

# The Rude Awakening: Libra's Revelations and Financial-System Transformation



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- Regardless of its future, Libra is transformational because it laid bare the inability of legacy finance to meet modern market demand.
- Threatened as never before, central banks will save themselves even at sacrifice to regulated financial intermediation.
- Three outcomes are possible: radical transformation with resulting systemic risk; *de facto* nationalization; or orderly, rapid transformation into a resilient, equitable modern financial architecture. Policy decisions – not market acumen – dictate final outcome, with high risk of delayed decision-making leading to crisis-generated correction, not well-designed innovation.

When Libra emerged in June of this year, I was among the most skeptical, detailing the differences between running a global payment system with as many as 2.6 billion customers and handling billions of day-to-day postings of puppy pictures, the news of the day, and newly-discovered fashion must-haves.<sup>1</sup> Even if Facebook's public-policy record were resplendent – which of course is far from the case – handling other people's money encompasses a range of risks and responsibilities ill-suited to a "move fast and break things" corporate culture.<sup>2</sup> Indeed, this corporate culture couldn't even properly manage

Libra's product launch. But, bloodied but still unbowed, Libra soldiers on. The rationale for this dogged persistence is palpable: Facebook's on to something. In my talk today, I'll focus on what that something is, what it means for the structure of U.S. finance, who wins and loses thereby, and what's to come.

### ***What Facebook Knows***

Libra managed to muster a unified global response seen to date only in movies in which a spaceship from beyond the galaxy threatens Earth. President Trump<sup>3</sup> was joined in opposition to Libra by his implacable enemy, House Financial Services Chairwoman Waters,<sup>4</sup> FRB Chairman Powell,<sup>5</sup> Treasury Secretary Mnuchin,<sup>6</sup> and even the amassed financial authorities of the world's largest countries.<sup>7</sup>

Even so, it is undaunted, recently reaffirming its plans soon to launch in Switzerland no matter the high-profile "partners" who thought better of it.<sup>8</sup> I doubt this persistence is meant solely to prove a point.

With the instinct for the market's jugular that propelled all of the tech-platform companies from the garage to the billionaires' club, Facebook knows that the payment system is essentially stapled together from bits of central banks, big-bank interfaces, giant payment processors, all sorts of new payment devices, and a few core utilities. Although the Federal Reserve has spoken of the need for real-time U.S. payments since at least 2013<sup>9</sup> it only just now finally proposed a faster U.S. system.<sup>10</sup> Although the Fed trusts no one else to do it, FedNow won't go sort of live until maybe 2024. Even if payment providers are patient – and they're not – the U.S. system even under Fed control will still interface only clumsily with the other faster payment systems being more quickly built out around the world. As a result, anyone who thinks he or she can build a faster system has an open field.

Indeed, it's a downhill open field covered with powder snow if the payment provider straps on skis prohibited to its competitors under applicable retail-banking rules. Designed to slow things down to be sure no one gets hurt, these rules demand financial wherewithal and operational capacity with which to honor legal obligations. These protect consumers from fraudulent or erroneous transactions, ensure finality, permit transaction tracking, and enhance law enforcement. For all the payment system's clumsiness, it's very safe, safety that provides essential protections for low-and-moderate income (LMI) households who can't afford to lose even a few dollars. An in-depth paper my firm released earlier this year goes into more detail on the economic-equality issues posed by payment-system transformation.<sup>11</sup> Suffice it now to say that, for all the true benefits speed offers LMI households hard-pressed to pay their bills,<sup>12</sup> speed is only equitable when it's also safe.

### ***The Central-Banking Solution?***

Although Libra advocates tout financial inclusion,<sup>13</sup> tech-platform payment ambitions are at least as much about obtaining high-value troves of personal information that permit still greater precision marketing, cross-selling, and market dominance. With billions of customers – acolytes might be a better word – and existing dominance over an array of critical consumer sectors, the ability of tech companies to transform retail payment systems is not just clear, but also already upon us.

This existential threat to traditional payment systems posed first by Libra and soon by other tech-platform companies has galvanized stodgy global central banking as never before. It took from only Libra's launch in June until the mid-October announcement at the annual IMF meeting for the creation

of a new central-bank digital currency (CBDC) construct meant to keep payments strictly under central-bank control.<sup>14</sup> The Federal Reserve joins other central banks in talking more about economic inequality than in doing anything to fix it, but central bankers are as one when it comes to protecting their institutional might over financial-market infrastructure with systemic-risk potential.

