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Why might Libra be "Dead in the Womb"?

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EXECUTIVE SUMMARY

The day after the news of Libra came out, it is said that Ma Huateng said on WeChat: "Libra has no technical problems, the main problem is about regulatory issues." I think this sentence is very simple, but it reflects many of his experiences, and I think it is correct.

Many people's analysis of Libra implicitly assumes that it can pass the review of regulatory authorities. However, I think that it may not pass such a review. So the topic I speak today is: Why might Libra be "dead in the womb"? Therefore, in the beginning, I want to talk about Libra itself, then analyse the impact and consequences of digital currency on the currency system.

INTRODUCTION

The Libra's white paper[1] was announced on June 18, 2019. I didn't agree with it at the time, thinking that it had a big problem and might not be approved by the regulatory authorities. Now after three months have passed, and people have familiarized with the concept, policy-makers can now analyse Libra comprehensively and objectively.

The U.S. Congress held a hearing on July 16 and 17, 2019. Libra's person in charge David Marcus, who heads Facebook's cryptocurrency development, attended. Members of the chamber raised a series of concerns. I have reviewed and selected the three that I believe are crucial for this discussion. First, Libra has great flaws in digital protection and personal privacy. Second, there are insufficient measures for anti-money laundering and anti-terrorist financing. And third, Libra could possibly have an impact on the stability of the financial system. These three can be divided into two major categories of hidden dangers originating from Facebook's cryptocurrency. First, Libra may be a risk within itself. Second, it may pose risks to the outside world and the global financial system.

RISKY LIBRA

The risks inherent in it are mainly its hidden dangers in protecting data privacy and anti-money laundering. Facebook is known for its data protection problems, with an estimated 50 million instances of personal data being leaked[2], in addition to a recent fine of $5 billion for violating consumers' privacy imposed by the Federal Trade Commission[3]. Additionally, Libra's plan has major structural flaws in the arrangement of this issue. To avoid data problems, the Libra Association announced that the cryptocurrency would run on a blockchain network secured at launch by 100 distributed computer servers, or nodes responsible for data and privacy protection[4]. It is irresponsible to push such a heavy responsibility on the nodes. If they are issued in one hundred countries, then one hundred countries will need to manage one hundred nodes. This is a big problem.

Besides, in terms of internal financial management, Libra has three problems:

1) Hosting
How can I host the Libra after purchase? Who will host it? Is it through a central bank custody or third party hosting? Is there a monitoring mechanism in place? None of these major issues were clarified.

2) Reserve
Because the funds raised are to be paid at any time, the Libra Association must have a portion of the reserve. How is this reserve determined? How is it calculated? These questions pose a larger issue. Also, it does not have a mechanism to balance regulatory error correction, which is also a flaw.

3) Exchange rate risks
Libra creates currency mismatches and exchange rate risks due to the variety of different currencies across borders. When other currencies are used to purchase Libra, there is a problem of exchange rate risks. Thus, how do organizations or individuals prevent such risks?

[1] https://libra.org/en-US/wp-content/uploads/sites/23/2019/06/LibraWhitePaper_en_US.pdf

[2] https://www.theguardian.com/technology/2018/sep/28/facebook-50-million-user-accounts-security-berach

[3] https://www.forbes.com/sites/mnunez/2019/07/24/ftcs-unprecedented-slap-fines-facebook-5-billion-forces-new-privacy-controls/#73b10f245668

[4] https://www.coindesk.com/facebooks-libra-cryptocurrency-a-technical-deep-dive

Including the privacy and data risks in Libra and three risks in financial management, there are four major risks and four shortcomings. Of course, some aspects can be gradually reviewed and modified in the future. However, the most fundamental is the second type of risk, that is, the shocks and injuries that may endanger the stability of the global financial system, and cannot be corrected or compensated.

There is also a lot of controversy about whether Libra is a real currency. Some people say that it is not, but rather a token or an asset. Nonetheless, Libra is, at least according to its intention, to be issued and circulated globally, so that it will perform the four functions of a currency: circulation, payment, valuation, and storage. In doing so, it undermines the sovereign rights of various countries to issue fiat currencies. A member of the German Monetary Commission calculated that assuming 100 million people have exchanged their currency to Libra, the Libra Association would be the world's largest creditor, with assets equivalent to the assets of all German banks. Such a large plate has a very high degree of liquidity, and it is impossible to do it without jeopardizing the power of governments to issue fiat currencies.

