Updating Dollar Diplomacy: Leading on Digital Currency Standards

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Today, we enjoy the privilege of a global economy in which the design and use of government money is largely uncontested. But this status quo is not guaranteed. In fact, the stability of this consensus is in jeopardy amid the current transition to an increasingly digital economy, complete with digital currencies. Governments across the world are currently building their own digital fiat currencies, which are digital versions of existing government money, and some of these projects look radically different from today’s fiat paper money (e.g., the US dollar). Notably, the United States, a long-time skeptic of the race for government digital currencies, has recently entered the fray with promises to deliver a prototype design, which would establish the function and features of a digital dollar for feedback by individuals and organizations, through its research with the Massachusetts Institute of Technology (MIT). While governments are moving quickly to move from prototypes to final versions, little action yet exists at the most important frontier of this issue: coordinating standards and designs for digital currencies across countries.

Central bank digital currencies (CBDCs) are not like Bitcoin or other cryptocurrencies. Cryptocurrencies are not backed by governments, and compensate for this non-sovereignty with unique technologies like blockchain ledgers that insure transactions through encryption. Cryptocurrencies also serve more often as investment instruments, similar to gold or stocks, and do not currently act as money in the way that currencies like the dollar operate. Finally, while many cryptocurrencies are already finalized products with relatively wide user bases,
CBDCs remain largely in the stage of research and development among countries at this point in time, and as such there are not yet finalized features of CBDCs which are mutually agreed upon. In this respect, digital fiat money stands as the principal monetary policy issue facing countries today, not only with how a digital currency should be designed, but most importantly in making binding global standards on how digital currencies should be used by states in global economic and political relations.

Countries have unique policy priorities that they hope to address with their digital currencies, like improving consumers’ access to banking services or improving the efficiency of fiscal and monetary policy at home. As governments build digital money for these domestic reasons, they also act in response to digital money projects in counterpart governments. This pair of incentives creates 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—quite similar to other two-level games like coordinating trade rules to balance domestic and international needs, or cooperating on appropriate banking supervision to prevent future financial crises—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 make the difference between a future economic order that resembles the one we have today, or one which is radically different for consumers, firms, and governments.

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 one hand, American leadership through diplomacy had been faltering as the country retreated further and further from its central role on the world stage. On the other hand, the role of the dollar as the globally preferred currency for economic exchange and lending is in active peril due to a combination of large-scale domestic spending programs and iterative applications of sanctions on countries that buck global norms. In both cases, the United States is witnessing a 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.
Digital Money and the Technology of Promises

Currency is the fundamental economic technology of money that makes promises credible. The physical properties of a currency have historically acted as the technology which makes currency viable for use as money. While digital currencies may be new to actors in the global economy, the evolution from paper money to digital currencies is part and parcel of the longer-term history in how currencies have evolved to address the changing needs of human society. Digital currencies share a common feature with other technologies of money—they are built not only to address chronic economic and political inefficiencies in and across societies, but they are also shaped explicitly by power structures around them.4

In order to understand today’s race for government digital money, CBDCs, we must first understand how evolution in private currencies and the patterns of strategic interaction among countries have respectively pressured governments to begin, accelerate, and finalize their projects with digital fiat money.

Many readers are familiar with Bitcoin, which has taken center stage in recent news for its wild price volatility and bellwether status for the broader cryptocurrency market. Some readers may be familiar with other major cryptocurrencies like Ether, or Tether, whose market capitalization is lower than Bitcoin and whose functional roles in the digital currency ecosystem are quite different. Importantly, though, there are thousands of cryptocurrencies beyond Bitcoin that exist today, all of which leverage blockchain technology—a database of transactions that exists on a network of many computers—to improve security and efficiency in traditional and new economic sectors of society.5 Firms, for example, are wading into new territory with digital corporate financing through initial coin offerings (like initial public offerings for corporate stocks, but in the form of digital tokens),6 and banks are cautiously testing their new permissions to use public blockchains and offer digital currency services to their consumers.7 Initial digital currencies had arguably clean-cut advantages like decentralizing retail banking and improving payment efficiency, and they also had clean-cut costs like their use in criminal financing and cross-border money laundering. These newer advancements in digital currencies among traditional actors like banks and firms, though, are creating thornier problems than earlier instances like Bitcoin, such as coordinating for consistency in technical implementations and building designs that are resilient to fraud, all of which serve to complicate potential regulation.

Governments now appear to be catching up in the digital currency revolution, albeit slowly. In 2017, when the first well-known price peak of Bitcoin coincided with a peak in initial coin offerings among firms,8 governments reacted with a wave of...
blanket warnings and bans against cryptocurrencies writ large. While this kept
the broader cryptocurrency market quieter for a time, rapid work continued in
the private development of non-governmental digital currencies, which has
today resulted in a much larger and more diverse market of digital assets and ser-
VICES. Indeed, even Facebook has established long-term plans to issue its own
digital currency, now known as Diem, which is meant to increase their power
over how users send and receive funds on their platform. This initiative, and
others among similar firms, increasingly rival central bank fiat money and pose
genuine concerns for the status quo of government money in economies where
the money supply is either tenuously managed or inefficient for consumers and
firms. Digital currencies have now entered the mainstream economy and are,
by extension, a qualitatively different entity than in 2017.