CBDC could come in varying guises, with a recent IMF evaluation of these options positing a soup-to-nuts CBDC that pays interest to enhance its monetary-policy clout.<sup>15</sup> A recent letter from Federal Reserve Chairman Powell also provides an overview of CBDC in the U.S. context.<sup>16</sup> Importantly, Mr. Powell for the first time revealed that the Fed is already running some trials to see how CBDC might work. The President of the Federal Reserve Bank of Philadelphia posits that CBDC will be essential after the Fed gets it together on faster payments.<sup>17</sup>

Other senior Fed policy-makers are ambivalent or even opposed to CBDC, but the U.S. central bank's position remains to be seen. Importantly, Congress could also force its hand – progressives have suggested not just state and local “public banks,” but also direct Fed entry into consumer finance.<sup>18</sup>

### ***The New Payment-System Paradigm***

The *Financial Times* has concluded that, “...Regulatory arbitrage is actually at the heart of most fintech models.”<sup>19</sup> This is clearly essential to payment-system operations, evident not only in Libra's design, but also in all the hard work tech-platform companies have undertaken to gain access to FedNow. Facebook has proposed using its own awesome clout to become the global-payment utility; other tech behemoths are happy to let the Fed incur all the expense and take all the risk of doing so if they can access it without the cost of complying with all the regulations applicable to insured depositories.<sup>20</sup>

In its way, CBDC is also founded on regulatory arbitrage. Instead of escaping regulation, central banks assume that they are so impregnable that no safeguards need apply beyond the full faith and credit of an accommodating national government. CBDC would co-opt tech-platform ambitions by corralling them into a centrally-governed utility, ensuring safety and soundness by virtue of its own imprimatur and, perhaps, some entry-level payment-access eligibility requirements. However, along the way, CBDC also supplants bank deposit-taking and payment activity and poses a profound challenge to capital formation in the absence of private-sector financial intermediation.

### ***The Future of Finance***

All this leaves banks large, small, and in between in a devil of a predicament. Some of this is of their own making. The great financial crisis of 2008 came upon the banking system right as tech-platform companies were revving up. The lost decade in which banks at great cost complied with all the post-crisis rules created a vacuum in which Amazon, Google, Facebook, Apple, and potent fintechs honed their financial-services skills, determine where best to arbitrage regulated finance with data powerhouses, identified key product targets, and muscled their way into the payment-system reconfiguration of 2019. Had banks seen this coming, they might now be better prepared not just to defend franchise value, but also credibly to assure consumers that banks should be their trusted financial-services provider.

But however one might not love banks, I fear we'll miss them. If current trends continue, the U.S. will end up with one of two possible financial-services constructs: an unregulated financial system in which consumers run an access, fairness, resilience, and privacy gauntlet or a nationalized financial system in which central banks gather deposits, handle payments, and hold on their own portfolios the loans they think are good for us. Either way, the U.S. runs two very significant risks: heightened inequality and the prospect of bigger and still more devastating financial crises.

I would like to discuss these outcomes with you to see if they can be averted, so let me quickly sketch out why I fear these risks are present and compelling.

Private-sector finance is always inequitable because private-sector financial institutions always prioritize profit over purpose. However, unregulated finance with no purpose-driven guardrails is particularly potent due to its ability to marshal financial data to cross-sell other financial products or even to mandate the purchase of one service – an Amazon Prime membership? – on access to lower-priced loans or higher-yielding deposits. Another result of the great financial crisis is consumer indifference to whether funds are placed at a regulated bank or an unregulated fintech – after all, insured and uninsured depositors and debt-holders at many commercial companies were bailed out in 2008. In an ultra-low rate environment, the search to find something approaching a living return on savings dictates the market, not awareness of the resilience protections afforded only in a regulated bank, thrift, or credit union depository. Whether the Fed and FDIC will again bail everyone out is unknown, but even moderate macroeconomic or financial-market stress is likely to expose LMI consumers at unregulated financial institutions to considerable risk of loss they can ill afford.

It turns out that economic inequality is a leading cause of financial crises. Indeed, one study from the Federal Reserve Bank of San Francisco finds that inequality is the most significant indicator of subsequent financial crises.<sup>21</sup> The San Francisco study's findings are based on exhaustive research across decades in 17 countries and are largely the result of statistical correlations of inequality, productivity, credit growth, and crises. Productivity has a strong impact on crisis risk – an interesting issue in light of recent productivity lags attributed to tech-platform firms – but the widened income share of the top 1% is the most powerful antecedent to a crash even when controlling for an array of other possible causes. To put this in context, the most recent Federal Reserve analysis of U.S. economic equality shows that the top one percent now has 32.4% of U.S. wealth, now holding more wealth than the entire U.S. middle class.<sup>22</sup> What of the LMI earners about whom the Fed expresses such economic confidence? The wealth share of the bottom fifty percent of American households is up from year-end 2018, but these millions and millions of Americans still own less than two percent of national wealth.

Let me be clear: I do not blame Facebook, Amazon, Google, and all the rest for American inequality. It's been bad for decades and now getting hugely worse largely due to post-crisis monetary and regulatory policy.<sup>23</sup> However, making something really bad even worse is culpable. I think high-risk payments systems with no obligation to protect consumers and no ability to handle structural risk will indeed make inequality worse and crisis risk higher than that of course makes inequality even more awful. Were this to happen or even be understood to be the risk it is, then central banks will indeed nationalize consumer finance. This will make it safer, but will it be better? The history of central governments as central planners is not auspicious.

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<sup>23</sup> See the *EconomicEquality* blog site for more, available at <https://economiequality.blog/>.