Facebook's Proposed *New Currency*

By Claudia Biancotti and Joseph E. Gagnon

Libra's promises and pitfalls.

On June 18, 2019, plans for "a simple global currency" were unveiled by the Libra Association, a group of twenty-eight organizations led by Facebook and including, among others, Visa, Mastercard, and Vodafone. The project revolves around a digital token, the Libra, issued by the Association and offered to customers worldwide as a means for online payments.

The Libra tokens are likely to offer lower transaction fees than established payment instruments, such as credit cards and wires. The underlying technology, partly inspired by the Bitcoin protocol, has algorithms that permit cheaper decentralized clearing and settlement of transactions compared with existing systems operated by financial institutions.

The project has a chance of succeeding where previous experiments have failed. Contrary to other privately issued, retail digital payment tokens, Libra would not be plagued by extreme volatility because it would be pegged to a basket of major currencies and low-risk, low-yield government bonds. The Association would run a full-reserve scheme whereby whenever a new token is minted and sold to a consumer, all proceeds are invested in the assets that compose the basket. If the consumer sells tokens back to the Association in exchange for legal tender, the corresponding assets are divested. Creation and destruction of tokens would occur automatically to keep Libra's value equal to the market value of the underlying currency

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basket, much as exchange-traded funds automatically track the value of their underlying assets.

Libra could also capitalize on network externalities from the get-go, as Facebook alone would provide access to 2.4 billion potential users spread everywhere except for China, Iran, and North Korea. Involvement of key players in the card space would open the door to a vast network of merchants.

Should the project take off, it could bring some important benefits. As emphatically highlighted by the Association, it could be a vehicle for financial inclusion. In advanced and emerging economies alike, the poor are often on the fringe of the formal financial system. They are charged more than the wealthy for the few services that they can get and excluded from the rest. According to estimates by the World Bank, remittances by migrant workers today are burdened by an average fee of about 7 percent of the amount sent. Cutting the fees by, say, 5 percentage points would yield $16 billion per year in savings, mostly in favor of low-income customers.

Many digital services beyond payments could become more accessible and affordable. The Libra system is built in such a way that third-party developers can leverage the infrastructure behind the payment token to build their own applications. The same computer network used to validate payments in Libras can be used for trading stocks, time-stamping digital content, notarizing contracts, or any other endeavor that requires trustworthy record-keeping and can be automated. This possibility is not specific to Libra—most notably, it has existed for years in the Ethereum network. So far, however, it has been confined to niche ecosystems.

These promises are not without downsides. Libra would introduce risks of unprecedented size and scope. The Association met with regulators in several countries before publishing the project's white paper, but the proposal is still not acceptable in its present state and a number of questions remain. The payment token should not be allowed on the market before these questions are answered to the satisfaction of authorities in the countries where Libra will operate. Indeed, the Financial Stability Board and a number of national authorities have already promised careful reviews of the Libra proposal, and the G7 finance ministers and central bank governors promptly established a task force to evaluate its implications for the global financial system. At their July meeting in Chantilly, France, they issued a statement emphasizing that projects such as Libra "would in any case need to meet the highest standards of financial regulation" and require close scrutiny before any authorization is given since they "may affect monetary sovereignty and the functioning of the international monetary system."

The Libra Association will have to work with authorities to guarantee the safety of the reserve assets that back the token and the security of the blockchain by which payments are settled. There are difficult trade-offs between the privacy of Libra users with respect to

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Libra could be a vehicle for financial inclusion. In advanced and emerging economies alike, the poor are charged more than the wealthy for the few services that they can get and excluded from the rest.

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Facebook and other members of the Libra Association and the risk that Libra could facilitate illegal transactions, money laundering, and terrorist financing. Network externalities could give Libra a near monopoly on cross-border digital payments that would require thorough supervision.

A key issue is the choice of currencies and weights in the reserve basket. The obvious reference is the special drawing right of the International Monetary Fund. IMF members (which include nearly every country in the world) have pledged to make the SDR the world's premier reserve currency. Libra offers a chance to make good on this pledge. A Libra-SDR link would open the possibility for international trade to be invoiced and settled in an officially agreed symmetric currency. It would reduce (but not eliminate) the outsized impact of U.S. policies on the global economy.

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There are arguments in favor of other basket weights, however. For example, the SDR includes only five currencies—the U.S. dollar, the British pound, the euro, the Japanese yen, and the Chinese yuan. A more diversified Libra basket might include assets denominated in the currencies of other advanced economies, such as Australia, Canada, Korea, and Switzerland, or even those of emerging market economies with relatively sound macroeconomic policy frameworks. Another issue is the inclusion of the Chinese yuan in the SDR basket. Given that Facebook is not allowed to operate in China, some might argue that the Libra basket should not include Chinese assets. For the time being, Facebook announced that the basket will "include the U.S. dollar, the British pound, the euro, and the Japanese yen," but no indication was given on whether other currencies are also being considered.

Finally, by creating a new unit of account, means of payment, and store of value, Libra would be trespassing on the traditional domain of central banks. A large-scale uptake of Libra tokens would increase demand for safe assets, and thus push down interest rates, in the currencies of the Libra basket, with corresponding upward pressure on interest rates in currencies of Libra users that are not included in the Libra basket. Smaller countries may wish to protect their control over monetary policy by requiring that taxes, salaries, property rentals, and other local services are invoiced and settled in local currency. Even so, a successful Libra would greatly increase the scope for capital flight from ordinary households, particularly in countries without a sound framework for macroeconomic policy. To some extent, this could discourage bad policies in affected countries, but it also could increase the risk and speed of financial crises. Emerging and developing economy governments in particular will need to consider how to respond to these risks and benefits before allowing their citizens to access Libra. ◆

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