Furthermore, it will most likely affect the implementation and transmission of monetary policies in various countries. The Libra Association claims that it has no intention to do so, as it claims this is within the purview of central banks. However, Libra has so much liquidity, that it will most likely affect the monetary policy worldwide. Some people think that if Libra was issued, the U.S. dollar will have the largest share in the Libra basket. Therefore, the U.S. government may support it later because it might strengthen its currency. This is completely untenable logically. Why? Because the U.S. government or the Federal Reserve will lose control of this portion of liquidity and they are most likely unwilling to accept this. Besides, if this reasoning holds, the United States should support SDR, since the U.S. dollar is also the major share of the SDR basket. Nonetheless, the United States does not support SDR as it could weaken the dollar. The United States will not tolerate this situation even though the Libra Association is based in Switzerland.

IMPACT ON MODERN ECONOMY AND SOCIETY

I believe that a privately controlled global currency such as Libra has reached the bottom line of modern civilization. At present, the status quo of legal currency issuance by central banks is formed by history, its objective necessity, and its role in modern civilization. Although there are many problems with this monetary system, such as how currency issuance matches the development of the real economy, there are no better alternatives. I would like to quote a paragraph from Governor Zhou Xiaochuan on July 1, 2019. After describing the central bank's goals and mission, he said, "The central bank's personnel, management, and organizational composition support its mission and are guaranteed by law and legislation. It is also an important product of modern civilization. At least for now, this is far from the goals and missions of business organizations, and it is hard to believe that it can have a good result if something impacts this civilization." I think that, in his usual euphemistic style, he has grasped the essence of the problem, the issuance of sovereign currencies by central banks in various countries is part of modern civilization, and no other private commercial institutions can replace it with good results. And this is the most fundamental reason why Libra fails the investigation of the regulatory body and will be dead in the womb.

The issue of sovereign currencies or credit currencies issued by state central banks is a feature of the credit era. When people talk about currency, they often pay attention to the material form of money, from shells to precious metals, to paper money, or pay attention to the function of money. Yet, they don't pay attention to the relationship between money and society, nor the system of money, an important but often overlooked link to fully understand money. Most of the articles and discussions on Libra are interpreted from a technical perspective without considering the factors of the monetary system.

The relationship between money and society can be roughly divided into three categories. The first type is money, which has intrinsic value, and creates a system. The second type is based on precious metals and reserve currencies. The form of this currency is not important. It can be paper money, accounting currency, or electronic money. The third type, credit money, emerged after the collapse of the Bretton Woods system. The physical form of credit money is not important. They can be banknotes or accounting currencies, sovereign currency or fiat currency that is supported by the government's credit. It has no intrinsic value and no guarantee. Whether it is Alipay or Tenpay, there is no change in the characteristics of the credit era. They are only a means of payment for fiat currencies. This is very important.

The emergence of the credit currency era is not accidental but rather it gradually formed. Everyone knows that Shanxi Ticket number played a great role in history, and then it declined. Economically, the gradual independence of Outer Mongolia had impacted the economic foundation of Shanxi businessmen. In 1905, the Qing government established the Central Bank. In the beginning, it was called the Ministry of Households Bank, which was co-organized by government and business and opened in Beijing. In 1908, the Ministry of Households changed its name to Daqing Bank and later changed its name to Bank of China after the 1911 Revolution. The credit of the government was stronger than the credit of the private, and Shanxi Ticket had to withdraw from the stage of history.

Similar entanglements between government credit and private credit also occurred in the United States. Before the establishment of the Federal Reserve in 1913, the United States set forth an unstable system for almost a hundred years. It established a central bank, withdrew, and established again. Over time, people's understanding of the monetary system progressed and currently, the central bank is the most important financial institution or financial infrastructure in the era of money and credit. Not surprisingly it has many problems, but are they enough to have Libra or anything else replace it? In my opinion, Libra is a bigger problem. PayPal, Stripe, MasterCard, Visa and eBay have recently announced their withdrawal from the Libra Association. The G7 Stablecoin Working Group released a report, which concluded that no global stablecoin project should be implemented without a full assessment of the challenges and risks they may generate. Bruno Le Maire, France's economy and finance minister, said: "We want financial innovation to respect the sovereignty of states. Neither political nor monetary sovereignty can be shared with private interests." From the statement, it's evident that Libra will face "dystocia."

Nobel Laureate in Economics, Robert Alexander Mundell, stated in his pioneering paper on the "optimal currency zone" from 1961: "in the real world, the currency is primarily a manifestation of national sovereignty, so only the reorganization of real currency accompanied by political change is feasible." Therefore, technological progress alone is not enough to solve the problems of the monetary system. The concept of "technology supremacy" that technology can solve all problems is one-sided. Historically, changes in the monetary system (not the physical form of money) were primarily driven by economic growth. The rapid development of the economy has made precious metal currencies fetters, making the guarantee of banknote issuance a burden. The intricacies of the modern economy not only make finance the core of the economy but also make its form more complex. Interest groups representing different economic sectors and different financial formats inevitably form a political game. This game eventually leads to the monetary system's variety.