These newer private initiatives like Diem have visibly accelerated the pace of
government CBDC projects. Notably, many projects began long before the
advent of private initiatives like Diem and substitution pressures from crypto-
currencies. Venezuela, China, Uruguay, and several other countries all have
long-running research programs dating back before 2015. Other countries,
conversely, have begun their projects later on, in what appears largely a reaction
to both the expansion of the private digital currency market and the increasing
number of central bank colleagues exploring the topic already. While many
observers have noted the important domestic policy priorities associated with
central bank digital currencies, ranging from financial inclusion to improving
transparency of monetary policy, the international dimension remains generally
overlooked in this discussion. This omission of the international pressures in
digital government money is in sharp contrast with the prevailing narrative
among policymakers that a global race for central bank digital currencies is
already underway—and the United States is falling behind both its allies and
its competitors.

The Race for Digital Fiat Currencies

The United States must in this context make assertive decisions on its CBDC
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, more effective cross-border payments for firms and banks,
and a better ability to limit money laundering and criminal financing, to
ame 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. 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 policymaking. 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.

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 US leadership, China’s digital currency stands to challenge the dollar as a global reserve currency. The DCEP has already been piloted in several major Chinese cities since its inception in 2013 and is slated for widespread use in time for the 2022 Winter Olympics. While denying allegations publicly, Chinese leadership has been ambiguous 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, US alliances in Asia as it can substitute for one of the United States’ greatest peaceful incentives for military cooperation—cheap and reliable debt. It also stands as an instrument for potentially subverting US sanctions and serves as a force multiplier for Chinese influence through the Belt and Road Initiative (BRI).

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. Notably, this includes a significant number of US allies whose projects are described as “just-in-case” measures for when other countries (e.g., China) launch their digital currencies. Some clean-cut US allies fit this bill such as Canada and Japan, whose projects are described as precautionary pilots in case other countries’ pilots bear fruit. 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. Yet other countries more closely aligned with China, like Malaysia, are also building digital currencies and actively working with China to ensure the technical consistency critical to these projects.
Importantly, these different rates of progress and coordination are complemented by meaningful differences in digital currency designs across these projects. Some 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. For example, while some projects simply resemble a digital version of existing paper money in a country, other projects have borrowed features from cryptocurrencies, like encrypted ledgers, which directly implicates policy trade-offs between privacy and security in digital fiat money. Crucially, while more radical digital currency designs might seem idiosyncratic to countries’ various preferences, they pose real long-term issues for both private and public actors, namely in challenging how different digital government currencies will work together in global trade and investment. Here, we face meaningful options that were previously either untenable or infeasible, ranging from a transition toward direct retail 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 may simply not be compatible for cross-border exchange.

As such, an important thread in this recent debate has been the dire need for mutually-agreed upon standards in digital currency designs. These are not simply technical quibbles; 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 digital 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, such as Venezuela’s failed attempt to subvert US sanctions with an oil-backed digital government currency. Many countries have a domestic incentive to build digital currencies as a means of subverting sanctions and are able to pursue this through unique CBDC designs given the lack of any existing standards over such practices. This has obvious negative consequences for the ability of the United States to employ its 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 any attempt to sidestep US sanctions demonstrates the security implications of design standards, other implications 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. Such a 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 certainly may irritate private banks in those countries, it also 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 its effects 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.

The Importance of Leadership in Standards

Although the past half decade may suggest otherwise, the United States has a long record of global leadership through standard-setting. Following World War II, it helped establish standards of free trade, which guided the global economic order for the following decades through the General Agreement on Tariffs and Trade, or GATT (now the World Trade Organization). This simple set of standards on trade protectionism—while historically contentious—helped the world avoid a continuation of weaponized trade while those standards were followed. Similarly, when scientists detected a hole in the ozone layer in 1985, the United States helped to lead the charge to eliminate hydro-fluorocarbons from consumer-facing products, leadership that has had ripple effects in later cooperation on heat-trapping emissions. More recently, when the world suffered the worst financial crisis since the Great Depression, the United States coordinated with key allies to help craft and implement the Basel III Accords, which have provided a much-needed framework for the global banking economy and strike a balance between moral hazard and systemic risk. In each of these cases, the world faced an urgent need to solve collective action problems with mutually agreed upon standards in an issue area. In all of those cases across decades, the United States engaged partners to provide both material and intellectual resources to solve those issues.

