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Central Bank Digital Currencies

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MAIN POINTS

- The digitization of money through a Central Bank Digital Currency (CBDC) creates substantial threats to financial privacy, increases government power, and could be weaponized against the American people.
- Further innovation of the payment system may increase speed and decrease costs, but those benefits can be realized without a CBDC.
- The Federal Reserve neither has the authority nor can be trusted to create a retail CBDC, displacing today's private banks. Congress must not authorize the creation of a CBDC.

Executive Summary

On March 9, 2022, President Biden issued Executive Order (EO) 14067 (Federal Register, 2022)— Ensuring Responsible Development of Digital Assets — which directed the United States Department of Treasury, the Federal Reserve, and other relevant agencies to begin exploring the adoption of a U.S. Central Bank Digital Currency (CBDC) (The White House, 2022). The executive order cites a litany of threats that would prompt the exploration of adopting a CBDC, including national security, economic risks, the stability and integrity of the financial system, illicit crime, and climate change. EO 14067 "places the highest urgency on research and development efforts into the potential design and deployment options of a United States CBDC…and the actions required to launch a United States CBDC if doing so is deemed to be in the national interest."

This report outlines the role of money as a federal government tool and means of exchange. Analyzing the evolution of money in the modern world and examining how currency operates domestically and globally, this report examines how a shift to a CBDC would substantially alter the role and nature of money. In particular, the report assesses the extraordinary economic control, discrimination, and threats to data privacy that might result from the development of a CBDC. Additionally, given the extraordinary failures of the Federal Reserve recently, one must question whether they have the competency to replace the private sector banking system that has served our nation throughout its history. The fact is: The Federal Reserve cannot issue a CBDC without Congressional authority. Congress must make this clear by enacting legislation that restricts the creation and use of a CBDC.

The Role of Money

At its foundation, money exists to perform three primary functions. First, money is used to facilitate the exchange of goods and services, operating as a medium through which economic activity can take place. Second, money operates as a store of value, providing users of that money with confidence that they will be able to make purchases in the future, rather than having to acquire goods and services contemporaneously with earning income. Third, money exists as a unit of measure, providing a baseline of worth for the buyer and seller of a particular good or service and facilitating government action such as the collection of income taxes.

The role of the dollar is especially significant as both a currency and a system of exchange. Nearly half of all global trade is invoiced through the dollar, even though the United States is responsible for only about 10 percent of global trade. As a result, the

United States Dollar (USD) is the world's reserve currency, meaning the currency is internationally recognized as the currency to be held in reserve by most national banks. As a system of settling payments, the dollar plays the most substantial role in determining the ebb and flow of the global economy of any currency in history. Its status as reserve currency facilitates implementation of our nation's trade and sanctions policies.

The Evolution of Payment Systems

The development of payment systems can be traced back to ancient Mesopotamia in 6000 B.C.E., where bartering was first introduced almost 2000 years before the first officially documented society of Sumer began (Butt et al., 2023). The first documented use of coins in the Western world originated in Lydia (modern-day western Turkey) around 650 B.C., the coins being a combination of gold and silver alloys (Middelkoop, 2016). Nearly 1,350 years would pass before paper currency would be invented in the 7th century A.D. during the Tang Dynasty in China (Collectibles & Currency, 2020). Paper currency was convertible into gold, but the fact that it is lighter to carry and can be printed in different denominations made it easier to engage in commerce. Roughly 600 years would pass before the check was developed in early Venice to operate as a legally binding promissory note in lieu of physical coins, allowing ships to carry fewer coins and more shipping products, thus establishing a system of commerce based upon fiat in the Western world (Barclays, 2016). Paper money can be damaged or stolen so checks may be a more secure form of payment for the purchaser.

The next major innovation in money would be the credit card in the 1920s, with the first universal credit card introduced by the Diners' Club, Inc, in 1950 (Brittanica, 2023a). Credit card systems have evolved to provide nearly immediate authorization, improving the likelihood of payment for the merchant, whereas checks may be returned for insufficient funds. Expanding access to the ease of paying by plastic to those who did not have good credit, debit cards provided for funds to be immediately held at the customer's bank, rather than charged against a line of credit. Today in the United States, debit cards are the most frequent form of payment (The Federal Reserve, 2023). The most recent major advancement in payment systems followed in the wake of a 2008 whitepaper entitled "Bitcoin: A Peer-to-Peer Electronic Cash System", generating interest in the media and across markets. By 2009, a group known only as Satoshi Nakamoto invented Bitcoin, the world's first completely digital currency, known as cryptocurrency (Britannica, 2023b). The advent of copy-and-pasteable cipher encrypted algorithms is revolutionizing the financial sector and digital payments, introducing a direct, easy, and transparent way to settle payments quickly. The first commercial transaction with Bitcoin was in 2010 for pizza, further validating the new use case and sparking the creation of new digital markets.

