. Some market watchers have hopes that private currencies could bring into being a financial world devoid of inflation and crises. In view of what history teaches us here and of the business-policy plans of those issuing private currencies, such notions of a crisis-free financial system are probably an illusion because all the questions about stability directed at a public-sector currency system would also apply to a private-sector system (preservation of monetary value, bank security, deposit security, reliability of operation, etc.). However, issuance of private currencies would entail the earnings accruing from this activity, as well as decision-making power, flowing to the private sector.

Unsettled questions regarding Libra

The repercussions of Facebook's putative currency on the financial system will depend very much on the extent of its reach. In the past, regional private currencies ("local exchange trade systems," LETS) have repeatedly elicited the attention of central banks. The Bundesbank has always been prepared to tolerate such LETS currencies as long as their reach remained merely regional and as long as certain further criteria were fulfilled (as in the case of the still existing "Chiemgauer," which started as a south German school-currency project). Such a merely regional reach is not to be expected in the case of Libra; on the contrary, it could very rapidly find more voluntary users than the involuntary ones forced to use many of the individual national currencies that are legal tender in the countries concerned. Even if every Facebook member were to convert only a small amount into Libras, that could quickly result in a pool of currency reserves equivalent to those of major nations. In crisis phases, this could, in turn, significantly aggravate stress symptoms within the financial system - for instance, if large volumes of government bonds were required or on offer due to mass conversion or reconversion into Libras.

In crisis phases, Libra could significantly aggravate stress symptoms within the financial system

In the first instance, it would be the international payments system, above all in many threshold countries, that would be immediately affected. In this connection, Libra would be an interesting alternative to cashless payment transactions, and one which would be more cost-effective than the offerings of existing providers. Admittedly, it needs to be noted that functioning mobile-payment systems are already up and running - WeChat in China and M-Pesa in Africa. Even though the concrete modes of use by people without access to the existing payment system remain unclear, it is here that the most immediate utility would presumably be unlocked. Banks, along with other international payment-transactions service providers whose business model is geared to international payment services (Western Union is a case in point), would find themselves confronted with a direct competitor. Within developed economies too, payment-transfer services and bank-system deposits would migrate to the extent that users moved over to utilising Facebook's currency.

Questions regarding social responsibility

Over and above this, questions have to be asked regarding social responsibility. What power can be wielded by a financial-services provider on whom people - and thus states - in developing countries are completely dependent? Will further competing currencies be able to come into existence at all, or will the incumbents/"first movers" in the market buy up all other start-ups in the same way that they have done in the case of their social-network activities?

In its current conception, Libra is not to be construed as a new form of money, but only as a cryptotoken, i.e. as a unit of account. Nonetheless, checks should take place to determine to what extent there need to be clear regulatory stipulations concerning currency-basket management (e.g. no lending transactions beyond the purchase of government bonds, so as to ensure immediate redemption at any time). It is also necessary to look critically at the rules governing how Libra coins are created by the companies participating in the project. At least according to the white paper, new Libras are only permitted to be minted "when authorized resellers have purchased those coins from the association with fiat assets to fully back the new coins." Such cash resources are then to be invested in government bonds and other short-term securities. Libra would only grow into an autonomous form of money if the planned Libra Association were to operate its own monetary policy and if Libra were to evolve into an accepted social norm by gaining the acceptance and trust of users ("money is what serves as money"). However, such a scenario is not to be inferred from the current conception. The white paper has the following to say on this score: "The association decided not to develop its own monetary policy but to inherit the policies of the central banks represented in the basket." Or to put the point a different way: the association is not permitted, at least not for the

time being, to engage in fractional reserve banking, i.e. to put more Libras into circulation than is "allowed" by the corresponding stock of reserves. However, if the 28 current members of the consortium, or the 100 founding members on which Facebook has set its sights, were to agree on decoupling Libra from the underlying reserve basket, that would naturally be possible at a later date.

From a currency-policy and stability-policy point of view, the implication of the new currency launch is that the Libra is comparable to the Singapore dollar (which is pegged to a basket of currencies) or to the German regional currency "Chiemgauer" (pegged 1:1 to the euro) referred to above - albeit with far greater market potential. It remains to be seen to what extent a kind of private global currency - of the kind already proposed in 1961 by later Nobel laureate Robert A. Mundell when suggesting the introduction of a "globo" - can be put in place further down the line through management of the basket of currencies and by dint of sheer volume. Mundell did, however, at least envision the world's states as stakeholders in such a new global currency; his proposal could now pave the way for a privatised global currency system.