LIBRA'S POTENTIAL

Although I criticized Libra and questioned its efficiency from the start, I also think that the emergence of Libra still gives a lot of inspiration. First, it has aroused global attention to digital currencies. Recently, the Governor of the Bank of England, Mark Carney, believes that the hegemony of the U.S. dollar is not enough, and the hegemony of other single currencies is also not enough. He has proposed to build a global digital currency called Synthetic Hegemonic Currency (SHC)[5]. The specific details are not clear. The general meaning is that after each central bank has implemented digital currencies; it may be possible to engage in global digital currencies.

Secondly, I think Facebook's Libra is very resourceful. Facebook knows how to make full use of its brand, and continues to partner with other brands such as Uber, VISA cards, etc. In this case, its traffic entrance will be very large. In the future, if you want to engage in global digital currency, you need to learn how to expand the flow entrance.

Third, it captures a prominent problem in the current global financial system, which is that cross-border payment costs are very high. Some people say that the cost of cross-border payments is 5%, and some say 10%. This is something that must be paid attention to in the future when it comes to global digital currencies.

THE FUTURE EVOLUTION OF THE MONETARY AND CURRENCY SYSTEM

I once said such a sentence, which may be relatively absolute: "Without a central bank, there can be no real and legal global currency. To have a global central bank, there must be a global central government. Without a global central government, there can be no real central bank." One might ask, what about the dollar? The U.S. dollar is the de facto global reserve currency, but this is not legal and can be changed. From this perspective, I think the euro is an interesting experiment, although it might be a "premature baby." Despite Europe not having any real central government, it has a council and a parliament. There is also a very strong political reluctance towards military conflicts. After the horrifying experience of the two world wars, European politicians feel that they must be united to have a place in the world's political landscape. Therefore a unified currency was created. The next step is to engage in a banking union and fiscal unification. Fortunately, the unification of Europe through the euro is still alive, and whether it will continue to stand will depend on future actions. Such concerns posses implications for our analysis of the future evolution of the global financial system.

The evolution of the physical form of money depends on technological progress. From precious metals to paper money, there can be no paper money without papermaking technology. But the currency system is not driven by pure technology. The steam engine created did not create the gold standard. When Nixon announced in 1971 that the U.S. no longer guarantee dollars for gold, it was not for technical reasons. Today, we cannot return to the gold standard simply because the global economy is growing faster than the growth rate of gold production.

Therefore, how will the global monetary system change in the future? It depends not only on body weight but also on the pattern. Why did the dollar still dominate since the 1970s? It is because the United States has a large economy and dominates the global economy. Economic hegemony has led to diplomatic and military hegemony, all of which are closely related to the hegemony of the U.S. dollar. As long as the United States continues to withhold its role on a global scale, the status quo of dollar hegemony will be difficult to change. However, if

[5] https://www.coindesk.com/bank-of-england-governor-calls-for-digital-currency-replacement-to-the-dollar

the global economic pattern experiences a major change, with the United States, China, and Europe standing in union, the global monetary system may experience a significant change. Such a scenario is possible in the distant future.

China's economic aggregate will surpass that of the U.S. in 15 – 20 years. There should be no major problems as long as the economic growth worldwide is well regulated and maintained at a high quality. If the economy is to remain viable, the Chinese government's next step would be to transform the increase in economic volume into extending its soft power. On the other hand, the total economic volume of the euro area is already the largest in the world, but such a first place has not yet improved Europe's position in the global geopolitical pattern and failed to make the euro widely used outside Europe. Solving this would be the next big challenge for Europe. If China and the EU can resolve these issues, we might face the following possible developments in the global monetary system.

The first possibility is that the euro can strengthen its position as a consequence of renminbi becoming a real reserve currency following its substantial internationalization progress. In this way, a new global reserve currency system may emerge, with the U.S. dollar, the renminbi, and the euro split equally. It will provide global liquidity and support the global currency system.

The second possibility depends on the progress of the digital currency issuance by the central banks of all countries. If the progress is smooth, a sovereign global digital currency, similar to SHC, may be possible to form. Yet, it would be completely different from the global private digital currency like Libra.

The third possibility depends on whether it is feasible to promote the widespread application of SDR through the form of digital currency. For various reasons, SDR has not been widely used at present, but after all, it is an internationally recognized reserve asset and has a legal basis for expanding into a global sovereign currency.

In the end, there may be some kind of global emergency leading to a strong interstate consensus. In this way, a new international financial organization may be established. Although it most likely won't be a global central bank, it can play a role similar to the IMF. The IMF is currently targeting short-term behaviour of the balance of payments. If another international financial organization is created to coordinate exchange rates, it might promote global currencies.

Nevertheless, I think the above-mentioned possibilities are difficult to conceive in advance, and one can only pay attention to the situation as it develops.