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Libra – a global challenger in payments and for central banks?

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Author
Heike Mai
+49 69 910-31444
heike.mai@db.com

Editor
Jan Schildbach

Deutsche Bank AG
Deutsche Bank Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

DB Research Management
Stefan Schneider

Facebook's Libra project aims to establish both a private digital currency backed by a basket of hard currencies and a global payment network. It is thus challenging many established players in the financial system, including central banks, credit institutions and payment providers. However, Libra might separate from the basket and become well-accepted fiat money independent from the official currencies if monetary policy gets even more aggressive and interest rates turn negative across the board.

Facebook can integrate Libra services into its digital platforms and benefit from strong network effects. So far, though, "global" means "US led" and does not include China.

In Europe, Libra would enter a competitive but fragmented digital payments market. As a currency, Libra will carry a foreign exchange risk for Europeans. But if the ECB were to drive interest rates deeply below zero, Libra could offer an easy digital way out. The flipside, though, would be a loss of sovereignty for Europe.

Introduction

Facebook's announced expansion into the financial services business is based on a private cryptocurrency, Libra, available to anybody worldwide via a wallet offered by Facebook's subsidiary Calibra and potentially other providers, which are invited to build financial services on Libra's open source protocol. According to the white paper, Libra will be issued by a consortium of large internet, payment and other companies (Libra Association) and will be fully backed by a basket of bank deposits and short-term government bonds in various hard official currencies (Libra Reserve) to minimise FX fluctuations ("stable coin"). Hence, the investment strategy resembles that of a money market fund with a variable net asset value. Rules and technology will be steered centrally by the Libra Association. Unlike a public, permissionless blockchain such as Bitcoin, the Libra system will run on a permissioned and scalable distributed ledger technology with Libra Association members operating validator nodes, with future Libra brokers being subject to authorisation by the Libra Association.

Libra in the European payments market

What could Libra mean for Europe? We will focus on the economics rather than the numerous regulatory hurdles Libra will have to overcome. From a payments perspective, Libra comes to the European market at a time of change as cash payments are increasingly being replaced by digital alternatives, PSD2 is paving the way to open banking and regulators are pushing for pan-European payment solutions. Libra will be available for domestic and cross-border payments alike.

What are the potential advantages of paying via Libra? Given the support of Facebook and other financial and tech companies with millions of clients in Europe, Libra can offer network advantages from the very beginning – which has the potential to propel the adoption and use of Libra.

Moreover, Libra will probably be attractive due to its convenience. Its payment services can be embedded in existing Facebook accounts (including WhatsApp, Messenger, and Instagram) and may thus be easily accessible to prospective users. Nevertheless, competing with established payment instruments will not be easy in a developed market with already high financial inclusion, retail customers expecting free transactions, and established digital payment solutions.

To win market share through competitive pricing, the Libra Association aims to invest its seed capital in client adoption measures, e.g. in the form of rebates or bonus points. Longer term, interest earned on the Libra Reserve will be used to cross-subsidise Libra transaction fees, which could mean more price competition in the charges that merchants must pay. As Libra owners will not be paid interest on their funds, all interest earned will go to the Libra Association.

Instant and cross-border payments: Already there, but a fragmented market

As regards competition on service levels, Libra will enter a European market where consumers already use efficient non-cash instruments like cards (e.g. girocard) as well as online and mobile payments (e.g. iDEAL, Swish) offered by bank and non-bank providers with different features regarding transaction speed and access channels. Even though many solutions serve only one domestic market, there are also easy cross-border solutions. US providers like Visa, Mastercard and PayPal are successfully offering pan-European retail payments for online and offline situations. European providers (e.g. SEPA banks, TransferWise) also compete for market share. Competition from Libra will likely put more pressure on all payment institutions to improve their offerings across national boundaries.

At the end of the day, the distinctive technical feature of Libra is not money transfer, for which European clients can already use various payment instruments, but Libra's potentially huge network effect and its nature as a currency. Libra payments will not transfer euros but Libras, a private currency that will fluctuate vis-à-vis the euro. Will Europeans use Libra for payments if this means incurring a foreign exchange risk?

Introducing currency competition in the retail space: Euro or Libra?

The Libra Association aims to build an infrastructure that will allow people around the world to easily and cheaply convert their savings into stable, digital and secure Libra funds. Safety against theft, fraud and operational failure will be paramount in convincing potential users to hold savings in Libra. Details on the management of the Libra Reserve, which will determine the stability of Libra, are not yet known.

A funding risk for banks

If successful, Libra would give consumers the option to easily turn their backs on the domestic currency (unless it is the USD, see below) by exchanging their bank deposits into a stable digital non-domestic currency at low cost. Unprecedented lax monetary policy is punishing traditional forms of saving in euro (bank deposits, insurance policies) very openly. However, even though it has long been possible for private persons to hold foreign currency accounts at banks, administrative hurdles and fees for foreign currency transactions still pose considerable hurdles.