Indeed, the success of US leadership in setting multilateral standards contrasts sharply with the failures of US unilateralism. We have seen a comparable battery of issue areas in which the United States did not step up to provide global leadership in standards, with a variety of undesirable outcomes. In some cases, the underlying issue has become weaponized and made coordination problems yet more difficult to solve. For example, the lack of standards in unmanned aerial vehicles (UAVs) has helped those weapons to proliferate globally. In other cases, countries like China have filled the leadership vacuum in contested
issues and cemented their own preferred standards. The failure of the United
States to accede to the Trans Pacific Partnership (TPP) and set standards for ser-
vice is an excellent example of a lost opportunity to lead through standards,
which has calcified the costs of competing standards in a trade agreement.36
Finally, in other cases we have seen incoherence give rise to the nationalization
of standards, which locks in incompatible standards across borders. We need look
no further than the internet to see how basic services can vary quite substantially
between Europe and China, for example.37 While there is much to gain by
leading through standards, there is also much to lose by failing to lead, especially
in the domain of money.
Countries badly need standards for digital money to proceed and are already
working to secure them—without the United States. One of the most salient
cases can be found in wholesale digital currency projects, which seek to make
cross-border payments between private and
central banks more efficient. While a variety
of countries are pursuing wholesale digital cur-
cencies on their own, a notable alliance has
emerged in Project Inthanon-Lionrock.38
Originally a collaboration between Thailand
and Hong Kong, as well as myriad actors
from the private banking space in those
countries, the project seeks to leverage decen-
tralized ledger technology—the underlying
technical promise of cryptocurrencies like Bitcoin—to make cross-border finan-
cial transactions more secure, faster, and simpler to monitor for fraud. The orig-
inal partnership aimed to facilitate information sharing between the two already
close economies and to limit reinventing the wheel on technical demands for
cross-border compatibility in these new currencies.
This year, China and the United Arab Emirates have joined the project,
which has been renamed the Multiple Central Bank Digital Currency (m-
CBDC) project.39 While the initial partnership of Project Inthanon-Lionrock
sought to limit redundancy in concurrent research, the pivot to m-CBDC in
the second phase of research explicitly recharacterizes the focus to ensure that
all four participating economies can enjoy the efficiency and regulatory gains
afforded by the underlying research. Whereas Thailand and Hong Kong
already enjoyed close financial ties before the race for digital currencies, as
well as generally friendly political relations, the added partnership with China
and the UAE potentially rewrites the attractiveness of all four economies to
one another in the private banking sector. More simply, in joining Project Intha-
on-Lionrock, China and the UAE have forged an opportunity to further inte-
grate their financial economies with strategic US allies in the region,
potentially shifting Washington’s negotiating postures in this issue area and others. This has real implications for related issues that hinge on these alliances in Asia—most notably ensuring a united front in mitigating Chinese aggression in the South China Sea.

While the G7 economies have launched their own working group into researching digital currency interoperability among their economies, the initiative remains much more of a thought-experiment than a project in binding standards. The latest update from this effort comes in the form of a joint report by a number of G7 banks which details high-level design principles for digital currency projects.40 These include generally vague guidelines for government digital currencies, namely that any digital currency project must coexist with cash, do no harm to financial stability, and promote innovation and efficiency. While these principles represent some movement from the prior G7 posture of avoiding digital money altogether, they pale in comparison to the rate of progress seen in the m-CBDC project, whose immediate next steps involve developing a working prototype.

Restoring Leadership through a Digital Dollar

The United States is uniquely well-positioned to provide leadership and enforce norms around digital currencies; failing to do so may mean this ability will disappear as other countries—notably China and Russia—are able and willing to fill that void. In this respect, the Biden administration faces a low-cost win, but an enormous downside of inaction. 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 US 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, 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 that touch on highly diverse sectors of political and economic relations, digital currency leadership cannot be meaningfully undertaken without buy-in from all these US government actors whose roles will be affected by these new instruments. Without active coordination across these arms of the US government, the constitutionally slow pace of delegated government activity would 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 would represent a critical first step in this direction.

Second, the United States should 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 could 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 that 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 necessary step to developing them through leadership. As with many of the challenges facing countries during the 21st century, US unilateralism would be at best a haphazard solution, and at worst deepen divisions among countries whose respective opportunities and costs associated with different digital currency standards vary significantly.

Third, the United States and its allies should work to bring non-allies to the table by collaborating on issues around digital currencies which all countries will need to resolve. A bloc-level approach to setting standards would at best produce a bipolar world of competing digital money standards; at worst, it would encourage the weaponization of money to achieve unilateral political goals. 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, and more recent initiatives on climate change. In this case, the United States can avoid a bipolar monetary order by setting clear lines in the sand before 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 drawing up clear lines around whether banks or other financial institutions may engage in business with countries whose rules are too different from US 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 should 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 which are not related to money. Successfully leading in digital currency standards would open up a wide range of options to the Biden administration for restoring American leadership, from strengthening cooperation in anti-money laundering efforts to establishing the much-needed regulatory link between banking—as well as private financial activities—and climate change. 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. 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.

Fiat money is the fundamental economic technology that makes government promises credible. As the Biden administration inherits years of abdicated US leadership in multilateral forums, 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 US 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. What remains to be seen is whether the United States is willing to take these simple steps toward restoring American leadership, starting with its digital dollar.

Notes


