A (Digital) Shock to the System

"Central banks have been providing trusted money to the public for hundreds of years... Providing cash for public use is an important tool for central banks. Yet the world is changing…To evolve and pursue their public policy objectives in a digital world, central banks are actively researching the pros and cons of offering a digital currency to the public."
– Central Bank Digital Currencies: Foundational Principles and Core Features, a report issued by western central banks in October 2020

Raoul Pal, the former Goldman Sachs hedge-fund chief and founder of Real Vision, made news last week when he proclaimed the price of a single bitcoin could hit $1 million within five years. Considering that the price of bitcoin hovers just above $13,000 presently, the proclamation of a 75X return over a relatively short window was quite astounding – even for the most enthusiastic bitcoin bulls.

His reasoning?

That there is an "enormous wall of money" ready to pour into the speculative asset and that "a lot of smart people are working" on making it happen. And the rhetoric isn't hyperbole for Pal – he's walking the walk. The former hedge-fund chief said he has allocated more than 50% of his capital to bitcoin (while holding other large positions in cash and gold).

* On the subject of bitcoin, despite new tailwinds, we're still fairly skeptical that the digital coin will provide investors with anywhere near the level of returns posed by the often-hyperbolic Raoul Pal and very much prefer the tried-and-true investment areas mentioned at the end of this article compared to the speculative coin.

While this newsletter has been rightfully skeptical of cryptocurrencies over the years, especially during the bitcoin bubble mania of three winters ago, it does seem that the winds in the digital currency space are shifting due to two factors:

1. Fiscal and monetary policies that have triggered massive deficits and increased the money supply, likely leading to inflation and eventual US dollar depreciation; and,
2. The fact that both western and eastern central banks have seemingly embraced digital currencies as a way to modernize payments in the digital age.

Last week, seven western central banks and the Bank for International Settlements issued a fascinating joint report on central bank digital currencies, pointing to a step towards the issuance of Central Bank Digital Currencies (CBDC). By definition, should these CBDCs be released to the public, the CBDCs would be centrally-issued and -managed currencies – something that stands in sharp contrast to cryptocurrencies like bitcoin. Further, these CBDCs would be convertible, at par, into other forms of the domestic fiat money such as cash or deposits. As the report states: “A CBDC, as the digital claim on a central bank, is just a different manifestation of the same unit of account, store of value and medium of exchange already offered by central banks.”

So, if it’s just “more of the same” then what’s the big deal?

First, it should be noted that while the joint report was issued in collaboration with the world’s largest western central banks (Bank of Canada, European Central Bank, Bank of Japan, Sveriges Riksbank, Swiss National Bank, Bank of England, Board of Governors Federal Reserve System, and Bank for International Settlements), the People’s Bank of China has made the most progress towards releasing a nascent digital currency to help internationalize the yuan (China’s currency).

China’s version of its sovereign digital currency – the Digital Currency Electronic Payment (DCEP) – is managed privately by the People’s Bank of China (PBOC) under a centralized system. As the world’s largest mobile payment market, China has been the most vocal champion for central bank digital currencies due to growing tensions with Washington, which has threatened to impose sanctions on Chinese financial institutions to restrict their use of the US dollar.

Among western central banks, regulatory concerns over bitcoin, rising interest in contactless (i.e. cashless) payments amid the coronavirus pandemic, and China’s push to internationalize the yuan, have pressed these monetary mandarins to jump on the proverbial bandwagon and push for a centralized, digital form of money. The question is whether the shift in thinking is too-little, too-late, with China already trialing its DCEP in four cities – Suzhou, Xiongan, Shenzhen and Chengdu. Additionally, two weeks ago, the Shenzhen government carried out a lottery to give away a total of 10 million yuan (about $1.5 million) worth of the digital currency, accelerating some of its ongoing trials. In contrast, while engagement in CBDC research has been on the rise for the last few years among western central banks, actual pilots/trials remain quite small, and were actually lower in 2019 than in 2018.

Image not found or type unknown

As outlined by Forbes last week, the imminent release of its DCEP by People's Bank of China shows that, while China is not an open economy, it is gradually loosening control of its currency. This is being done so that the Chinese DCEP will be used in Belt and Road countries*, helping the yuan gain influence over the dollar in emerging markets and developing economies.

Giving banking services to the previously "unbanked" is especially important for developing economies, which is a stated motivation by western central banks for releasing a CBDC. But, again, with the PBOC already trialing their digital currency, western banks are behind the eight-ball in reaching these "unbanked" communities.

Furthermore, while western central banks unsurprisingly insist that releasing a new digital currency would not upend cash or the banking system, it could prove to be radically progressive – and destructive – for the current monetary system. Specifically, if central banks introduce a digital currency that gains in popularity and moves money out of cash, it could open the door to negative interest rates, which would, in the process, "kill" cash because digital currencies are far easier to track and impose negative rates on. Currently, rates cannot go *too* negative because savers can always demand cash. But if digital currencies gain in momentum, and the door is opened to even more negative interest rates, savers will have fewer alternatives to fall back on.

This is not a desired outcome for western central banks. Alternatively, China has advocated for a far different approach, stating its willingness to phase out cash completely through its DCEP (this sounds like what western central banks are trying to do; however, a big difference is that Chinese authorities have avoided zero rates, much less negative rates, on money markets).

This newsletter has frequently warned that the continued issuance of helicopter money by fiscal and monetary authorities has undermined the strength of fiat currencies. And, while fiat moneyis unlikely to be ditched in the near-term, the likelihood is relatively high that the purchasingpower of that cash will dwindle over time due to several factors, namely:

- The rollout of Central Bank Digital Currencies (by both eastern and western central banks) due to the rising risk of negative rates.
- The weakening of the US dollar due to increased money supply and the Fed's buying of US government debt with fabricated funds.
- The emergence of the yuan as an alternative reserve currency to the US dollar.

As such, investors would be wise to consider phasing out US dollar-based cash, and methodologically moving money towards gold, international equities and bonds, and hard assets, such as real estate and commodities. (This is one of the reasons why Evergreen has taken the opportunity to lower its cash position for clients during recent market routes). The consequence of failing to do so is all that hard-earned cash will become 'worthless' in the coming years – or, at the very least, worth a lot less.

*The Belt and Road Initiative (BRI) is a global strategy adopted by the Chinese government in 2013 to deliver trillions of dollars in infrastructure financing to nearly 70 countries in Asia, Europe, and Africa.

Image not found or type unknown

Michael Johnston
Tech Contributor