Hence, Libra could provide consumers the ability not just to shift their funds into foreign currency but also to shift them away from their traditional financial counterparts altogether. In an extreme form, this might deprive banks and insurance companies of an important part of their direct funding and client base. To some extent, the funds would still return to their current recipients as the Libra Reserve would mainly invest in bank deposits and high-quality debt securities. Nevertheless, some of the funds may be held directly at central banks (Will they cooperate? At least the Bank of England has already suggested it might do so.) and may not be available as a funding source for banks. In addition, banks would also have to deal with one huge institutional investor rather than thousands of small retail customers, which could fundamentally change the established refinancing mechanism in bank-based economies.

One reason to hold Libra instead of euro would be yield, of course. Even though Libra owners will not earn interest, this could still be attractive if the ECB were to drive euro interest rates deeply into negative territory, forcing banks to charge negative interest on their clients' deposits. Any decrease in euro interest rates would also result in an appreciation of the Libra against the euro – possibly another reason for consumers to invest in Libra. Likewise, in times of high inflation, the digital currency could offer greater price stability and thus act as a better store of value.

Limiting the power of central banks and governments

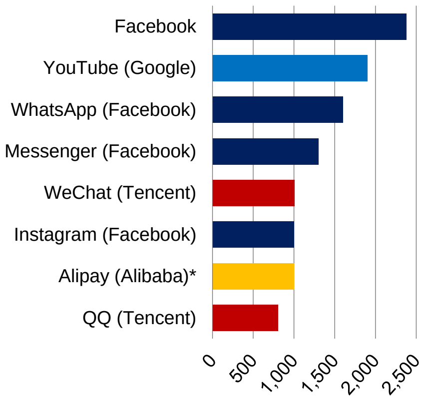
As of now, Libra would not offer a significant advantage over euro holdings given low inflation and slightly positive average interest rates on household deposits in the euro area. Nevertheless, introducing currency competition in the domestic retail space has the potential to limit the monetary power of the European Central Bank, as well as the power of European legislators and governments to enact and enforce laws. It is questionable whether European laws regarding data protection or taxation could be fully imposed on such a supranational currency. Furthermore, Facebook's whole business model essentially relies on capitalising on its users' data, and there have been data privacy issues in the past. Instead of Europe enforcing its own set of rules, monetary power and control of payment rails would shift to a consortium of private companies, most of which are US-based.

Libra could therefore limit the ECB's power, without necessarily affecting the Federal Reserve's monetary power. The Fed's monetary policy might even become more influential in Europe. The Libra project's economic viability rests on the interest earned on the Reserve – besides transaction fees – to cover operational costs and to pay investors. Holding the Libra Reserve in "bank deposits and short-term government securities in currencies from stable and reputable central banks" does not leave too many assets to choose from. USD-denominated bank deposits offer interest income, while euro or yen deposits do not. Liquid and deep markets for US government bonds would also hint at a strong weight of USD assets in the future Libra Reserve. The more weight is given to the USD, the more Libra could resemble a digital USD.

Since the global financial crisis, central banks have been pulled into "closer cooperation" with fiscal policies and the overall support for central bank independence has been weakened; however, competition from privately issued money could actually limit the scope for governments to influence (or abuse)

Leading online networks 1

Monthly active users in millions, end-2018 / Q1 2019



* Annual active users

Sources: Company reports and websites, DataReportal by Hootsuite and We are social, Deutsche Bank Research

central banks to finance fiscal policies. Currently, with most governments in advanced economies highly indebted, central banks face (at least informal) pressure to keep interest rates low to sustain debts and deficits ("fiscal dominance"). If Libra establishes itself as a credible alternative to official currencies, central banks might gain more freedom from governments and fiscal policy given a potentially more stable, new private competitor. In that sense, Libra could go a long way towards Friedrich von Hayek's proposal to de-nationalise money and allow (private) currencies to compete freely with each other. Whether the Libra Association – a not-for-profit organisation consisting of profit-oriented private companies that cannot be held accountable by voters in democratic elections – would have a stronger incentive than national governments to keep Libra stable remains an open question, though, and will ultimately decide whether citizens' trust will shift away from public to private money.

"Global" means "US"

In essence, Libra currently means "US led" rather than "global" and tellingly, China seems to be out of scope. China denies US online giants access to its domestic market and itself has become home to world-leading digital payment companies – Alipay and WeChat. They have taken to international expansion, challenging the US hegemony in international bank payments and regulation. IT and financial services are important export goods for the US, while China sees global leadership in digital services as a strategic goal. Not surprisingly, in reaction to Facebook's Libra plans, China is speeding up its efforts to issue a "government-backed digital currency, aiming at securing a cutting-edge position in the global cryptocurrency race" (Chinadaily.com, Central bank unveils plan on digital currency, 9 July 2019).

And what about Europe? Libra can give Europeans an alternative to the euro and the underlying monetary policy, as well as another payment option that works domestically and cross-border alike. This would be a "liberation" from national boundaries. The flipside, though, would be a loss of sovereignty.

Heike Mai (+49 69 910-31444, heike.mai@db.com)

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