China's digital currency could threaten the US dollar. Should the Fed build its own?

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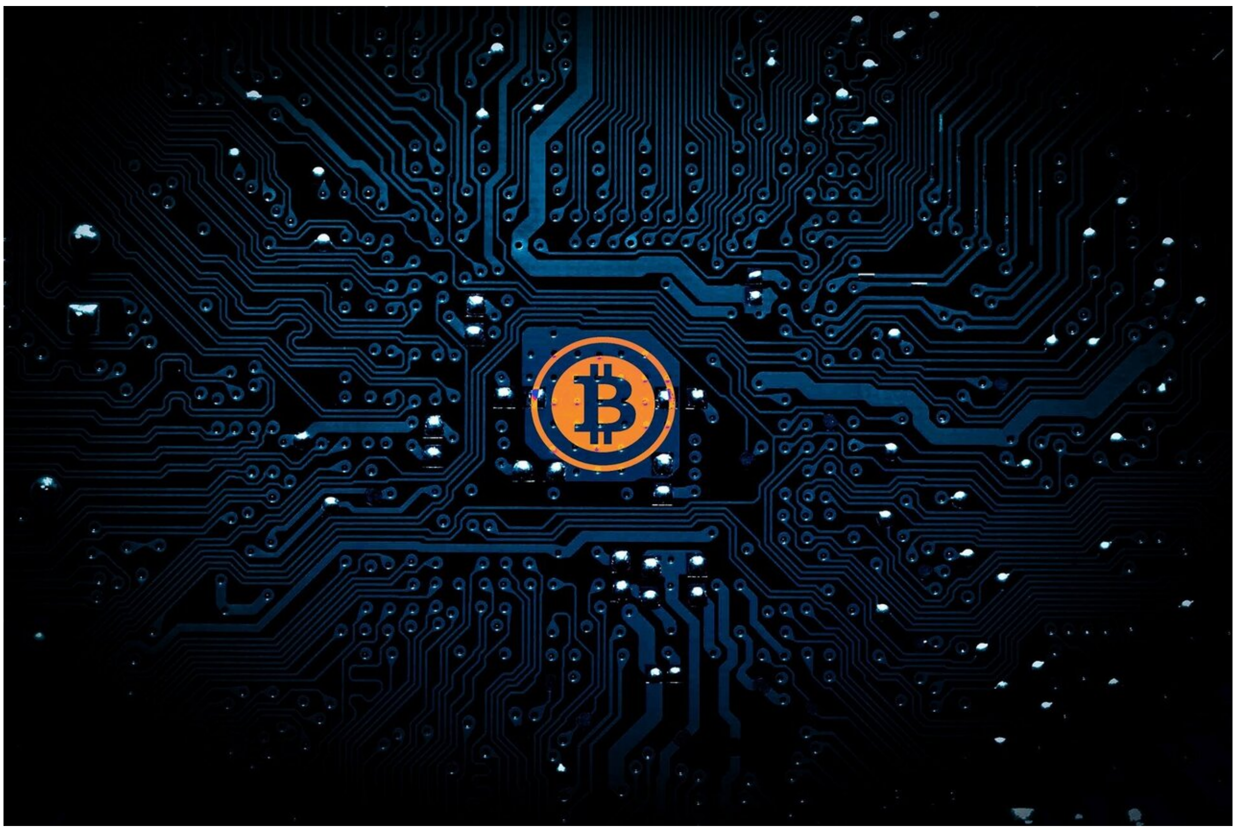

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From his office overlooking the Schuylkill River, Paul Melchiorre is puzzling over which new billion-dollar tech giants could rise from this economic slowdown.

A onetime SAP manager, who made the bulk of his fortune building software developers iPipeline and Anaplan, Melchiorre has spread his earnings among a string of tech funds, including LLR, NewSpring, Osage, and Stripes, all firms with local ties, and others.

Can recession spawn big, new, profitable companies? Melchiorre cites past phoenixes: Salesforce rose from the 2001 dot-com collapse and Uber amid the Great Recession.

In the COVID-19 pandemic shutdowns, he said, "tech companies hired like crazy," backed by investors eager to capitalize on delivery systems and work-from-home start-ups. But the cycle turned faster than expected: "Now they are cutting back. It's all about profitability again," Melchiorre said. "Watch the news, and you'll just get depressed."

Yet he still sees new wells of prosperity amid the gloom: data analytics, cybersecurity, artificial intelligence.

