Intelligence MEMOS

From: Mark Zelmer and Jeremy M. Kronick

To: Canadian Crypto Watchers

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Re: **Is This Going to Be the Year for Crypto?**

The world got its first digital currency, DigiCash, in 1989. Nine years later it filed for bankruptcy.

We're still waiting for digital money to take over from cash – as seems inevitable.

Is 2022 the year?

Bitcoin (est'd. 2009) is the best-known crypto currency. It has no value in its own right, yet it has a market value around US$800 billion, almost 40 percent of the total crypto currency market valuation. Bitcoin aspires to be used widely as a currency and has been accepted as legal tender in some developing countries, most notably El Salvador. But its price in US dollars – its exchange rate, if you like – is very volatile, making it too unstable for transaction purposes. And it currently processes about seven transactions per second compared to VISA's average of about 1,700. At bottom, its cumbersome blockchain technology slows settlement speeds even as production of new Bitcoins is extremely energy-intensive.

Meanwhile, "stablecoins" look more promising as a currency replacement. They are designed to be closely tied to conventional currencies, like the US dollar or a basket of currencies. This tight link is achieved by having stablecoins place their funds in high-quality assets, such as US Treasury securities and other high-grade US denominated assets linked to the US dollar, which should make for stable values.

Stablecoins backed by fiat currency and large social platforms such as Facebook could easily become global in scope given the sheer size of the potential user base. One concern for governments and central banks in particular is the possibility that most financial transactions in (to pick a country), Canada, might eventually be conducted in a stablecoin linked to a currency that was not the Canadian dollar.

Some might welcome that – Canada's history is littered with advocates for the (US) dollarization of our economy – but we think most would not.

If Canada's money supply consisted mostly of Facebook stablecoins backed by US dollars, Canadian governments might have trouble borrowing in Canadian dollars, while the Bank of Canada might struggle to provide liquidity.

Without access to deficit finance and monetary expansion, Canadians would have to absorb such economic shocks via potentially painful adjustments to prices and wages, as was the case during the Great Depression of the 1930s. History suggests such pain usually is borne by the most vulnerable in society.

If crypto currencies really are the future, we therefore need stablecoins whose value would be closely linked to the Canadian dollar, thus enabling Canadians to continue to conduct most of their transactions in their national currency.

There are many possible options. At one extreme, some suggest we should leave things to the private sector to sort out; at the other are advocates who believe the answer is simple: give everyone in Canada an account with the Bank of Canada and let them conduct transactions using those accounts instead of cash.

In our recent C.D. Howe Institute paper, we argue for a middle road: a monetary system all Canadians will willingly accept, not one created by outlawing various alternatives.

Over the years, Canadians have demonstrated a clear preference for private-sector payment vehicles for conducting their transactions – think commercial bank deposits. We believe they would favour privately issued stablecoins that were well-designed, well-regulated and linked to the Canadian dollar.

To encourage economic stability, however, these stablecoins should have access both to central bank liquidity facilities, so that transactions settle in good times and bad, and to deposit insurance, so as to mitigate the risk of runs.

But we also believe stablecoins will only succeed if they can be digitally converted into Canadian dollars without having to rely on paper banknotes. One mechanism would be for the Bank of Canada to issue a digital currency – a "Bank of Canada Digital Currency" or "BCDC" (as opposed to AC/DC, a heavy metal variant).

A BCDC would be the digital equivalent to our current paper banknotes: everyone can use it, transactions are private between the two parties involved, transactions settle immediately, and there is no exposure to cyber or technology risks. Unfortunately, the world still doesn't have an effective digital currency that can meet those requirements – so the time to begin is now.

Meanwhile, governments must never forget that while they can encourage Canadians to use BCDC or stablecoins tightly tethered to the Canadian dollar, they cannot compel them to do so. Canadians will continue to have choices. They will favour Canadian dollar-linked payment vehicles under two conditions: first, that Ottawa allows innovation in the payments world so transactors can actually use new payments technologies, including crypto, and, second, that the government and Bank of Canada maintain the attractiveness of the Canadian dollar by keeping inflation low.

Mark Zelmer, former Deputy Superintendent of Financial Institutions at OSFI, is a Senior Fellow of the C.D. Howe Institute, where Jeremy M. Kronick is Associate Director, Research.

To send a comment or leave feedback, email us at blog@cdhowe.org.

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