

## The Rationale for Establishing a Digital Dollar and the Perils of Delay

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Chairman Himes, Ranking Member Barr, and members of the Subcommittee, thank you for inviting me to testify at this hearing. In these remarks, I will start by highlighting how the establishment of a digital U.S. dollar provides a crucial opportunity to improve the payments system for small businesses and ordinary families. Next, I will outline a set of sensible design principles that should be followed in implementing a digital dollar. Finally, I will highlight the perils of following an inertial approach and underscore the urgency of moving forward promptly on this initiative.

### The Rationale for a Digital Dollar

In considering the rationale for establishing a digital dollar, a crucial question is whether the current payment system falls short in serving the needs of ordinary American families and small businesses. Rather than providing a barrage of statistical analysis, I'd like to start by highlighting the views of various small business owners in my region:

***The People's Barbershop, Hanover, NH.*** About two years ago, Sean Taylor finally achieved his dream of starting his own [barbershop](#) in downtown Hanover. Sean's business has been thriving, and he recently hired his first apprentice, Charlie Foster. Nearly all of Sean's clients use online forms of payment that take a substantial chunk out of Sean's revenue. For example, many customers use [Square](#), to which Sean has to pay a fee of 2.6% plus 10 cents for every payment transaction. On average, about 3% of the price that Sean receives for each haircut is being transferred to a huge multinational payment provider instead of going into the savings fund that he is trying to accumulate so that he can keep expanding his business.

***Norwich Farm Creamery, Norwich, VT.*** Laura Brown and Chris Gray started this business about five years ago, producing a variety of [dairy products](#) with a very close eye on their budget and operating expenses. Prior to 2020, nearly all of their customers paid with cash and coins, both at their own farmstand and at weekly farmers markets. Once the pandemic started, they quickly shifted gears and began accepting payments via Venmo (a service of Paypal, Inc.). However, [Venmo](#) charges 1.9% plus 10 cents for every transaction. Thus, if a customer makes a \$5 purchase, then about 3% of that revenue is being transferred to a huge multinational payment provider; meanwhile, Laura and Chris are making heroic efforts to keep their business running, with [vocal support](#) from the Norwich community.

***The Vermont Bookstore, Middlebury, VT.*** This [bookstore](#) has been a fixture in the town of Middlebury since 1949, and Becky Dayton has been running it for the past sixteen years. Nearly all of the bookstore's customers make their purchases using credit cards, and Becky indicated that about 3% of her bookstore's revenue goes to payment providers like [Visa Inc.](#), which was ranked last year as the most profitable corporation in America. It's also noteworthy that Becky's bookshop is competing very directly with Amazon.com, which has its own branded credit card, [Amazon Prime Visa](#), that pays 5% cash back to its customers whenever they purchase books or other items on its website. Nonetheless, Becky is undaunted, saying: "[I'm working extra hard to keep this little bookstore alive in my community.](#)"

It should be emphasized that these shortcomings of the current payment system are faced by small businesses in big cities as well as small towns. My colleague Arunima Sinha, an associate professor of economics at Fordham University, has heard similar concerns in conversations with small retail businesses in New York City, including bagel shops, bakeries, diners, and bodega markets. Moreover, this is not just a problem for brick-and-mortar stores. Many customers of online retailers make purchases using [PayPal](#), which charges 3.49% plus 0.49 cents per transaction. For an online retailer whose typical item sells for \$20, Paypal will keep a truly exorbitant 6% of the retailer's sales revenue. Almost every small business – whether its customers are in person or online -- faces very tight operating margins, and hence such high costs of payment transactions can determine whether the balance sheet of a small business falls into the red or stays in the black. Presumably that's why a farmstand out west has posted the following sign out front: “*We Accept All Cards, But We Prefer Cash. Thank you! :-)*”

Nonetheless, paper cash has its own pitfalls. Just ask the owners of a mom-and-pop convenience store that stays open late at night despite their fears of an armed robbery, or a taxi driver operating in an urban area who constantly worries about being assaulted and robbed by a random customer. Moreover, paper cash isn't really free. Most small businesses have a cash management contract with their bank, which has to sort and clean the cash that it receives. Indeed, for many retailers the costs of managing paper cash are just as high as the transaction fees on credit cards and electronic payment services.

Consequently, it's not surprising that small business owners (including those whom I've described above) are uniformly enthusiastic about the prospect of using digital dollars that would be secure, convenient, and costless for both the payer and the payee. Indeed, reducing transaction costs for small businesses will foster more entrepreneurs and business startups – in inner cities as well as rural areas -- and contribute to greater job creation across the country.

