SASAKAWA USA
Sasakawa Peace Foundation USA

Alliance Perceptions of Central Bank Digital Currencies

Abstract

On November 30, 2021, Sasakawa USA's U.S.-Japan NEXT Alliance Initiative held a Track 1.5 bilateral dialogue focusing on Central Bank Digital Currencies (CBDCs). This off-the-record, not-for-attribution event welcomed around 20 American and Japanese experts from central banks, government agencies, think tanks, universities, private banks, and the Embassy of Japan. It featured brief opening remarks from Mr. James Schoff, Senior Director of Sasakawa USA's "U.S.-Japan NEXT Alliance Initiative," a panel discussion moderated by Mr. Robert Greene, nonresident scholar of Carnegie Endowment for International Peace, and subsequent group discussion moderated by Mr. Schoff.

Introductions

In his introductory remarks, Mr. Schoff described the big picture of current policy discussions of CBDCs and how they connect to the "NEXT Alliance Initiative," including the development of CBDC in countries like China and their potential geopolitical implications for the United States and Japan. He introduced Mr. Greene as a scholar who has been conducting valuable research on China's financial sector and digital currencies, and then passed the baton.

Panel Discussion

In this opening panel session, Mr. Greene first set the stage by mentioning several points to keep in mind. First was the importance of appropriately distinguishing the public policy problems that wholesale CBDC proposals aim to solve from problems targeted by retail CBDCs. Second was how policymakers think about the risks of CBDCs, particularly with regards to interoperability concerns and private sector alternatives. Third was how the U.S. and Japan should respond to the potential impact of China's rollout of the e-CNY (also known as the digital renminbi, China's CBDC), and what China's digital currency could mean for the global payment system infrastructure. He introduced four panelists and asked one American panelist to provide an overview of the state of the debate over CBDCs in the United States.

The first American panelist raised four major areas of debate over CBDC policy in the United States: 1) financial inclusion; 2) international consequences; 3) privacy; and 4) competition with banks. The first issue has become politicized as a result of progressive calls for postal banking, and this was demonstrated by the fight over the confirmation of the Biden administration's nominee for Comptroller of the Currency (Saule Omarova, who withdrew her name from consideration just a week after this bilateral workshop). A key question here is whether or not CBDCs could meaningfully improve financial inclusion of the "under-banked."

The second issue is whether China's push for a CBDC will influence the role that the U.S. dollar serves in the global economy (for both reserve purposes and as an instrument of payment), and the perception by some policymakers that China's push underscores the need for the U.S. to launch a CBDC. The third is the privacy issue, which the American panelist believes will be an essential issue as the U.S. designs a CBDC, as he believes Americans will be sensitive to the federal government controlling information about private transactions. The last is the extent to which a U.S. CBDC would create competition with banks and the bank-dominated payment system.

A Japanese panelist went next and described how the Bank of Japan (BOJ) started a proof of concept (PoC) experiment of CBDCs this April. After the PoC, the BOJ may move on to a pilot program involving private businesses and end-users, but it has not decided if or when to go forward. He stated that the BOJ still has no plans to issue a Japanese CBDC, since Japan's existing safe and efficient payment system makes it difficult to find persuasive use cases. However, he emphasized that the BOJ recognizes the importance of getting prepared for possible future changes. He gave two examples of those changes. The first is the decline of cash circulation that may stimulate demand for CBDCs. The second is the potential fragmentation of the payment market where a small number of private players provide their own digital payment platform and create “walled gardens,” as it seems to be happening in China. In this case, CBDCs could play an important role to increase interoperability and fair competition. He noted that the BOJ’s CBDC project has a domestic focus, while recognizing a debate over China exists in the political sphere. He added that he thought the BOJ’s approach would be common to most central banks working on their CBDC projects.