And, past the wreckage of the cryptocurrency bubble, he sees opportunities based on central bank digital currencies (CBDCs)—electronic money based not on some salesperson's futuristic pitch for private-money electronic "tokens," but on today's familiar national currencies, backed by central banks and powerful governments.

Central banks are studying CBDCs amid a high-stakes struggle between the U.S., China and their allies and trading partners as to whose money should serve as the world's favorite currency.

How does electronic money work?

Melchiorre, beside his investments in East Coast tech funds and Shore cannabis ventures, has a stake in that question: He's an investor in and chairman of R3, one of the technology start-ups that builds systems for use by digital currencies, with offices in New York and London.

Isn't our money already electronic, mostly? Since the 1960s, a complex network of online payment systems has grown to serve consumers and companies. Credit, debit and ATM cards; automatic bill-pay; computer-transmitted letters of credit; and other familiar services move our money, each grabbing a cut from your bank or merchant.

Supporters of CBDCs say an explicitly digital Federal Reserve dollar, operating on a secure, high-speed network under careful rules, could cut down on the fees charged by banks and other intermediaries. It could also take a lot of the pain and insecurity out of distant transactions by setting programmable conditions for making payments in compliance with each nation's laws.

Politicians like Florida Gov. Ron DeSantis and others fear this could give central bankers new access to personal and business spending records. If the Fed not only issues money, but also controls a system to track its every electronic move, won't that give central banks the power to control people by denying them the use of the digital currency, for example for political reasons?

Or would that power be nothing new? Today's payment systems "already disclose a great deal of user data to their operators and authorities," said David Rutter, R3′s chief executive.

R3 has developed a "distributed-ledger" digital system that updates records as payments are made—not publicly to all users like the "blockchain" ledgers that cryptocurrencies are based on, but among secure transaction participants, including regulators as needed. R3 claims 400 financial-institution users, including governments. Melchiorre is the company's board chair.

According to Rutter, a digital central bank currency can coexist with old-fashioned cash even as it replaces more cumbersome electronic systems; it can be designed with "cash-like privacy features."

Competing with China's digital yuan

Why now? I asked Melchiorre. "China has a digital yuan," and it's using it to bully its many trading partners into abandoning the dollar, which threatens to weaken American financial power and drive up the cost of imports.

This "e-CNY" (CNY is the trading symbol for China's currency, the yuan), was presented to the world at last year's Beijing Olympics and has quickly rung up billions in online payments, despite concern the government uses the system to track and bully its own citizens and businesses.

Without more efficient rival systems from the U.S. or other developed countries, Melchiorre said, China may "force their trading partners into their digital payments system," replacing the U.S. dollar and threatening the benefits Americans enjoy from the dollar's popularity. Being the dominant currency for international trade boosts the dollar's value, which makes imports cheaper for Americans. It also makes it easier for the U.S. to enforce multinational sanctions against Russia, Iran, and other countries whose warlike actions the U.S. wants to punish.

China's push has U.S.-aligned countries studying whether to develop their own digital currency powers.

In April, the United Arab Emirates, a U.S. ally and oil supplier in the Middle East, announced it had agreed to use R3′s system to help develop "a cutting-edge CBDC infrastructure" that "will digitally transform the UAE economy" and make the country ever more of "a global financial hub," Talal Al Kaissi, chief of a UAE-based company, G42, that is working with that central bank on its digital-currency project, said in a statement.

Rutter said a growing number of banks around the world are embracing this technology to make cross-border payments less "painful and risky."

"The more central banks adopt [digital currencies], the greater potential there is for money to be moved across borders in a more direct and efficient way," cutting costs and opening businesses to more investment and more customers, he said.

"Even though it is still in pilot, the e-CNY has a considerable reach and transaction frequency," he added, citing reports that users logged transactions worth over $10 billion last year.

In other countries, it's been slower. The "Sand Dollars" issued by the Bahamas, which has worked to establish itself as a haven for cryptocurrency and electronic money enthusiasts, attracted far less than 1% of that nation's transactions in its first year, Rutter said.

Nigeria's e-Naira faced such a "lack of demand and public awareness resulted" that the central bank in that most-populous African country obliged people to accept it, instead of cash or checks, for large withdrawals, he said.

But "digital currency is coming," worldwide, Melchiorre concluded. "I hope we can get our (act) together for the dollar, before it's too late."

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