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Global Bookmark

The Bonfire of the Currencies?

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Eswar S. Prasad, *The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance*, Harvard University Press, 2021.
Kenneth S. Rogoff, *The Curse of Cash: How Large-Denomination Bills Aid Crime and Tax Evasion and Constrain Monetary Policy*, Princeton University Press, 2017.

SANTA BARBARA – Ready or not, the financial world is being forced to face the possibility of a future without traditional notes and coins. Is cash going the way of the dodo? Should the prospect of its extinction be welcomed or feared? And what would its disappearance mean for domestic and global markets and politics?

Two recent books by renowned economists have set the stage for the coming debates, highlighting two questions in particular. The first is whether cash *should* disappear. The second is whether it actually *will* disappear. Kenneth Rogoff of Harvard University and Eswar Prasad of Cornell University have much to say on both issues.

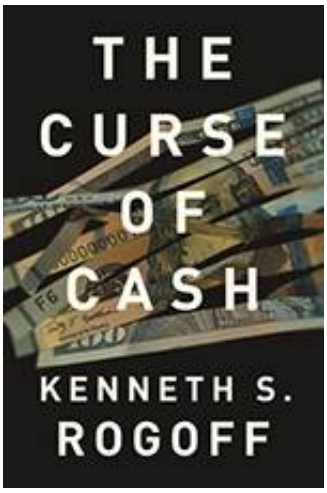
Does Money Make the World Go Around?

For Rogoff, cash is a curse. Paper currency, he argues, "lies at the heart of some of today's most intractable public finance and monetary problems," and thus should be phased out as quickly as possible. He highlights two big problems. On one hand, by permitting large recurrent and anonymous transactions, cash facilitates tax evasion and other crimes. High-denomination bills like US "Benjamins" ($100 notes) or Switzerland's 1,000 franc note play a starring role in a broad range of criminal activities, from drug trafficking and money laundering to racketeering and extortion.

On the other hand, cash handicaps monetary policy. The availability of currency effectively sets a "zero lower bound" on interest rates. Returns on Treasury bills or other fixed-income

securities cannot fall much below zero so long as people have the option of holding paper money, which at least pays zero interest. Cash therefore ties central bankers' hands, inhibiting negative-interest-rate policies.

The Curse of Cash represents the culmination of a campaign that Rogoff has waged for more than two decades, and he pulls no punches in his advocacy of a "less-cash" economy. Written in accessible if somewhat colorless language, it is a clarion call for action – in effect, a manifesto for our times. The sense of urgency is palpable.



Prasad, by contrast, is more in the forecasting business. He believes we are in the midst of a financial revolution that is being driven by "FinTech" – the ongoing wave of innovations in financial technologies that are dramatically disrupting traditional ways of doing business. In the vanguard are cryptocurrencies, a new class of financial instruments that threaten to displace conventional notes and coins. "The era of cash is drawing to an end," Prasad declares, though he hesitates to offer any firm predictions concerning what will come next.

Prasad's text is relatively easy to read, showing flashes of humor despite the complexities of the subject. Its analysis, however, is ultimately inconclusive, because most of its discussions end cautiously (and rather unhelpfully) with words like "seem," "may," or "could." In a book that aspires to be virtually encyclopedic in its coverage, Prasad's takeaway message is that there remain "many unanswered questions."

The FinTech Disruption

Cryptocurrencies have become one of the hottest sectors in finance, led by Bitcoin, which is barely a decade old. New cryptocurrencies have since proliferated like dandelions; according to the International Monetary Fund, there are around 9,000 digital tokens listed on various exchanges today. Earlier this year, the market value of all crypto assets surpassed $2 trillion – a tenfold increase in not much more than a year.

The roots of the crypto boom go back to the dawn of the digital age in the last years of the twentieth century. Traditional notes and coins are creatures of an analog world, physical in nature and reliant on face-to-face interactions. Cryptocurrencies, by contrast, are digital – that is, based on encrypted strings of zeros and ones – and transferable through vast electronic networks.

