Updating Dollar Diplomacy: Restoring U.S. Leadership with Digital Currency Standards

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Imagine a world where governments disagree about what fiat money should be and what it should be able to do. While today we enjoy the privilege of a global economy in which the design and use of government money are largely uncontested, this status quo is not guaranteed. In fact, the stability of this consensus is in jeopardy during today's transition to an increasingly digital economy – a pattern that has not left currencies behind. Indeed, governments across the world are currently building their own digital fiat currencies, some of which look radically different from today's status quo fiat money. Notably, a long-time skeptic of the race for government digital currencies, the United States, has recently entered the fray with promises to deliver a prototype design by July through its research with MIT. While governments are moving quickly with their projects, little action yet exists at the most important frontier of this issue: coordinating standards and designs.

Central bank digital currencies (CBDCs) are not like Bitcoin or other cryptocurrencies, which substitute sovereign backing for encrypted ledger systems. CBDCs are also unlike other, more recent kinds of digital money like stablecoins, which replicate the stability of government money without an actual government behind them. Rather, CBDCs constitute an evolution in the technology of money, the fundamental economic technology that makes government promises credible. In this respect, digital fiat money stands as both the most radical and likely the most disruptive technological change in the design of public or private money today. As a result, it also stands as the forefront monetary policy issue facing countries today, not only with respect to how a digital currency should be designed, but especially in terms of making binding global standards on how digital currencies are used by states in global economic and political relations.

As governments build digital money for either domestic reasons, like financial inclusion, or in response to digital money projects in counterpart governments, they face a wide array of critical questions which will shape the future global monetary order. Issues of timing, technical design, and cooperation all raise classic collective action problems, which are typically resolved through robust global leadership. Unfortunately, the race for government digital money comes at a time when leadership is lacking, and challengers to the global order are more active than ever. For this reason, although governments are estimating years-long timelines for their various projects, what happens in the coming months and years will play a critical role in shaping the future of digital money. More simply stated, actions countries take today around digital money will likely create both the opportunities and constraints they face as digital currencies begin to be used at scale.

At this juncture, the United States faces twin crises of political and economic power stemming from abdicated leadership on critical issues facing the world today. On the one hand, American leadership through diplomacy has been faltering – and in the last four years, actively imploding – as the country retreats further and further from its central role on the world stage.[1] On the other hand, the role of the dollar is in active peril, due to a combination of large-scale domestic spending programs and iterative application of sanctions on countries that buck global norms.[2] In both cases, the United States is witnessing corrosion of its instruments for setting and enforcing norms through non-military means across the world. The Biden administration faces a unique opportunity to begin solving both problems with a single move: leading on standards with the digital dollar.

The Race for Digital Fiat Currencies

The United States must make assertive decisions on its central bank digital currency with a clear timetable for progress and a clear template for technical standards. Some may dismiss this call for action as another argument in the already-lengthy list of what a digital dollar can deliver: more efficient direct payments to Americans,[3] more effective cross-border payments for firms and banks,[4] and a better ability to limit money laundering and criminal financing,[5] to name a few. The domestic benefits of a digital dollar are certainly promising and bode well for the vast numbers of unbanked and underbanked Americans who struggle to access traditional consumer finance options.[6] The promise of more efficient taxation and transparent direct payments to Americans may serve as a rare point of unity for conservatives and liberals in Washington at a time of gridlocked partisan policy-making. The improvement in monitoring how money is used within and across our borders almost certainly guarantees the support of America's geopolitical security personnel, who can be reticent to support risky new ideas that interface with their turf.[7]

While these are surely good reasons to pursue a digital dollar, there is a second central drumbeat in this conversation: China's unchecked pilot of its own digital currency, the Digital Currency Electronic Payment (DCEP). Many commentators with an eye toward global monetary affairs have rightly suggested that, absent U.S. leadership, China's digital currency stands to challenge the dollar as a global reserve currency.[8] The DCEP has already been piloted in several major Chinese cities and is slated for widespread use in time for the 2022 Winter Olympics.[9] While denying allegations publicly, the Chinese leadership has been transparent about its goals of regionally – and eventually globally – unseating the dollar as an all-powerful currency for economic relations among countries. A number of observers have detailed the ways in which this directly threatens America's economic standing in the world. The DCEP challenges the power of the dollar, and by extension, U.S. alliances in Asia.[10] It also stands as an instrument for subverting U.S. sanctions,[11] and serves as a force multiplier for Chinese influence through the Belt and Road Initiative.[12]

