DIGITALIZATION OF (LEGAL TENDER) CURRENCIES: OVERVIEW OF CURRENT MARKET INITIATIVES AND IMPLICATIONS FOR THE FX MARKET

Presentation to the ECB FXCG

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All documents and information placed and intended at the disposal for the ECB FX Contact Group meeting September 2021
WIDER PRIVATE CRYPTOCURRENCY ADOPTION TAKES PLACE…

Bitcoin now introduced as official currency

EL SALVADOR TO START, PANAMA AND UKRAINE TO FOLLOW?

El Salvador
• officially enabled Bitcoin as legal tender and official currency on 7th September 2021.
• Connectivity takes place via an app, that offers citizens $30 of free bitcoin.
• The government announced that it purchased additional 150 Bitcoins on the launch, bringing its total holdings to 550 Bitcoins (~$25mio). The programme is backed by a $150mio government fund that was approved at the end of August.
• The change means businesses should accept payment in bitcoin alongside the U.S. dollar, which has been El Salvador’s official currency since 2001 and will remain legal tender.

Panama
• On 8th September 2021 Panamanian Congressman Gabriel Silva introduced a bill designed to provide "legal, regulatory, and fiscal certainty to the use, holding and issuance of digital value and crypto assets in the Republic of Panama."
• The bill, entitled "Crypto Law: Making Panama Compatible with the digital economy, blockchain, crypto assets, and the internet," was announced on Twitter by Silva.

Ukraine
• passed a draft law to legalize cryptocurrencies the day after El Salvador’s Bitcoin Law came into effect, with a view to open up the crypto market to businesses and investors by next year.

Sources: Bloomberg, Reuters, Twitter
…AS THE CRYPTOCURRENCY SPACE EVOLVES

Catering for different participants

STABLE COINS AND PRIVACY COINS SEE INCREASED DEMAND

Parallel trends that cater for investors searching for:

1. the benefits of cryptocurrencies but less volatility = stable coins (e.g. Tether, USD Coin, Binance USD etc.)

2. The benefits of privacy and disguise of origin = privacy coins (e.g. Monero, Zcash, DASH, Horizen, Verge etc.)

The introduction of CBDC’s bring change to FX and could even become a regulatory tool, if pre-programmed against a conversion into private cryptocurrencies (something that can’t be done with fiat cash that is in circulation).

Sources: Bloomberg, Reuters
COUNTRIES STEP UP REGULATION IN DIFFERENT WAYS

Approach of China vs. US

CHINA’S CRYPTO-REGULATION IS ACCOMPANIED BY THE LAUNCH OF A RETAIL CENTRAL BANK DIGITAL CURRENCY*

**China**

- In China regulators already drew the line early on. Crypto mining is banned and the ability of Chinese individuals and entities to participate in cryptocurrency is limited. As recent as May the Government issued warnings to the country’s financial institutions to stop cryptocurrency activities.
- **Simultaneously China rolls out its own retail Central Bank Digital Currency (CBDC).** E-RMB tests first began in April of 2020 and as of July 2021 1.3 million outlets use e-RMB, nearly 21 million retail e-RMB wallets are opened and transactions of 5.3bn USD in value have been facilitated.
- A pilot for foreigners attending the Beijing Winter Olympics is planned.
- Moreover, the PBOC in its CBDC whitepaper stated it is exploring cross-border payments using the Digital Yuan and seeks to participate in discussions on setting Global CBDC standards (Multiple CBDC Bridge project with the BIS*).

**US**

- U.S. Securities and Exchange Commission Chair Gary Gensler put the cryptocurrency industry on notice of how far he’ll go to bring it to heel. In threatening to sue Coinbase Global if the exchange lets customers earn interest on digital tokens, the regulator sent a warning to other firms offering similar products or even just thinking about it.
- Most recently treasury officials recommended stricter oversight of stable coins and Tether in particular.
- Federal Reserve Bank announced it will issue a discussion paper on the digital dollar – expected in September 2021.
- Federal Reserve Chair Jerome Powell has repeatedly said that the Fed is not eager to be first with a CBDC but wants to get it right, if it goes down that road at all.

* Retail central bank digital currency (CBDC) focuses specifically on the general public. A retail CBDC would therefore allow households and businesses to make payments directly and store value using an electronic form of central bank money.

Sources: Bloomberg, Reuters, * https://www.bis.org/about/bisih/topics/cbdc/mcbdc_bridge.htm
WHAT IS NEXT?

What will the impact of CBDC’s be on the FX market?

POTENTIAL IMPLICATIONS ON EXCHANGE RATES AND THE INFRASTRUCTURE OF THE FX MARKET

Therefore we should discuss with a forward looking angle:

What could be the impact of CBDC’s:

A) on the FX market as it exists today and

B) on private cryptocurrencies, as they are added to the FX suite (and the sell- & buy side is embarking on trading it)?

How about:
WHAT WILL THE IMPACT OF CBDC’S BE ON THE FX MARKET?

Potential implications on exchange rates and the infrastructure of the FX market

RESERVE CURRENCY VALUATIONS TO CHANGE & RENEWED PRESSURES ON FX MARGINS WITH INCREASED EFFICIENCIES

Geostrategic:
• An overhaul of the composition of global FX reserves could take place
• The IMF defines foreign exchange reserves as “official public sector foreign assets that are readily available to and controlled by the monetary authorities” (IMF 2001). This definition lends itself to be extended to the best practices of reserve management, like prudent liquidity and credit risk management or the generation of a steady cash flow.
• Would a digital currency, or more generally a digital asset, qualify as a reserve instrument? So far, only a very limited subset of the existing asset universe enjoys reserve status.
• According to the IMF, worldwide allocated reserves amounted to $11.9 trillion at the end of 2020, of which roughly 80% were denominated in either US dollars or euros.
• Would a first movers advantage in launching a Central Bank Digital Currency result in substantial shifts in flow, changing that current composition?

Valuations:
• If countries are able to build wholesale, cross-border CBDC mechanisms at scale, these payment systems could begin to replace SWIFT and other messaging systems as the preferred bank-to-bank transfer system. This could reduce the share of international trade and capital flows denominated in USD?

Infrastructure:
• Distributed ledger technology (DLT) could have numerous benefits when applied to clearing and settlement of FX (e.g. less counterparty risk, lower settlement fees, fewer intermediaries, higher level of transparency).
• DVP provided by clearing houses and t+2 trading to account for time differences in settlement in FX become obsolete. Would a higher degree of standardization pave the way for an exchange traded model?
• Efficiencies will most likely lead to continued pressure on margins (less ticket cost, less credit risk).

Sources: Bloomberg, Reuters, IMF
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