What is a Central Bank Digital Currency?

With improvements in technology and the rise of cryptocurrency over the last 14 years, the concept of completely digitizing currencies has emerged. In such a scenario, in addition to people having physical money in the form of paper currency, they could also have digital money issued directly by the central bank. This is an important distinction from digital currencies which are means of exchange issued by private entities and whose value are determined independent of the value of gold or the U.S. dollar. What makes a CBDC unique and potentially problematic is that it is issued by and transacted through means established by a central bank, i.e. the federal government.

At least three versions of this scenario have been contemplated. In the first, only banks may hold CBDC, known as wholesale CBDC, effectively giving them an account with the Federal Reserve. Individuals would still have access only to paper money issued by the Federal Reserve, and their bank accounts would still be with private banks. To a great extent, this already exists because banks have accounts at the Federal Reserve, where they hold assets called "excess reserves." In fact, a significant monetary policy tool of the

Federal Reserve is the setting of the interest rate paid on excess reserves. Such deposit transactions between private banks and the Federal Reserve are already carried out electronically, so there is little innovation by creating a wholesale CBDC.

The second version is called "intermediated retail CBDC." Individuals would hold CBDCs assigned to their name at the Federal Reserve, but they would have to transact through a private bank to access the funds. Presumably, in such a scenario, banks would offer lower interest rates on deposits that are held in CBDCs and higher interest rates on those that are held in normal deposits but that the bank can still lend out. This has the potential to be destabilizing to the banking sector because our financial system relies on deposits being used to fund commercial loans for small businesses, car purchases, and credit cards.

The third version is "direct retail CBDC." In this case, everyone would have access to a bank account directly at the Federal Reserve. All transactions between buyers and sellers would be facilitated solely through the central bank, reducing the role of private banks in the economy. This new socialist model means that all individual and business bank accounts would be directly with the Federal Reserve, similar to the backward-looking postal banking system progressives have been advocating for years (Brown, 2018). It would be accompanied by the level of customer service, technological innovation, and gross inefficiency Americans have grown accustomed to with government-run systems, such as the U.S. Postal Service. In addition, direct retail CBDCs create concerns about funding the consumer and local small business lending activities currently done by community and regional banks and privacy issues we address below.

The Potential Benefits of a CBDC

Substantial arguments can be made for and against such proposals. Proponents of CBDCs argue that reductions in bank bailouts and improvements in payment efficiency are key points in favor of implementing a CBDC (Corporate Finance Institute, 2023).

One argument in favor of a direct retail CBDC, for example, is that it might end the need for government-backed deposit insurance. Because the Federal Reserve does not engage in risky lending (or is not supposed to without an equity position invested by the U.S. Treasury), the Federal Reserve should never fail, and thus depositors would never require bailing out. To the extent that consumers want their funds secure, they would only be able to hold CBDC money and anything else would be subject to default. A challenge to this approach, as we saw with the failure of Silicon Valley Bank, is that the federal government may guarantee funds that were previously “uninsured.” Therefore, the argument that a retail CBDC would eliminate bank bailouts is likely overstated.

Advocates also argue that with direct retail CBDCs, merchants in retail transactions might no longer incur processing fees from credit card companies for cards used in transactions, as the central bank would be the only third party involved. Moreover, proponents claim that lower transactional costs at the retail level may also attract additional foreign investment, as lower transactional and operating costs at the international level could encourage a greater level of foreign direct investment (Lee, 2020a).

Proponents argue that the economic benefits of cutting this overhead cost would increase economic investment across the economy by getting rid of unnecessary fees created by transactional middlemen and potentially increase financial inclusion (Lee, 2020b). The central issue with this argument that proponents ignore is that the payment system costs money to maintain and to be improved upon, necessitating a revenue stream from somewhere. Would there be widespread disinvestment in commercial financial institutions that results in reductions in cybersecurity risk management, expansions of government-owned ATM and online payment networks, and compromised customer service, similar to what Americans currently receive from their local Department of Motor Vehicles? Many of these same advocates claimed that reduced processing fees on debit cards (a law known as the Durbin Amendment) would reduce costs for consumers. In fact, research has documented that fees were raised elsewhere in the financial system to offset the reduced revenue, actually leading to a decline in financial services accessibility (Mukharlyamov & Sarin, 2019).

