

# The soul of money

I RECENTLY taught an undergraduate course in money and banking. In the online final exam, I asked students to list two lessons they have learned from this course. Since there were no incorrect answers, I wanted to see their freedom of thought. Unsurprisingly, an overwhelming majority of students identified the various functions of money as one of the main take-aways from this course. What they were trying to say is that before taking this course, they didn't realise the various functions that money serves to our society.

At the start of the course in October 2021, I asked students why we accept taka for transaction purposes? A few students attempted to answer the question that I was looking for. The core reason we trust taka (fiat money) as it is a legal tender and thus serves the three functions of money (unit of account, medium of exchange, and store of value). Trust is a public good. As Agustin Carstens, General Manager of the Bank of International Settlements (BIS), has recently remarked: "the soul of money is trust."

Imagine you met a person with physical strength and skills and displays intelligence and knowledge, but his soul is corrupted. You would hesitate to rely on that person. The supporters of cryptocurrencies believe that the souls of major central banks-particularly the Federal Reserve-have been corrupted.

They have a point. Major central banks are abusing their power of printing money. The unconventional, emergency monetary tool of the 2008-09 global financial crisis introduced to deal with the credit crunch, has somehow become a conventional monetary tool. As pointed out by Stephen Jen of Eurizon Capital, a hedge fund, central banks have hijacked this tool to finance open-ended and large fiscal deficits. As a consequence, we now live in an environment of massive financial repression and distorted financial prices.

Today, there are more than 8,000 cryptocurrencies. Most, if not all, cryptocurrencies are not currencies yet, but are trading as assets. An often-cited argument against cryptocurrencies as currencies is their extreme volatility. For example, the annualised volatility of Bitcoin is around 73 per cent, compared to 52 per cent, 21 per cent, and 5 per cent for crude oil, S&P 500, and US Treasuries, respectively. Given that the Bitcoin hype is so strong, it is not unusual for it to be so volatile, particularly at the very early stage of its development.

Cryptocurrencies or digital assets are like a revolution. By nature, a revolution faces strong resistance from the incumbent. Being incumbents, central banks have stepped up their fights against cryptocurrencies. Understandably, central banks do not want to surrender their monopolies over issuing fiat currencies and the associated seigniorage. As a response to the future challenge from cryptocurrencies, central banks are developing their versions of digital money (the so-called Central Bank Digital Currencies, or CBDCs). Privately issued cryptocurrencies provide anonymity, which

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their holders crave. Whereas any transaction using CBDCs can be monitored and tracked by central banks and tax authorities.

Consider an analogy with Sanchayapatra (government savings instrument) in Bangladesh. As soon as the government made it a requirement to submit tax identification number (TIN), the sale of Sanchayapatra declined. Although recent cuts in interest rates on Sanchayapatra partly explain the declining sales. Nonetheless, the fact that government savings instruments still offer higher rates than bank deposits underscore the point that investors value anonymity over returns. The upshot is simple: the degree of mistrust between ordinary citizens and the government will likely shape the adoption of digital currency in Bangladesh.

Big central banks are racing to build their own CBDCs. In February, at the Winter Olympics, the Peoples Bank of China will likely showcase e-CNY. The Federal Reserve has issued a concept paper in the last week to start a debate on the merits of a possible digital dollar (e-USD). In a white paper published two weeks back, the UK Parliament had played down the possibility of e-GBP. The European Central Bank (ECB) launched its digital euro project in July 2021, and it may take two years before it is available for circulation.

Car technology can best illustrate the dilemma over whether to remain in old-fashioned fiat money or embrace digital currency. As pointed out by Stephen Jen, big automakers such as Toyota had invested so much in diesel and petrol ICE cars, they thought that they had the luxury of being late movers in electric vehicles. But their simple cost-benefit trade-offs turned out to be short-sighted.

The smaller, risk-taking disrupters like Tesla have revolutionised the electric cars market. Likewise, if major reserve currency banks such as USD, EUR, GBP, and JPY delay issuing digital currency, their hegemony would finally be disrupted by smaller but more nimbler digital currencies such as e-CNY. Therefore, sooner or later, we will see major central banks embrace digital currencies, the most logical new equilibrium.

During a recent sale transaction of an apartment that I witnessed, the seller was hesitant to sign the land registry until the 'pay order' was cleared by the bank with cash deposited into his account. On the other hand, the buyer was trying to assure the seller that a pay order has no chance of

dishonoring, unlike a cheque. The crux of the dispute stemmed from the fact that digital payments denominated in taka have liabilities that belong to other agents (in this case the buyer or his bank) unrelated to Bangladesh Bank that issued the currency. In contrast, CBDCs are liabilities on the central bank's balance sheet, thus having no counterparty risk. In developing countries with clunky and expensive banking systems, CBDCs will help facilitate trade and commerce. Needless to say, this advantage comes at the cost of financial disintermediation of the traditional banking system.

As we slowly move into the digital realm of metaverse, the traditional economy structure comprising agriculture, industry, and service will deem inadequate. The fourth sector-Metaverse-powered with virtual reality and augmented reality will become increasingly prominent. In 1839, the share of the three traditional sectors (agriculture, industry, and service) in the US economy was 43 per cent, 19 per cent and 38 per cent respectively, compared to 1 per cent, 19 per cent and 80 per cent today. Just as it was unthinkable in 1839 that the share of agriculture would dwindle to 1.0 per cent in the not too distant future, a day will come, and likely sooner, when the fourth sector will become a dominant sector in developed countries.

By design, the currency of the metaverse will be digital. As for now, cryptocurrencies are ahead of the game in supporting gaming, non-fungible token, and other activities in the metaverse. The technological superiority of successful cryptocurrencies like Bitcoin or Ethereum has the ability to contest traditional fiat currencies. But the competitive threat from cryptocurrencies is also an ideal opportunity for central banks to introduce their own CBDCs.

Unlike decentralised cryptocurrencies which derive credibility from algorithms, for digital currencies the 'soul' of the money is one key feature that makes them different from the former. After all, we are more willing to place our trust in stable and independent central banks. The bottom line is this: cryptocurrencies are confusing, but we should not dismiss them. The rise of the metaverse seems inevitable. Recalling the words of Agustin Carstens, "trust can never be outsourced nor automated."

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