Project Syndicate

Eswar Prasad Says More...

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Project Syndicate: *Last year, you warned that the pandemic recovery would be uneven, with the 2020 recession leaving "long-lasting scars on both GDP and employment" in most regions, including Europe and Latin America. How is the Ukraine war, and the Western sanctions leveled against Russia in response, likely to affect the trajectory of the global recovery?*
Eswar Prasad: This year will be a tough one for global growth, not only because of the Ukraine war, but also because of the resurgence of COVID-19 in China and the limited policy space that most governments have for responding to the economic pressures they face.
The pandemic's disruptive impact seems well contained in most parts of the world, but with new variants continuing to emerge, the coronavirus remains a wildcard. In China, however, an apparent determination to stick to an increasingly unviable zero-COVID strategy, which has recently necessitated lockdowns of major cities like Shanghai, already poses serious risks. China might have to resort to further stimulus measures to maintain decent growth.

Meanwhile, escalating geopolitical tensions have exacerbated global supply-chain disruptions. With prices surging even before the invasion, and demand having generally held up in most major economies, this is likely to compound inflationary pressures around the world. And if demand begins to flag in the face of mounting economic uncertainty and financial-market volatility, the ability of most governments and central banks to use fiscal or monetary policy to bolster it will be limited.

The US economy continues to power along, with the labor market having healed to pre-pandemic levels, at least in terms of headline employment and unemployment rates. But the US Federal Reserve could well control of inflation and be forced to tighten monetary policy even more aggressively than it has signaled, raising the risk of a marked slowdown in growth.

These factors will further tighten the vise on developing countries, many of which are already suffering from surging inflation, a strengthening US dollar, and tightening financial conditions that will restrict their access to foreign funds.
PS: *In 2020, you predicted that China's new digital currency and its cross-border payments system would enhance the renminbi's role as an international currency, as long as the country continued pursuing liberalizing reforms. Nonetheless, you argued, the US dollar would retain*

its status as the dominant global reserve currency. Have Western financial sanctions against Russia – which have frozen Russian assets and excluded some Russian banks from the SWIFT financial messaging system for international payments – altered your outlook? How might China leverage the crisis to expand the renminbi's global role?

EP: New financial technologies have been driving several changes, all of which could now gather steam. For example, new technologies are facilitating direct transactions between pairs of emerging-market currencies. By reducing reliance on "vehicle currencies," this is likely to erode the US dollar's role as an international payment currency.

At the same time, China's Cross Border Interbank Payment System, which facilitates direct payments and settlement with other countries' payment systems, could bolster the renminbi's role as an international payment currency. The CIPS also has messaging capabilities that could sideline SWIFT. What will not shift the balance of power among major payment currencies is China's digital renminbi; after all, international payments are already digital.

In any case, the fundamental structure of global finance, including the relative importance of the major reserve currencies, will not be easily shaken. Digitization will not, on its own, elevate the renminbi's status as a reserve currency. And while China has made progress in areas that could make a difference here – such as liberalizing cross-border capital flows, bolstering exchange-rate flexibility, and giving foreign investors greater access to Chinese bond markets – the government has disavowed institutional changes, including central-bank independence and rule-of-law guarantees. Such changes would be essential to win the trust of foreign investors.

Given all this, the US dollar is likely to retain its role as the dominant global reserve currency. And while its use as a payment currency might be eroded, even this is not guaranteed. Global investors might embrace private stablecoins backed by US dollars over those backed by other currencies, thereby bolstering the dollar's prominence. The likeliest prospect is a reshuffling of the relative importance of other currencies, with the US dollar retaining its primacy.

***PS:** At our upcoming Finance 3.0 event, you will participate in a discussion about what lies ahead for crypto and crypto-adjacent industries amid tightening financial conditions and massive geopolitical upheavals. During the Ukraine crisis, some policymakers, such as European Central Bank President Christine Lagarde, have worried that cryptocurrencies will undermine the West's response to the Ukraine war by enabling Russia to evade sanctions. Will they? More broadly, how will cryptocurrencies factor into the strategies of countries seeking to reduce their dependence on a Western-dominated international financial system?*

EP: Decentralized cryptocurrencies such as Bitcoin do not yet offer the scalability to enable the evasion of economy-wide financial sanctions, especially since they must be converted into more widely accepted currencies to make international payments. Even if Russia accepted Bitcoin as payment for its exports, it would struggle to use a cryptocurrency to pay for imports. And cryptocurrencies cannot prevent a country's currency from collapsing in value relative to major reserve currencies, because those values are determined in formal financial markets.

