Testimony of
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Digital Money: More Competition? Even More Central Bank Monopoly?

Mr. Chairman, Ranking Member Moore, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. As part of my many years of work in banking and on financial policy issues, I have studied the history and various concepts of money, including the development of central banks and banking systems, and authored many articles, presentations and testimony on related subjects. Before joining R Street, I was a resident fellow at the American Enterprise Institute 2004-2015, and president and CEO of the Federal Home Loan Bank of Chicago 1991-2004.

<u>Central Bank Monopoly or Privately-Issued Money?</u>

As we think about the future of money, which grows ever more digital in its transactions and records, it helps to consider the varieties of money displayed by the past. Today we are accustomed to the Federal Reserve and other central banks having a monopoly on the issuance of each national money. A senior officer of the Bank of England has summed up the prevailing view:

"The distinctive feature of a central bank derives from its role as the *monopoly supplier* of outside money, [that is] notes and coin and commercial bank reserve deposits. These constitute the ultimate settlement asset for an economy and mean that the central bank has a *unique* ability to create or destroy liquidity." (Italics added.)

But do you have to have a central bank as the monopoly supplier of money? Historically, clearly not. For one thing, there have not always been central banks. The Bank of Canada, for example, dates only from 1934 and there was obviously money in Canada before that, as there was in the United States before the Federal Reserve was chartered in 1913 and subsequently developed its currency issuing monopoly. Even with the Fed, there were other forms of U.S. currency existing until the 1960s—namely, silver certificates and United States notes. National banks issued their own currency until the 1930s, as authorized under the National Bank Act of 1863-64.

One of the intriguing questions posed by Bitcoin and other "cryptocurrencies" (hereafter "Bitcoin" for short) is whether today there can be a successful privately issued currency, which is widely accepted and constantly used in settlement of purchases and sales, and thus actually serves as money. This would be a money which is not issued by the government or its central bank, and is not backed by the force and power of compulsion of the federal government.

There have been numerous historical examples of private currencies, but to my knowledge there has never been a private fiat currency. They all were claims on some kind of assets, which Bitcoin and its siblings are explicitly not.

Consider a classic form of money: gold and silver coins. As the interesting book, *Money and the Nation State*, tells us, "Nothing about operating a mint requires the state rather than private enterprise to perform that function… Private mints operated in the United States until they were prohibited during the Civil War." Such coins, unlike all currency today, were intrinsically valuable, whether minted privately or by governments.

A common form of private money in the American 19th century were the circulating notes of state-chartered banks. So you might have carried in your wallet a $5 bill issued by something like the Third State Bank of Skunk Creek or hundreds of others. I had an acquaintance who had a huge collection of such banknotes—he gave me a copy of a $3 bill issued by the Wisconsin Marine and Fire Insurance Company, a predecessor of one of my former employers, now a tiny part of today's JPMorgan Chase. All such notes were backed by the loans, investments and capital of the issuing bank—they were not fiat money, as Bitcoin wishes it might become.

The "free banking" theory maintains that a monetary system is better when composed of competing currency issued by private banks, instead of a monopoly currency of the central bank. This is far from the dominant view, however.

Most money used in transactions today is in the form of deposits, already a kind of digital money, operated for the most part and settled electronically, in this country denominated in U.S. dollars. Deposits are also backed by the assets and capital of the issuing bank, as well as the guaranty of the federal government, which if its deposit insurance fund fails, can tax some people to make good the deposits of others. Deposits are thus a mix of private and government money.

Troubled financial times have given rise to experiments with currency. "In America's first depression, 1819-1821," we learn from economist Murray Rothbard, "four Western states (Tennessee, Kentucky, Illinois and Missouri) established [their own] state-owned banks, issuing fiat paper." Unfortunately, this did not end well, as "the new paper depreciated rapidly." In contrast, the strategy of the Federal Reserve today is to have its paper depreciate slowly and steadily.

During the great depression of the 1930s, many municipalities, including the financially desperate City of Detroit, issued their own currency, or "scrip," to make payrolls. They were out of U.S. dollars and could not borrow any more. The script could be used to pay property and other local taxes, which gave it some currency. It often traded at discounts to regular dollars, but still could be used to buy things locally. Says one history of this emergency experiment:

"Some sort of scrip was issued by several hundred municipalities, business associations, companies, banking organizations, barter and self-help cooperatives. … Cash-strapped counties and cities across the country paid their employees with scrip issued against prospective tax receipts and good for current taxes and other public fees. In the early 1930s, 25 states revised their laws to authorize the issue of scrip."

These were interesting, but temporary expedients. They do not provide much support for the monetary hopes of Bitcoin enthusiasts.