Another American panelist provided an update on technical CBDC research being done in the United States and how experience from working with prominent cryptocurrencies is helping inform efforts to understand the range of technical possibilities for CBDCs. He explained that the core principles of official CBDC research in the U.S. relate to transaction speed, system resiliency, and safety, all of which are uncontroversial but hard to achieve technically. The results of the work that this American panelist is involved in will ultimately be open source and could allow policymakers, both in the United States and other countries, to choose different policy options for CBDCs. He noted that his team will continue to research appropriate CBDC designs over the next several years, focusing on programmability, auditability (ensuring central banks know the amount of CBDC on the system exactly), and privacy issues.

The final American panelist expressed her excitement about private sector alternatives to CBDCs such as stablecoins as well as the emergence of increased competition in finance. In her view, new private sector payments alternatives are more attractive than CBDCs as they allow greater competition and provide different payment options for people than CBDCs do on their own. She was concerned that CBDCs could drive out private sector innovation and leave us only one option. Also, she agreed with the other panelists’ concerns regarding privacy issues. She noted that there may be a possibility of not only the government watching what you spend your money on, but also an attempt to turn off your ability to spend money in a particular way. She also pointed out that having prominent stablecoins based on dollars can be a way to maintain the dollar’s status as a dominant global currency.

The moderator asked what challenges the BOJ faces in proceeding with its CBDC project, as well as how it views recently announced private sector efforts to launch a digital currency. He also asked about how the BOJ thinks about interoperability with regards to CBDCs and other payments systems.

A Japanese panelist responded that the BOJ faces many challenges. For starters, establishing any CBDC involves huge technical challenges and operational costs. Second, the risks of any CBDC system are quite large, and so any CBDC would need to have sizable protection measures to withstand cyberattacks and natural disasters. Third is the trade-off between the promotion of CBDC among the public and ensuring financial stability. Fourth is finding the right balance between privacy protection, AML/CFT (antimoney laundering/countering the financing of terrorism) requirements, and intermediaries' need for some data access. He emphasized that these challenges and trade-offs have to be considered carefully and weighed against potential benefits. In terms of the competition/walled garden argument, he elaborated upon his idea that in the case of big tech firms issuing stablecoins and enclosing customers and their data, it could hamper fair competition and undermine innovation.

At the end of the panel session, the moderator asked the group to share their perspectives on synthetic CBDCs, as well as concerns over interoperability between CBDCs and other emerging payment systems.

An American panelist suggested that CBDC could be designed as a core operating system on which private companies can build private stable coins. From his view, keeping in mind the importance of maintaining private innovation, it is hard to imagine a world with a lot of private stablecoins and this is where regulatory focus is needed. He also traced a lot of the debate about CBDCs to both U.S. and Chinese policymakers' reactions to Facebook's first proposal of Libra (backed by a basket of currencies). At the time, U.S. Congress members expressed strong concerns that it would undermine the U.S. dollar and government control over monetary policy. Meanwhile, Chinese policymakers instead worried that the dollar would become the biggest element of the basket and that this would cement the dollar's role in global finance and trade. He argued that this perception led China to accelerate its efforts to create its own CBDC. He suggested it is necessary to keep discussing how to upgrade public money in the U.S. while maintaining private innovation.

Group Discussion

In the group discussion part of the bilateral dialogue, Mr. Schoff posed several general questions. He asked the group how the United States and Japan assess the pressure to change and consider CBDC, such as the extent to which they should worry about the potential development of global standards of CBDC led by China, whether CBDC is a necessary component for the overall goal of improving the speed, reliability, and cost-effectiveness of cross border payments, and whether the United States and Japan can be key players in the process of financial modernization without issuing CBDCs.

An American participant started with questions to Japan's side, asking how the privacy argument fits in the BOJ's CBDC research project, as well as the politics of CBDC discussions in Japan, especially how various players look at the issue differently.

A Japanese participant responded that privacy issues regarding CBDC are a big topic within the BOJ, but it is not widely discussed outside the BOJ. There are many mixed views for CBDC among stakeholders in Japan, although there has yet to be high public interest. He felt that the BOJ was in no rush and is being careful to keep up dialogue with various stakeholders.