While governments cannot count on cryptocurrencies to provide a reliable and scalable sanctions workaround, citizens might view them as a better option than a plunging domestic currency. In this sense, crypto might make things worse for Russia: citizens could dump rubles – in particular, ruble-denominated deposits – in favor of crypto, which would facilitate capital flight.

Many central-bank consortiums are working on using new digital technologies, including wholesale versions of central-bank digital currencies, to improve the international payment system. But these approaches will be regulated; they will hardly help a rogue government to subvert sanctions.

BY THE WAY . . .

PS: *In your latest book, The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance, you show how new financial technologies can help developing economies, such as by improving their access to global financial markets. But you also argue that these technologies could hurt them, say, by making them more vulnerable to major central banks' policies or even threatening the survival of their native currencies. How can regulators and international institutions maximize the benefits and mitigate the risks?*

EP: New financial technologies can do significant good, but it is becoming clear that neither new technologies nor decentralized frameworks are sufficient to mitigate the risks such technologies raise. Government oversight is necessary to minimize the risks to consumers and investors, and to limit negative spillovers into traditional financial markets.

As developing economies attempt to manage new cross-border payment systems and other frameworks that facilitate international capital flows, they will also need to confront increased capital-flow and exchange-rate volatility. But a key tool on which governments have long relied – capital controls – is less potent in this new context. This raises serious challenges for national regulators, especially because it is often not clear which entities must be regulated or how certain products and services should be classified. Moreover, many new technologies are not constrained by traditional borders, so international coordination will be vital.

The United States may be poised to assume a key role in defining global standards for regulating new financial technologies and products, including cryptocurrencies, stablecoins, and blockchain-based finance. US President Joe Biden's recent executive order on "ensuring the responsible development of digital assets" sets out an ambitious agenda for such regulation. But key challenges remain, including determining which agencies should be responsible for regulating particular products and technologies, and developing specific regulatory policies that mitigate risks without hampering innovation excessively.

PS: *You also predict that cash is on its way out. What are the biggest obstacles to this transition, and what dangers does it entail?*

EP: As consumers, businesses, and governments worldwide embrace digital payments, the era of physical currency or cash is coming to an end. Digital payments have distinct advantages over cash, which is susceptible to theft, loss, and counterfeiting. The shift away from cash will bring economic activity out of the shadows and preclude the use of official money for illicit commerce.

But for all its flaws, cash does have many advantages. Perhaps most important, cash allows for privacy in commercial transactions, which digital payments simply do not. Cash is also easily accessible and requires no electronic device or internet connection. During a natural disaster or other emergency, when communications networks might collapse and electricity might be cut off, cash will still do its job.

There are concerns that the shift away from cash will disenfranchise the elderly, the poor, and the technologically disadvantaged. But new technologies and systems – such as for conducting transactions using basic mobile phones – will mitigate these risks. Moreover, by enabling widely accessible, low-cost digital payments, central-bank digital currencies might broaden financial inclusion.

PS: *In a recent interview, you noted that cryptocurrencies like Bitcoin "have not proven they are efficient" and "have very unstable value," but "the technology Bitcoin has bequeathed to us" – blockchain – is "really going to have legs." Can you give us some examples of interesting, unexpected, or promising applications of blockchain?*

EP: This future is upon us; innovative decentralized finance (DeFi) products built on blockchains are already operational. For example, flash loans can be taken out without collateral, used for a transaction, and then repaid, all for a small fee. A flash loan is initiated, executed, and completed instantaneously, using just computer code. This helps to minimize default and liquidity risks.

Financial products like flash loans can, for instance, help arbitrage price differences across markets, bolstering market efficiency. Computer tools can perform rigorous economic-risk assessments of smart contracts and specific DeFi products. The open-source nature of DeFi applications enables the discovery and elimination of security and other weaknesses.

Blockchain technology could soon be adapted for a broad range of uses, such as buying a car or house, managing ownership records for electronic and physical assets, and maintaining digital registries of public records. Smart contracts facilitate the exchange of financial and other assets for money or different assets. Such transactions can be executed and recorded on the blockchain through computer algorithms, without the involvement of trusted third parties like attorneys or bankers.

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