Once computers and the internet came to be part of our daily life, smart operators realized

that it might be possible to create units of purchasing power that would be fully usable through cyberspace. The race was on to produce "virtual" money that could be employed as easily as conventional paper money or coins to acquire real goods, services, or assets.

The earliest attempts to achieve this, going back to the 1990s, aimed simply to facilitate the settlement of payments electronically. These initiatives, which *The Economist* once playfully labeled "e-cash version 1.0," included diverse card-based systems as well as network-based systems. Operating on a principle of full pre-payment by users, each scheme functioned as not much more than a convenient proxy for conventional cash – in effect, something akin to a glorified traveler's check. Few caught on with the general public.

Subsequent models, "e-cash version 2.0," were more ambitious, aspiring to produce genuine substitutes for traditional notes and coins. Examples included Flooz (using the comedienne Whoopi Goldberg as a spokesperson) and Beenz. But the impact of these schemes, too, was limited, because most were offered as a reward for buying products or services from designated vendors – constituting, in effect, updated electronic versions of ancient scrip. Vendor-specific media live on in airline mileage programs and the like; but they failed to provide a direct substitute for traditional currency. Most disappeared after the brief downturn in financial markets at the turn of the century.

Revolutionary Dawn

Then came Bitcoin, a revolutionary innovation introduced in 2009 by a person (or persons) who remains anonymous. Bitcoin could be called "e-cash version 3.0." Designed as a decentralized payments system independent of governments and private financial institutions, the currency has soared in popularity. Since Bitcoin's unheralded inception, its price has skyrocketed from $1 per unit to as much as $66,000 earlier this month.

Many other digital currencies, including increasingly well-known rivals such as Ether, Litecoin, and Ripple, have followed in its wake, especially over the past year. Prasad calls Bitcoin the "granddaddy" of cryptocurrencies. Digital money is now an established part of the global financial ecology, and has been declared legal tender in two countries, El Salvador and Cuba.

Prasad finds it hard to conceal his enthusiasm for Bitcoin, which he describes as "truly ingenious and innovative." Words like "magic," "genius," and "elegant" are liberally sprinkled throughout his discussion. For anyone who really wants to understand how the currency works in all its technical splendor, there is no better introduction than Prasad's fourth chapter, which dwells on the Bitcoin revolution in elaborate detail.

There you will find a step-by-step tutorial on the currency's underpinnings – the so-called blockchain technology that enables Bitcoin to function without any trusted central authority to manage it. No government agency or private institution is needed to validate transactions. Instead, blockchain relies exclusively on a public consensus mechanism managed through a peer-to-peer network that alerts participants to every exchange in real time. A publicly shared ledger of transactions is created and maintained in a decentralized network.

The ledger is called a blockchain because once transactions coming into the network are grouped into blocks of data and validated, the blocks are then chained together. The "magic" comes from delegating trust and verification to the public square. As Prasad breathlessly puts it, "This is people power, backed up by computing power, at its finest."

People power to manage money is obviously attractive to libertarians and others who, taking inspiration from the Austrian economist Friedrich von Hayek, have long argued for the "denationalization" of currency. Governments, driven by politics, all too frequently abuse their control of "state" money, sooner or later generating runaway inflation. In recent years, we have seen that ruinous process devastate countries like Venezuela and Zimbabwe.

Cybercurrencies, by contrast, are designed to rely on market forces to keep the growth of money supply in line with real economic activity. Inflation, crypto enthusiasts contend, will be contained by the wisdom of crowds.

The Cracks in Crypto

But there are also downsides, and they are not insignificant. First and most obvious is the danger that competition among cybercurrencies could lead their sponsors to take ever greater risks. Many of the thousands of digital tokens currently available are backed by nothing more than flimsy promises. Even so-called "stablecoins" like Tether or USD Coin, which in principle are fully backed by conventional reserves, are in practice often quite lacking in transparency.