Another American participant chimed in asking the group whether or not there has been any thought about the legal design (or foundation) of CBDCs, to make users comfortable with regularly transferring large amounts of money, noting that the current international transfer system has been well litigated in terms of each stakeholder's responsibilities. Another American participant agreed on the importance of this issue and noted that there should be more attention paid, particularly in the stablecoin space. Some participants noted that there are bills in Congress that if passed, would authorize the Federal Reserve to create rules related to CBDCs.

The moderator added that, looking at the recent G7 principles for CBDCs, rules related to CBDC transactions likely would be derived from existing AML/CFT laws and should be essentially the same. Then he proposed a topic about China's interest in fostering an alternative cross-border payment system that would be faster, cheaper, and isolated from the influence of U.S. financial sanctions. He argued that, while Federal Reserve Board (FRB) Governor Waller dismissed the view that China's move would be a threat, there are potentially a lot of companies or countries that are interested in avoiding U.S. financial sanctions.

An American participant remarked that established economies like the United States already have a sufficiently effective payment system, so fixing this system is not really a priority. Improving financial inclusion is also unlikely to become a priority of incumbent industry, since it requires capital investment and the profitability of these programs is limited. Under these circumstances, she expressed her expectation that stablecoins can provide faster and lower-cost payments, as well as the ability to improve financial inclusion. She also touched upon differences between particular types of CBDCs referring to the recent World Economic Forum's white paper. It highlights the risk of non-distributed ledger technology (non-DLT) CBDC, which inherently has higher privacy costs, greater difficulty in maintaining confidentiality, and preventing unwanted data transmission. Lastly, she added that supporting private sector competition that drives innovation is beneficial, as it will continue to lead to greater choice for consumers.

An American participant then took the conversation back to the political dynamics over CBDC in Japan, asking where disagreement might exist. Responding to his question, the moderator introduced recent news that a consortium of Japanese firms announced a plan to test a new digital currency to be launched in FY 2022.

Following this input, a Japanese participant explained that Japanese banks feared the CBDC concept at first, but now they fear being left out of potential changes brought about by CBDC. In the consortium mentioned, banks and other companies are engaged with a series of discussions on specific use cases and key technology implementations. He thought that the further the consortium partners progress with detailed discussions and preparations, potential use cases have provoked fundamental questions about what the key difference (i.e., competitive advantage) would be between the new digital currency and digital bank deposits. Would the potential benefits outweigh potential costs? He added that banks and other companies in Japan will contribute to the BOJ's CBDC discussion to make the best product possible, but the jump from conceptual to real-world usage is a big one.

Another Japanese participant remarked that CBDC might enable the government to control and collect information of transactions between private parties, and that is a driving force for China to develop CBDC. However, this point and its implications have not been deeply discussed in Japan. He noted that advanced democratic countries might not want to issue CBDCs.

Remarks from these two Japanese participants provoked a question from an American participant, asking whether transferring bank deposits is much easier in Japan than in the United States, such that Japanese bank deposits behave more like modern digital currencies? This might explain why Japan may be slower to explore incorporating CBDCs into its financial system. Responses varied, as some noted that U.S. options include zero-cost methods of transferring, although the clearance time is longer (a few days), while in Japan they settle more quickly but with associated costs. In Japan, a participant noted that one can facilitate instant payment through bank deposit transfer, such as Zengin-Net (the equivalent of CHIPS in Japan). Furthermore, Zengin-Net plans to allow eligible non-banks to have access to Zengin-Net by FY 2022, which should enhance interoperability across banks and non-banks. End-user satisfaction with existing options in both countries is hard to compare.

Next, the moderator posed a topic related to large-value cross-border payment. He set the stage by arguing that while there seems to be a global consensus for the necessity of improving cross-border payment (various multilateral statements exist on this at the G7, G20, and OECD levels), views seem to be mixed about whether CBDCs are critical for making these improvements. FRB Governor Waller said in August that he was skeptical of the idea. Also, separate efforts are being made at G7, G20, and SWIFT to make international payments more efficient.