Furthermore, CBDCs are touted as a safeguard against illicit activities because a currency that is centralized and digitally traceable through every transaction would be more capable of tracking and reducing illicit activities. CBDC advocates claim that money laundering, tax evasion, and the financing of terrorist activity are risks that can be mitigated through a system that the federal government can monitor in real time, fostering greater transparency and increasing public trust by cracking down on crime. However, the government currently deputizes private banks to intermediate, monitor, and report illicit transactions through wires, checks, credit cards, and debit cards. Improving our anti-money laundering activities is not solely realized through the launch of a retail CBDC.

Privacy Issues

The single greatest concern about a direct retail CBDC is that it would represent the greatest threat to what little financial privacy and data security Americans enjoy in the current world of private banking. A universal CBDC, where all financial transactions occur through a federally owned central bank, would almost certainly guarantee that Americans' financial privacy was compromised. The central bank would have access to every individual and wholesale account in order to process and track transactions accurately. Therefore, the federal government would have access to every single

American's financial data, ranging from metadata and particular spending habits and consumer interests all the way down to private and sensitive financial records. Currently, with private banks facilitating all transactions, such data are protected by the Fourth Amendment for all American citizens. A federal judge must approve the government gaining access to that information.

Creation of a CBDC therefore raises a substantial privacy concern: would the federal government still need warrants issued to access user data to which they implicitly, for all intents and purposes, already have access? The slippery slope of allowing the government to have a full and complete window — and *de facto* ownership of — users' financial information and data presents a clear risk that the federal government would bypass the constitution and appropriate legal protections that Americans have relied on throughout our history in how they access and use their private financial data.

By allowing the government to implement a CBDC, whether a wholesale, intermediated, or direct CBDC, the United States would open a Pandora's box, wherein the government could have the power to completely suppress or cut financial services from any individual or entity they desired. This is not mere conjecture; it is a historical fact. In 2013, President Barack Obama's Department of Justice implemented "Operation Choke Point," an initiative authorized under the guise of investigating financial institutions that were believed to be conducting business with "firearm dealers, payday lenders, and other companies believed to be at a high risk for fraud and money laundering." (Murray, 2014). The operation was hidden from the American people for four years until it ended in 2017, with several high-level officials even lying about the existence of the program (Blackwell, 2018a). However, unsealed government documents revealed a far more disconcerting truth (Community Financial Services Association of America, 2018). At the time, Kenneth Blackwell, the former Treasurer (1994) and Secretary of State of Ohio (1998-2007), who now serves as the Chair of the Center for Election Integrity at the

American First Policy Institute, argued that the Federal Deposit Insurance Corporation (FDIC) "engaged in a targeted campaign against lawful and legally operating businesses, cutting them off from banking services without due process or other legal recourse" (Blackwell, 2018b). Moreover, upon cutting off a financial institution, FDIC regulators then pressured banking institutions to "claim the action as their own, effectively covering up the government's involvement."

The actions of the federal government during Operation Choke Point underscore the heart of the issue with giving the federal government full authority to bypass the law in accessing and censoring Americans' financial privacy and assets. They also raise an additional question regarding the legality of sharing financial data across agencies (such as the Internal Revenue Service (IRS), the FDIC, the Department of Treasury, the Federal Election Commission, etc.) without a warrant or subpoena.

By allowing government agencies full access to monitor every transaction, user data and financial transactions can be monitored and tracked in real time. Such power would enable the government to administer fines, block transactions, or freeze accounts of individuals whose transactions were not aligned with the administration in office at the time. Such extraordinary power grants government the ability to withhold financial freedom from individuals with whom they disagree, further weaponizing government against its own law-abiding citizens.

This is already a reality in China through their social credit program, which monitors, tracks, and influences Chinese citizens in all their interactions and transactions in the public space (Canales & Mok, 2022). By allowing the central bank to have unfettered access and undefined authority over the entire financial system, the United States risks creating a domestic surveillance state–styled economy that completely erodes the freedoms and liberties that are fundamental to the constitution and foundation of the United States.