### **Design Principles for a Digital Dollar**

In my [joint work with Michael Bordo](#), a distinguished professor of economics at Rutgers University, we have emphasized that central bank digital currency (CBDC) can fulfill the three basic functions of money, serving as a practically costless medium of exchange, a secure store of value, and a stable unit of account. While private forms of money can fulfill some aspects of these functions, there are [intrinsic reasons](#) why households and nonfinancial firms should also have access to a fiduciary form of money issued by the central bank. In particular, the central bank's money serves as a unit of measure -- analogous to the inch or the kilogram -- that facilitates the economic decisions and financial plans of ordinary people and small businesses. Moreover, in an efficient monetary system, the medium of exchange should serve as a secure store of value that bears the same rate of return as other risk-free assets. By contrast, any purely private form of money is intrinsically subject to default risk and hence cannot serve as a reliable medium of exchange nor as a stable unit of account. In light of our analysis, we have [formulated](#) the following set of basic design principles for establishing a digital U.S. dollar:

**Public-Private Partnerships.** A digital dollar should be provided through designated accounts held at supervised financial institutions, which would hold part or all of those funds in segregated reserve accounts at the Federal Reserve. In effect, the Federal Reserve will be responsible for managing the centralized ledger, while supervised financial institutions provide digital dollar “wallets” for their customers. This approach would foster competition among financial institutions and protect the privacy of individual transactions while facilitating appropriate law enforcement. In effect, the provision of digital cash would be similar to that of many other aspects of our public infrastructure.

**Security and Efficiency.** With a centralized ledger, each payment transaction can be transmitted instantaneously and securely at practically zero cost, simply debiting the payer's digital dollar account

and crediting the payee's digital dollar account. Moreover, the scope and scale of fraudulent transactions can be mitigated by standard and efficient security methods such as two-step identity verification.

**Legal Tender.** The digital dollar should serve as [legal tender](#), usable for all public and private payment transactions. In addition, consumers and firms should remain free to make transactions using any other legal form of payment, such as credit cards, debit cards, or online services. Moreover, some individuals and small businesses may still prefer to use paper cash for some of their transactions. However, once digital cash becomes convenient and ubiquitous, the demand for paper cash and coins will rapidly diminish. Indeed, it may not be very long before dollar bills are merely collectors' items, similar to typewriters and audio cassette tapes.

**Store of Value.** Digital dollar accounts should serve as a secure store of value that bears the same rate of return as other risk-free assets such as U.S. Treasuries, thereby eliminating the opportunity cost of holding money. While interest-bearing digital dollars might seem like a dramatic new development, in fact the Federal Reserve has already implemented similar measures whose benefits accrue mainly to large financial institutions and "high net worth" individuals:

- A wide array of financial institutions (such as money market funds and pension funds) can engage in repo market transactions in which they "lend" funds to the Federal Reserve and earn interest on those funds. As of last Wednesday July 21, the Federal Reserve's reverse repo facility held [over \\$1.1 trillion](#) in funds from such institutions. The minutes from the June 2021 meeting of the Federal Open Market Committee (FOMC) indicate that Federal Reserve officials are broadly supportive of creating a [standing facility](#) for conducting these reverse repo operations on an ongoing basis.
- Customer deposits at institutions designated as systemically important financial market utilities (FMUs) are held in special accounts at the Federal Reserve so that the clients of those institutions may rest assured that their funds are secure, liquid, and interest-bearing. For example, the margin accounts of [traders at the Chicago Mercantile Exchange](#) and the [customers of ICE Clear Credit](#) are held in segregated deposits at the Federal Reserve Bank of Chicago.
- The Federal Reserve pays interest on the reserves that commercial banks hold at the Federal Reserve. The interest rate on reserves (IOR) is currently very low, but as of two years ago it stood at 2.35%. At that time, commercial banks paid similar rates on the funds that they borrowed and lent in wholesale markets, whereas they paid no interest at all on the checking accounts of ordinary households and small businesses. With the establishment of a digital dollar, all consumers and small businesses will be able to receive a competitive interest rate on their payment accounts.

**Eliminating Arbitrage Incentives.** Given that funds held in digital dollar wallets will be fully secure, safeguards will be needed to ensure that "high net worth" individuals and financial institutions do not seek to transfer large amounts of assets into digital dollar accounts at times when the financial system is under stress. Placing fixed upper limits on the size of such accounts might prove impractical or exacerbate systemic stress. Therefore, our analysis involves a two-pronged approach:

- The Federal Reserve should impose fees on very large holdings of digital dollars. For example, digital dollar accounts above \$1 million could be subject to a holding fee of 2% that would be sufficient to discourage asset holders from liquidating private assets and moving those funds into digital dollars. In effect, this arrangement would be reminiscent of the fees that banks charge for maintaining safe deposit boxes, except that such fees would only pertain to very large holdings of digital dollars and would only be imposed under extraordinary circumstances.

- The Federal Reserve should impose fees on very large transfers between digital dollars and paper cash. For example, transfers exceeding \$100,000 in a single day might be subject to a transfer fee of 2 percent. Such fees would curtail incentives for arbitrage between paper cash and digital cash, while ordinary consumers and small businesses would remain free to use paper cash without incurring any fees at all.