Observers frequently liken today's cybercurrencies to the private bank notes that circulated in the United States during the co-called free-banking era of the nineteenth century. But that system was fragile and frequently subject to "runs," owing to the ebb and flow of public trust. Crowds did not always show the greatest wisdom. Why should we expect today's

cybercurrencies to be any less prone to panics and wild price fluctuations? Just in the last year, Bitcoin has traded up and down by over 50%. Prasad calls it “wacky … a wild roller-coaster ride.” Others might call it a bubble that could burst any time.

Second, the prospect of unfettered price volatility limits cybercurrencies’ usefulness as a medium of exchange. Who wants to accept payment in a currency whose value might drop through the floor tomorrow? Admittedly, there will always be some market actors, particularly criminal elements, who might value cryptocurrencies’ supposed anonymity enough to take the risk.

It stands to reason, then, that Rogoff’s complaints about the role of cash in facilitating tax evasion and other nefarious activities apply to cybercurrencies as well. But Rogoff himself suggests that the real threat from cybercurrencies lies elsewhere. “Yes,” he says, “digital currencies raise important questions for the future, but more as competitors for other financial instruments and institutions, not so much for paper currency.” Prasad agrees, suggesting that the allure of digital currencies for illegal activities is wearing off. Some scholars, however, estimate that criminal activities still account for as much as 50% of Bitcoin transactions.

Moreover, the legitimate business world does not appear to be attracted to the quotidian use of cybercurrencies. Instead, cybercurrencies have primarily become a vehicle for risk-loving investors, serving as a class of speculative assets reminiscent of the seventeenth-century tulip mania in the Netherlands, when a single bulb sold for the equivalent of a mansion on the Amsterdam Grand Canal. In a sense, the “cybercurrency” label is a misnomer, because none of these new creatures actually perform all three of the traditional functions of money: medium of exchange, unit of account, and store of value. They are, at best, liquid quasi-moneys.

The State vs. Crypto

Looming over the entire incipient debate is the possibility of a real threat to state authority in monetary affairs. The more that ordinary transactions come to be conducted in cryptocurrencies, the more difficult it will be for monetary authorities to manage existing payments systems via traditional interest-rate policy or open-market operations. If traditional cash becomes largely extinct, so, too, does much of the power of central banks.

That is why we now see mounting interest around the world in the development of central-bank digital currencies (CBDCs). As Prasad points out, there is nothing mysterious about central-bank digital money. It is simply an existing fiat currency that is issued by a monetary authority in digital form as a complement to or in place of conventional notes and coins. For a clear guide to the merits and risks of such an innovation, readers could do worse than to consult Prasad’s sixth chapter, which provides a careful point-by-point examination of the case for CBDCs.

The rationale for CBDCs is simple: fight fire with fire. If conventional paper money really is going the way of the dodo, monetary authorities should create a more attractive alternative. In any competition with privately issued rivals, CBDCs would have the advantage of being firmly backed by the full faith and credit of their sovereign governments. One country, the Bahamas, has already created a CBDC of its own – the sand dollar – and others like Sweden and Uruguay are quickly moving in the same direction.

Who will prevail? Writing some five years ago, before the cryptocurrency craze really took off, Rogoff expressed confidence in governments' ability to fend off any competitive threat from the private sector. This is not the first time, he points out, that currency innovations have emerged from the private sector to leapfrog ahead of publicly issued money, at least for a time.

In every previous instance, he insists, innovations were either tamed by regulation or appropriated by governments, which have broad advantages in providing a safe guaranteed asset. Some governments, most notably China, have already begun cracking down on cryptocurrencies. "If the private sector comes up with a much better way of doing things," Rogoff observes, not without a touch of cynicism, "the government will eventually adapt and regulate as necessary to eventually win out."

But Prasad is not so sure. Writing more recently, he notes that cryptocurrencies have come a long way in the last half-decade. Yes, he concedes, central banks are likely to remain central. But that does not rule out sustained rivalry between the private and public sectors. Privately issued digital currencies have competitive advantages of their own, including faster, lower-cost transactions and broader access to financial products and services. A "glorious future" beckons, Prasad concludes – before adding, "perhaps."

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