Turning to theory as opposed to history, the great economist, Friedrich Hayek, in his essay, "Choice in Currency," provided a theory congenial to the libertarian strain of Bitcoin backers. Said Hayek:

"Why should we not let people choose freely what money they want to use? … I have no objection to governments issuing money, but I believe their claim to a *monopoly*, or their power to *limit* the kinds of money in which contracts may be concluded within their territory, or to determine the *rates* at which monies can be exchanged, to be wholly harmful. … I hope it will not be too long before complete freedom to deal in any money one likes will be regarded as the essential mark of a free country."

I sympathize with these ideas, but I think that Hayek's hope, expressed in 1975, will continue to be disappointed.

<u>Heading Toward an Even Greater Monopoly?</u>

Will the new and ubiquitous computing power of our time reverse the historical trend toward central bank monopoly of money and create more competition in currency? Bitcoin theorists imagine that it will, but it is easier to imagine digital currency moving us in exactly the opposite direction: toward even greater monopolization of money by the central bank.

Many central banks are interested in the idea of having their own digital currency. That means letting the general public, not only banks, have deposit accounts directly with the central bank, in addition to carrying around its paper currency. The appeal of this idea to central banks is natural: it would vastly increase their size, power and role in the economy.

In a digital age, it would clearly be possible for a central bank, in our case the Federal Reserve, to have tens of millions of accounts directly with individuals, businesses, associations, municipal governments and anybody else, which would be all-electronic. In terms of pure financial technique, there is nothing standing in the way. But would this be a good idea? Should Congress ever consider it?

In a recent article, "The Bank of Our Dreams," Matthew Klein suggests that it would be a wonderful idea. "It is time for the largest U.S. bank to open its doors to the public," he says. Citing the proposal of three law school professors, "A Public Option for Bank Accounts (Or Central Banking for All)," he summarizes:

"Their 'public option for bank accounts' would offer every American household and business a checking account [though presumably there would be no paper checks] at the Fed." This would "create a frictionless system, like email."

The Federal Reserve would be in direct competition with all private banks in such a scheme. It would certainly be a highly advantaged, government competitor. It could offer "risk free" accounts and pay a higher interest rate, if it liked, cross-subsidizing this business with the profits from its currency issuing monopoly. It would be regulating its competitors while shot through with conflicts of interest. It would put the evolution of central banks a hundred years into reverse.

There are in the American banking system about $12 trillion in domestic deposits. Could the Federal Reserve grab half of them? Why not? That would be $6 trillion, which would expand its balance sheet to $10 trillion. A pretty interesting and unattractive vision of enhanced monopoly.

Says Klein: "Offering Federal Reserve accounts to the general public would also reduce the taxpayer subsidy for bank risk-taking." Actually, it would do the opposite: vastly increase taxpayer risk by putting the risk into the Federal Reserve itself.

For the Federal Reserve would have to do something with mountain of deposits—namely make loans and make investments. It would automatically become the overwhelming credit allocator of the financial system. Its credit allocation would unavoidably be highly politicized. It would become merely a government commercial bank, with the taxpayers on the hook for its credit losses. The world's experience with such politicized lenders makes a sad history.

In short, to have a central bank digital currency is a terrible idea—one of the worst financial ideas of recent times.

<u>The Future of Money</u>

There is no doubt that the digitalization of financial transactions, records, access to information, and communication will continue to increase, and that the electronic networks underlying the activity continue to grow more intense and omnipresent. But the fundamental nature of money, it seems to me, will not change. It will either be:

-The monopoly issuance of a fiat currency by the central bank as part of the government, backed by the power of the government. That the whole world operates on such currencies is a remarkable—and dangerous—invention of the 20^{th} century.

-Or if private currencies do again develop, they will, as in the past, have to be based on a credible claim to reliable assets. With Hayek, we could hope (without much hope) that this might bring competition for government fiat money.

It is clear that having a fiat currency is far too precious and profitable for governments for them ever to go back to a government currency backed and convertible into actual assets, whether gold coins or otherwise.

Government fiat currencies will operate in increasingly digitalized forms. Still, paper money will retain its advantages of secure privacy, immediate settlement without intermediaries, and the ability to function when the electricity is shut down. Recently I was amazed to find that my younger son, an up-and-coming banking officer, was walking around with the total of one dollar in his wallet, but of course with a well-used debit card. As this generational difference indicates, doubtless our ideas of money will grow ever more dependent on having the electricity on at all times and everywhere.

Attempts at private fiat currencies, with no claim to any underlying assets, in my view have a very low probability of ever achieving widespread acceptance and functioning as money.

An increase of the monopoly power of central banks, which already have too much, should be avoided.

Thank you again for the chance to share these views.