***The Conduct of Monetary Policy.*** The interest rate on digital dollars should become the FOMC’s primary tool for conducting monetary policy. During normal times, this interest rate would be positive. In the face of a severe adverse shock, the FOMC could push market interest rates below zero by imposing fees on large holdings of digital dollars, whereas the interest rate on digital dollars held by ordinary households and small businesses would never drop below zero. Consequently, the establishment of a digital dollar would strengthen the Federal Reserve’s ability to carry out its dual mandate of fostering maximum employment and price stability.

### **The Perils of Inertia**

The establishment of a digital dollar can be viewed as fully consistent with the natural evolution of the economy and the financial system. Indeed, one might well wonder why digital dollars don’t already exist. After all, the citizens of Kenya have been making digital payments on a joint public-private platform called [M-Pesa](#) for more than a decade. More recently, one of the leaders of the European Central Bank stated in an interview that “*For us, the [digital euro](#) is not an option, it’s something we just have to do.*”

Of course, caution is warranted for any major decision. But caution is not the same as inertia. The digital world is intrinsically fast-paced, and hence inertia can be a risky strategy with costly and irreversible consequences. In particular, there are several compelling factors that call for moving ahead promptly in establishing a digital dollar:

***National Security.*** For the past 75 years, the U.S. dollar has served as a key pillar of the global economy. Numerous countries and private corporations issue debt securities denominated in U.S. dollars. A large fraction of international trade is invoiced in U.S. dollars, even when no American company is directly involved in the transaction. The Federal Reserve has actively supported U.S. dollar liquidity around the world through its [lines of credit](#) to other major central banks. And the primacy of the U.S. dollar has often played a significant role in conducting “soft diplomacy” to promote U.S. national interests. Nonetheless, this primacy should not be taken for granted and could be severely undermined by taking an inertial approach to establishing a digital U.S. dollar. For example, the People’s Bank of China has already launched a pilot version of its [digital yuan](#), which is now being used by millions of Chinese residents. No one should be surprised when pressure starts being exerted on sovereign countries and multinational companies to start denominating their debt contracts and invoices in terms of that digital currency. And such pressure will be more difficult to withstand [if no digital U.S. dollar is available for use](#).

***Interoperability.*** The Bank for International Settlements (BIS) is a longstanding association of central banks, including the Federal Reserve as well as many other central banks. Earlier this month, the general manager of the BIS [stated](#) that *each country should have its own sovereign digital currency* and noted that “*it’s a unique opportunity for different central bank digital currencies to be interoperable [so that] transactions in different currencies can be done in a seamless way.*” Consequently, if the Federal Reserve moves expeditiously in establishing a digital dollar, it can play a central role in the design of this cross-border platform, which will in turn influence many other aspects of the global financial system. By contrast, if the Federal Reserve takes a sluggish approach, then [such standards would be determined by other major central banks](#).

***Equitable Treatment and Privacy.*** The term “stablecoin” refers to a form of money issued by a private enterprise which guarantees that its value will remain stable, as distinct from cryptocurrencies whose value can exhibit sharp fluctuations over time. [Facebook](#) has been the first huge multinational firm to announce the launch of a stablecoin which was originally labeled “Libra” but is now called “Diem.” However, Facebook does not appear to be the only Big Tech firm exploring this opportunity: [Amazon](#) recently posted a job advertisement for a lead manager to oversee its work on digital currency and blockchain products. Each of these firms has a huge international network of customers and business partners as well as very deep pockets for funding promotional initiatives. In a scenario where one or two Big Tech firms succeeded in dominating the entire U.S. payments system, policymakers would face a regulatory nightmare in seeking to preserve consumer privacy and equitable treatment of small businesses. Indeed, concerns about disparities in payment transaction fees and processing times would likely dwarf concerns about internet service providers throttling the speed of their customers bandwidth. Consequently, the general manager of the BIS characterized the forthcoming launch of Facebook’s stablecoin as a “[wake-up call](#)” for central banks.

## **Conclusion**

As America’s central bank, the Federal Reserve has a crucial responsibility for ensuring the effectiveness of the payments system. Indeed, since Congress created the Federal Reserve a century ago, its first stated purpose in the official title of the Federal Reserve Act has been “[to furnish an elastic currency.](#)” That Act also refers to “commercial paper”, but to my knowledge no one ever raised any objections about the Federal Reserve’s statutory authority when the commercial paper market became fully electronic. Likewise, the Federal Reserve has taken a very expansive view regarding other aspects of its statutory authority, including previously unthinkable actions such as purchases of [corporate bonds](#) as well as securities backed by [commercial real estate](#). By contrast, the Federal Reserve Act does *not* have any clause requiring Federal Reserve notes to be issued as paper bills, and hence legislative action should not be viewed as a prerequisite for the creation of digital dollars.

Nonetheless, the Federal Reserve is responsible to the U.S. Congress as its boss, and hence it is fully appropriate for Federal Reserve officials to confer with members of Congress before proceeding with a major new initiative like this. However, the need for such consultations should not be interpreted as justification for inertia or protracted delays in carrying out the statutory mandate given by the Congress, namely, to ensure that the payments system works as well as possible for ordinary families and small businesses across America.

Thank you for your consideration; I will be glad to answer any questions.