



Consensus Currency Musings

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BITCOIN CO-EXISTING WITH FIAT CURRENCY AND THE BANKING SYSTEM

As bitcoin grows in popularity, so, too, might the school of thought that supports diminishing the central banking system. In our opinion, bitcoin will ultimately be successful without limiting the power of central banks in any way, nor will it lead to the abolition of central banks. Rather, a fiat currency will exist alongside a cryptocurrency, alongside perhaps many cryptocurrencies. But countries' fiat currencies will still continue to exist.

From the point of view of inflationist policymakers, they really should not oppose cryptocurrency, because it is the greatest gift that they could ever hope for. Inflation is very painful, so if one is going to engage in that policy, bitcoin serves as an escape valve. If an individual or institution, like a pension fund, really does not want its money to be inflated or debased, it can always transfer its fiat currency into bitcoin. Here is why that is a boon to policymakers, not a threat.

The cryptocurrency technology, the blockchain, cuts both ways. The great worry of policymakers would be that if a non-debasable cryptocurrency like bitcoin were permitted to flourish, it could pose the risk of demonetizing the banking system. People would withdraw money from their bank accounts to buy bitcoin. Except that the central banks, including the Federal Reserve, are now planning for digital versions of their own fiat currencies, in other words, their own cryptocurrencies. If a country has digital fiat money, the money cannot leave the system.

Say, for example, I have \$100,000 in the bank and it is digital. Theoretically I could withdraw that money and buy \$100,000 worth of bitcoin, but then the person who sells me the \$100,000 of bitcoin will have that money in the bank. The digital fiat currency, in other words, cannot leave the system and so it can never demonetize the banking system. Policymakers could inflate to their heart's content, and anybody who does not like it can go buy a bitcoin or some other cryptocurrency if they prefer. Over time, the appreciation of the fixed-issuance crypto over the weaker, constant-issuance digital fiat currency—the exchange rate differential—will offset the debasement of the bitcoin holder's fiat-based investments. *That is the escape valve.*

Furthermore, the evolution of central bank digital currencies will actually spur the adoption of bitcoin. Each government will have its own blockchains; it will set up accounts for everyone, and everyone will become conversant with transferring digital currencies. It will be the primary mode of payment. However, the purchasing power of the various digital currencies will differ. Fiat currency will lose purchasing power, and fixed-issuance cryptocurrencies, like bitcoin, will gain purchasing power in relation to the fiat currency – it sets a loose-monetary policy currency against a fixed-monetary policy currency. We think that is the way it will evolve, and it is indeed evolving very quickly.

Observing just the past couple of months alone, the Fed Chairman Jerome Powell recently said that a central bank digital currency could improve U.S. payment systems, and European Central Bank (ECB)



President Christine Lagarde said before the Franco-German Parliamentary Assembly (September 21) that the ECB may create a digital euro to supplement cash¹.

On October 9, 2020, the Bank for International Settlements (BIS) and seven central banks², published a central bank digital currency (CBDC) report outlining the feasibility and required features for a CBDC to help central banks accomplish their public policy objectives. This lays the groundwork for the future development of such currencies, which the report indicated would coexist with cash and other types of money. The core requirements outlined for a CBDC are:

- Resilient and secure to maintain operational integrity
- Convenient and available at very low or no cost to end users
- Underpinned by appropriate standards and a clear legal framework
- Have an appropriate role for the private sector, as well as promoting competition and innovation

The continued development and eventual launch of such CBDCs surely remove any remaining questions about cryptocurrency's legitimacy.

If we have a FedDollars app or wallet on our phones, which appears to be the plan, how much different would it be to have a Bitcoin wallet?

If people begin to wonder whether a FedDollar wallet will lead to the elimination of cash and to the inability to save or transact money outside of the banking system and Fed oversight, how might they judge the FedDollar wallet versus a Bitcoin wallet, particularly at a time of record-level money creation?

At some point, policymakers would have been in the position of hearing about cryptocurrency for the first time. The initial reaction would be fear that it would supplant the whole central banking and fiat currency system, and they would probably be against it. As they reflected on it, though, they seem to have come to understand that it will never replace the central banking system and fiat currency; it will merely exist alongside it.

The coexistence of fiat currency and cryptocurrency has very constructive implications for dealing with inflation. One problem with inflation is that it impacts the population unevenly: some people benefit from it and some are hurt by it. For an individual living on a fixed income, such as Social Security, it can be truly disastrous if the Consumer Price Index (CPI) does not properly measure the rise in living expenses. Policymakers cannot possibly design an inflationary policy that will be uniform throughout society, because there are too many variables. But, if policymakers gave people the option of switching into a cryptocurrency or remaining in a fiat currency, they might be able to carry out a measured or even a moderate inflationary policy. In that way, cryptocurrency becomes a policy tool that allows more flexibility.

¹ <https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200921~5a30d9013b.en.html>

² Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, Sveriges Riksbank, and the Swiss National Bank, <https://www.bis.org/publ/othp33.htm>, <https://www.bis.org/press/p201009.htm>



Taking the policymakers' point of view, we would come to see it that way. We do not know whether they will, but at least to the degree that we now hear such statements from the highest-level policymakers, it appears to be a possibility. Three years ago, we would say that policymakers' public statements about cryptocurrency were uniformly hostile, and now one could say that they are moderately impartial. That is a significant change in 36 months. They have come further than anybody had any right to expect them to come. And I say this as someone who is bullish on cryptocurrency and bitcoin.

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