Yet it is not only economic competitors to the United States who are pursuing digital currencies. Recent reports suggest that more and more central banks are getting in on the action.[13] Notably, this includes a significant number of U.S. allies whose projects are described as 'just-in-case' measures for when other countries (read: China) launch their digital currencies. Some clean-cut U.S. allies fit this bill, such as Canada and Japan, whose projects are described as precautionary pilots in case other countries' pilots bear fruit.[14] Other countries fall more ambiguously on this line, like Singapore, whose strategic positioning between Washington and Beijing has been both a political opportunity and, at times, an economic cost for the financial hub.[16] Yet other countries more closely aligned with China, like Malaysia, are also building digital currencies and are actively working with China in order to ensure the technical consistency critical to these projects.[17]

Importantly, these different rates of progress and coordination are complemented by meaningful differences in digital currency designs across these projects; some of these are simple digital reflections of existing money, whereas others propose substantial changes to what government money is and what it can do in both domestic and international economic relations. Importantly, while more radical digital currency designs might seem to be idiosyncrasies of countries' various preferences, they pose real long-term issues for both private and public actors, namely in challenging how digital government currencies will work together in global trade and investment. Here, we face meaningful options which previously were either untenable or infeasible, ranging from a transition toward direct banking with central banks, to the possibility of government surveillance of all consumer transactions on a sovereign blockchain. Most importantly, many of these design features are simply not compatible in ways that are needed for cross-border exchange.

As such, an important thread in this recent trend has been the dire need for consensual standards in digital currency designs. These are not simply technical quibbles over what ledger system to use; rather, they include fundamental questions about the role of central banks, the private banking sector, and how companies and consumers navigate domestic and global financial systems with fiat money. Standards for digital currencies mean the difference between a smooth transition to a yet-more-digital economic world, and a global economy in which revisionist states can use digital currencies to achieve economic, political, and even military objectives. A simple example comes from the popular discussion on several fast-moving digital currency projects, from Venezuela's past (and failed) attempt to China's ongoing pilot. Many countries have an incentive to build digital currencies as a means of subverting sanctions.[18] This has obvious negative consequences for the ability of the United States ability to employ soft power as a way of unwinding tensions in lieu of non-violent actions. Undermining one non-violent mechanism for settling disputes or incentivizing state behavior leaves fewer viable, peaceful options available to decision-makers.

While this issue makes clear the security implications of design standards, others are more nuanced. For example, a number of developed and developing economies are also moving forward on their own pilot projects as a response to chronic underbanking in their economies. Some of their pilots, as a result, lean on a design feature of digital currencies that is relatively rare among current pilots: direct accounts held by consumers with the central bank.[19] This system circumvents what is known as the 'two-tiered banking system', wherein individuals have accounts with (and claims on) private banks, who have accounts with (and claims on) the central bank. While this may irritate private banks in those countries, it raises serious questions about how multinational banks navigate a world of conflicting digital currency designs and standards. Such choices may disrupt one of the key ingredients to economic growth: efficient banking. While this tension may not be as immediately apparent as subverting sanctions, it may be a greater disruption to the global economy if consensual standards are not created and enforced for digital currencies.

Steps for Restoring Leadership Through a Digital Dollar

The United States is uniquely well-positioned to provide leadership and to enforce norms around digital currencies; failing to do so may mean this ability will disappear as other countries take the lead. In this respect, the Biden administration faces a low-cost win, but with an enormous downside of inaction. Should the administration choose not to lead on standard-setting, it is clear that other countries – notably China and Russia – are able and willing to fill that void. It is not a difficult mental exercise to understand the significance of losing the race for standards in digital money, especially given countries' explicit proposals to undermine U.S. sanctions enforcement and dollar hegemony with alternate currency designs and standards as the norm. If the administration does choose to meet this responsibility, there are four obvious and simple next steps for the United States to provide leadership through standards on digital currencies.