The ball remains in the court of central banks and regulatory authorities

Development remains problematic from a stability-policy perspective

To that extent, policymakers would be ill-advised to simply let such new developments run their course. For developments leading to a currency which could be controlled by selected companies is, and will continue to be, problematic from a stability-policy perspective. The lender of last resort should always be an independent central-banking system which is committed to the objective of ensuring price stability.

In contrast to central banks, private-sector actors cannot and will not always, in case of doubt, take monetary-policy action in keeping with the axiom "Whatever it takes" in order to safeguard a currency or unit of account they have issued. The reason for this lies in the way in which they differ from central banks: no powerful stability mechanisms such as government budgets underpin private currencies. Many observers may welcome a severance of the link between states and currencies, arguing that "no taxpayers' money could then be wasted on bailing out the errors of the financial sector." Such a severance would, however, entail a danger of whole currencies, along with the claims of those using them, being wiped out relatively quickly due to the absence of robust backstop mechanisms. The point is that operating a currency as a basic financial infrastructure for entire economies is hardly a simple matter and sometimes requires very sizeable financial reserves being mobilised. For example, if citizens were to witness drastic Libra devaluation and if Swiss society, for whatever reasons, were unwilling or unable to take countermeasures, the accumulated capital of the not-for-profit organisation

Libra Association would very quickly be exhausted. The association would have to cease converting Libras.

However, we do not take the line that cryptocurrencies ought to be prohibited in principle or that central banks should "buy up" the new currency. It should be recalled that Germany's financial-services supervisor BaFin and other regulatory authorities already permit so-called "security tokens," i.e. regulated cryptotokens. The efficiency advantages they offer are simply too manifest - the rapid, problem-free, low-cost transfer of funds for those using this type of money. All that we consider highly problematic is the development of private currency concepts which have moved on from the stage of being purely derivative accounting units to being fully-fledged currencies involving autonomous credit money creation. In that respect, avoiding such a development and preventing disruptive effects on the monetary policy being operated for established currencies is one of the principal tasks facing regulators. The second major regulatory issue involves controlling and circumventing illegal financial activities and preventing the legalisation of illegal money. In particular, there is reason to sound a warning that the possibility of private users of the Libra Blockchain programming their own smart contracts and setting up more complex financial transactions throws open the door wide to cyberattacks. What matters at the end of the day is to ensure a level playing-field. Finally, it is important to ensure by means of competition policy that Libra providers do not prevent start-ups offering future alternatives in the cryptotoken field from entering the market, or that they do not indeed buy them up.

Libra highly problematic as a private currency

When it comes to regulation of Libra, global solutions need to be devised, or there at least needs to be uniform EU-wide regulation. In particular, central banks should themselves investigate to what extent they, together with savings banks and other types of commercial bank, can make use of the advantages of cryptotokens for the benefit of their home currencies. If the proportion of cash in circulation is reduced as a result, that could lower the cost of cash transactions and even make it more possible to enforce negative interest rates (not that we are in any way advocating the prohibition of cash). The sovereignty of central banks, for example with respect to a digital e-euro, can also help with law enforcement. In the event of criminal activities, for instance, e-euros could be frozen and, if necessary, invalidated and taken out of circulation. E-euros could be employed in cross-border payment transactions to enable simple, inexpensive and rapid payments. Here too, however, it would be important to pay due regard to the macroprudential implications, and hence to the stability of financial systems. New digital entities would not create a new kind of money; they would mean that a small portion of the existing money supply was digitalised and made available to a global infrastructure.

What remains decisive at the present juncture is that central banks, supervisory authorities and the banking sector build up their own stock of know-how regarding digital money. Facebook's venture to set up a currency of its own is an indication that the monetary system is not sheltered from technological progress either, and that cryptocurrencies are going to be an integral fixture in the financial system of tomorrow. To simply accept such new developments uncritically and then wait to see what happens would be the wrong approach to be adopted by politicians, regulators, monetary institutions, and society in general.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks or the DSGV.

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