In addition to the severe overstepping of federal authority, another glaring privacy concern with CBDCs is the federal government's current mismanagement of user data and financial material. Data privacy and cybersecurity are foundational to the modern financial world, and the risks presented to America's economy from cyberattacks and hacking cannot be overstated. Given the recent leaks of confidential tax return data by the IRS, Americans have valid concerns about whether their transaction histories and financial information will likewise be leaked to serve partisan political ends (Kim, 2022).

Federal Reserve Mismanagement

In addition to the privacy risks that come with the implementation of a direct retail CBDC, another key consideration that the Biden Administration has left unaddressed is the merits and achievements of the Federal Reserve that warrant vastly expanding its role in the financial sector of the economy. In the last three years, the United States has suffered 40-year-high inflation that has ravaged consumers' real savings. Mismanagement of monetary policy has resulted in the highest interest rates in 22 years, resulting in the destabilization of the dollar. Moreover, in the last year alone, the United States has seen three out of the four largest bank failures in its entire history, despite Dodd-Frank granting ever greater supervisory authority to the Federal Reserve to keep such failures from occurring. Finally, the mismanagement of the Federal Reserve's balance sheet has meant that they have generated almost zero income for the U.S. Treasury this year, in contrast to an average of $84 billion per year over the last 10 years (Statista, 2023). In fact, its losses in the last year have created an arrearage of more than $82 billion (Board of Governors of the Federal Reserve System). When examining the track record of the Federal Reserve, no justifiable case can be made for expanding its role to issue a CBDC.

The mismanagement of financial and monetary policy extends beyond the Federal Reserve, including other agencies that are tasked with the financial data privacy and protection of consumers and merchants alike. The Consumer Financial Protection Bureau (CFPB) is a key example of a derelict agency that has grossly mismanaged the data that it is charged with overseeing. The most recent case was in April of 2023, when an employee with the CFPB sent the financial information of 256,000 individuals from a federal email to an unsecured personal email address, causing a massive data breach. These lapses in operational security extend beyond individual mishaps, unfortunately. The CFPB has been hacked several hundreds of times, with many of the hacks confirmed to have compromised private information, such as social security numbers, banking and home loan information, and credit card data.

The FDIC also houses financial data that has also been subject to hacking. Between 2010 and 2013, reports that the government attempted to cover up found that Chinese hackers compromised the secret sensitive data of the FDIC chairman, his chief of staff, and the general counsel (Pagliery, 2016). The FDIC handles the information of more than 4,500 banks and saving institutions, to which Chinese hackers had access for more than three years. The failure of federal agencies to protect consumers and businesses from data theft and cybersecurity threats raises serious questions about the ability of these agencies to preserve user data privacy and financial security.

The Need for Separation of Powers

Considering the risks that a CBDC presents, Congressional oversight and authority that establishes through legislation a clear separation of powers is undeniably essential to make clear that the Federal Reserve cannot issue a CBDC without Congressional authority. As the representative body of the United States, Congress retains the power of the purse, both in administering and regulating the establishment and functionality of our currency.[1]

CBDCs would have a detrimental impact on Americans' freedom, privacy, and prosperity. Given the staggering gaps in data security and protection from the Federal Reserve, the FDIC, the CFPB, and other agencies tasked with protecting financial information and data security, the government has not proven to the American people that a CBDC is in the best interests of the American people or our national security. CBDCs can destabilize the private sector banking system directly and indirectly through poor control of money and external risks to the financial network. Only Congress has the authority to create a CBDC, and it should not cede away more of its authority. The federal government's poor track record demonstrates that it cannot be trusted to take on this dangerous power creating an Orwellian-style state.

Conclusion

Innovations around blockchain, digital assets, and the technologies behind CBDCs are undoubtedly the way of the future. However, creating a government-issued Central Bank Digital Currency offers a far greater threat to society than benefit and is too tempting a tool for our weaponized government to ignore. Money is not a tool for coercion and control. The United States dollar is the world's reserve currency and symbol of freedom and prosperity. A CBDC would present a threat to both symbols. As such, creating a CBDC would require Congressional approval as it is not under the authority of the Federal Reserve. Congress should enact legislation that restricts the creation and use of a CBDC.

1 SEE Article I, Section 9, Clause 7 (the Appropriations Clause) and Article I, Section 8, Clause 1 (the Taxing and Spending Clause).

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