First, the United States must engage a whole-of-government approach to develop and launch the digital dollar by a specified date, and specifically one which matches the aggressive timeline of first-movers in this space. While there is a first step of collaboration between the Boston Federal Reserve and the Digital Currency Initiative at MIT,[20] a meaningful digital dollar prototype requires buy-in from a wide variety of government agencies ranging from the Treasury and SEC to the State Department and intelligence agencies. As with a wide variety of other regulatory issues in the past which touch on highly diverse sectors of political and economic relations, digital currency leadership cannot be meaningfully undertaken without buy-in from all actors in the U.S. government whose roles will be affected by these new instruments. Without active coordination across these arms of the U.S. government, the constitutionally slow pace of delegated government activity will prevent meaningful leadership on digital currencies internationally. In this respect, establishing a digital dollar czar to coordinate cross-government actions in digital currencies, or widening existing interdepartmental collaboration efforts, represent a critical first step.

Second, the United States must cooperate with its partners and allies through existing multilateral institutions to craft easy-to-reach rules on central bank digital currencies. On this issue, the high-level principles from the G7 joint report serve as simple starting points for bringing in allies who want to collaborate on standards but are unsure how exactly to do so. Critically, the United States and its close allies must move quickly from abstract principles of what a CBDC should do toward specific and actionable principles on what a CBDC can and will do. This more detailed cooperation will undoubtedly raise more issues than the abstract principles which initiated the talks, as discussion proceeds into the gritty details of winners and losers from different digital currency design standards, but establishing a foundation and rationale for shared standards is a

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necessary step to developing them through leadership. As with many of the challenges facing countries during the 121st century, U.S. unilateralism will be at best a haphazard solution, and at worst will deepen divisions among countries whose respective opportunities and costs associated with different digital currency standards vary significantly.

Third, the United States and its allies must work to bring non-allies to the table by collaborating on issues that all countries will need to resolve around digital currencies. A bloc-level approach to setting standards will at best produce a bipolar world of competing for digital money standards; at worst, it will encourage the weaponization of money to achieve unilateral political goals.[21] History shows us that differences in countries' preferences can be overcome by targeting higher-level goals, with rich examples from longer-standing sustainable development goals,[22] and more recent initiatives on climate change.[23] In this case, the United States can avoid a bipolar monetary order by setting clear lines in the sand before the conflict is even likely. This takes the form of not only carrots, such as crafting and clarifying incentives around shared digital money standards, but also sticks, like clear lines in the sand around whether banks or other financial institutions may engage in business with countries whose rules are too different from U.S. standards. With the weight of the world's largest economy, the United States still has the power to bring non-allies to the table, and must do so in order to truly lead on digital currencies through standard-setting.

Fourth and finally, the United States must extend its leadership in digital currency standards to restore its leadership in other related issue areas. As a natural extension of the third step – bringing non-allies to the table on digital money standards – this final step involves pursuing new avenues of leadership by building on success in this domain. Luckily, there are few domains that are not related to money and standards around money. Successfully leading in digital currency standards opens a Pandora's Box of options to the Biden administration for restoring American leadership, ranging from strengthening cooperation in anti-money laundering efforts,[24] to establishing the much-needed regulatory link between banking and private financial activities and climate change.[25] Indeed, a long line of international relations scholarship suggests strongly that international coordination on hard issues becomes much simpler when it builds on the success of easy wins.[26] In short, there are very few chronic issues that would not be easier to solve with robust U.S. leadership in the digital currency domain. Yet these cumulative gains are only possible if the United States begins leadership on an issue more foundational to the global economy: money.

Fiat money is the fundamental economic technology that makes government promises credible. As the Biden administration inherits not only the aftermath of his immediate predecessor, but also the consequences of years of abdicated U.S. leadership, credibility will be a precious asset. Today, as countries across the world actively reconsider what government money is and what it can do in international relations, traditional leaders like the United States face a unique opportunity to offer leadership where it is sorely needed. While the downside risks of inaction in this issue may be high, the upsides of re-establishing U.S. leadership through digital currency standards are yet higher. America has the ability to lead on digital money, and standards on technical design and cross-border compatibility of these instruments are a low-cost way to achieve this. What remains to be seen is whether the United States is willing to take these simple steps toward restoring American leadership by starting with its digital dollar.

ENDNOTES

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