A Japanese participant highlighted the importance of protocols (meaning a data exchange application programming interfaces or API) to this discussion. In terms of cross-border payments, SWIFT mandates a certain protocol. He argued that we cannot depend on the protocol of Ethereum for cross-border payments, instead, we need a safer protocol. If CBDC can define these protocols, it would be useful, but he was rather skeptical of the view that CBDC is uniquely necessary to define these protocols.

An American participant stated that although most Americans think the current payment system works fine, in certain circumstances compared to dealing in cryptocurrency, the current system is relatively slow. Also, due to demand for crypto assets, stablecoins have grown. People recognize that the U.S. needs to speed up the payment system, but they tend to think the Fed will manage the reconstruction. He argued that improvement in the payment system can be achieved either in the form of CBDC or in another way, but it should be taken into account that other countries are also moving in the direction of issuing CBDCs. The United States needs to think about how to ensure interoperability with those foreign CBDCs and also about having the means to impose financial sanctions. In conclusion, he suggested that there should be an effort into designing CBDC to meet those conflicting objectives.

Then one American participant asked another about the recent President's Working Group (PWG) report on stablecoins. She answered that stablecoins have grown fast without a clear regulatory framework, so there is a debate about who should regulate them. In that sense, the report appealed to her, because she thought it presented the wrong regulatory approaches. The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) are named as potential regulators, and indeed, depending on how a stablecoin is constructed, it could end up looking like a security or an investment company. She also commented that whether the issuer of a stablecoin needs to be an insured and regulated bank is an interesting question. She believed that imposing a deposit insurance framework on stable coins would be a mistake. In addition, regulating stablecoins from a financial stability perspective might not be the best approach, since the regulator would likely take a heavy-handed approach to stablecoins regardless of their stage in the development stage. She thought this was an area where the U.S. Congress needs to weigh in.

An American participant then returned to the issue of global financial inclusion and improvement of cross-border payment infrastructure. He stated that the decrease in the correspondent banking relationships, particularly in certain African countries and in certain emerging markets, has become an issue, since it can lead to a decrease in the ability of manufacturers and local businesses in those countries to participate in cross border commerce. Many of these countries are located along with China's "Belt and Road Initiative." He wondered whether it should be an issue for alliance consideration. He asked the group what solutions could facilitate large-volume cross-border payments and cross-border commerce in these areas, asking whether planned changes to existing payment rails or payments systems based on new technologies are best suited to address these issues. One American participant commented that certain proposed rules would implement for virtual asset service providers the same regulatory approaches that are currently constraining correspondent bank relationships.

Regarding a separate question of whether the forthcoming Boston Fed CBDC open-source code will be able to be used by central banks in emerging market jurisdictions to launch CBDCs, a participant responded that he hopes the result of the Boston Fed's work would indeed be to help improve CBDC systems in these countries.

In conclusion, Mr. Schoff thanked the participants for their attendance and announced that the Sasakawa USA "NEXT Alliance Initiative" will continue to host a series of events in the coming months related to fostering the U.S.-Japan alliance collaboration in the related fields of digital transformation, economic security, and cybersecurity.

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*The **U.S.-Japan NEXT Alliance Initiative** is a forum for bilateral dialogue, networking, and the development of joint recommendations involving a wide range of policy and technical specialists (in and out of government) to stimulate new alliance connections across foreign, security, and technology policy areas. Administered by Sasakawa Peace Foundation USA (Sasakawa USA) and led by Senior Director Jim Schoff, the goal is to help improve the alliance and how it serves shared interests, preparing it for emerging challenges within an increasingly complex and changing geostrategic environment. Launched in 2021, the Initiative includes two overlapping lines of effort: 1) Foreign & Security Policy, and 2) Technology & Innovation Connections.*
