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Libra – a view from Europe*

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Facebook's Libra project aims to establish both a private digital currency backed by a basket of hard currencies and a global payment network. Facebook can integrate Libra services into its digital platforms and benefit from strong network effects. It is thus challenging many established players in the financial system.

So far, though, "global" means "US led" and does not include China, which has shut Facebook out of its market anyway. In response to Libra, China is pushing the development of a digital yuan.

In Europe, Libra would enter an open and 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, could be a loss of sovereignty for Europe.

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1. 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 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, and with future Libra brokers being subject to authorisation by the Libra Association. In contrast to a decentralized peer-to-peer network like Bitcoin, Libra will thus be a centralised and tiered financial system.

Since the Libra announcement, Facebook has encountered serious international opposition from financial regulators and central banks. Western officials insist that many regulatory questions have to be clarified before Libra may be launched. EU and US authorities have raised concerns about Libra and Facebook relating to competition, money laundering and data protection.[1] As a result, all but one of the payment companies among the original Libra backers have withdrawn from the project.[2] Given the regulatory scrutiny, Libra will hardly be available to users in the first half of 2020, as originally scheduled by Facebook.

2. Why would European citizens and companies use Libra?

From an individual's perspective, Libra has two dimensions: first, it offers payment services and second, it is a currency alternative to the euro. In discussing these, we will focus on the economics rather than the numerous regulatory hurdles Libra will have to overcome.

2.1 Libra in the European payments market

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 tech companies with millions of clients in Europe, Libra can offer positive network externalities from the very beginning – which has the potential to propel the adoption and use of Libra.

Moreover, Libra will probably be attractive due to 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

[1] See e.g. Bloomberg, Facebook's Libra Currency Gets European Union Antitrust Scrutiny, 20 August 2019, and US House Committee on Financial Services, Waters Leads Bipartisan Delegation to Europe and Middle East, press release, 25 August 2019.

[2] Libra Association, Moving to a formal governance structure, press release, 15 October 2019.

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.

2.2 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?

2.3 Euro or Libra? Currency competition in the retail space

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.

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 savings 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.

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.

3. Euro or Libra? A macroeconomic perspective

3.1 A funding risk for banks

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[3] and the Swiss National Bank[4] are already offering accounts to non-bank payment providers) 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. The global search for and shortage of safe and liquid assets could be aggravated. If the Libra Reserve became very large, demand for government bonds in the Libra basket would rise and interest rates in those currencies would fall.

3.2 Limiting the power of the ECB and European 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[5], 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.

However, currency competition could also give central banks in advanced economies more leeway vis-à-vis fiscal policy. 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

[3] Bank of England, Enable, Empower, Ensure: A New Finance for the New Economy, Speech given by Mark Carney, Governor of the Bank of England, 20 June 2019.

[4] Schweizerische Nationalbank, Die Schweizerische Nationalbank regelt den Zugang für Fintech-Unternehmen zum Swiss Interbank Clearing, press release, 11 January 2019.

[5] European Central Bank, Money and private currencies – reflections on Libra, Speech given by Yves Mersch, Member of the Executive Board of the ECB, 2 September 2019.

privately issued money could actually limit the scope for governments to influence (or abuse) 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.

4. "Global" means "US": Libra fuels the race for currency hegemony

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"[6]. Contrary to Libra, though, China's digital currency will be issued by the People's Bank of China. Private companies like Alipay, WeChat and commercial banks will only be agents in the "e-yuan" system.[7] The large client bases and digital service expertise of private Chinese providers will be instrumental in convincing people to use the digital yuan. In the international arena, China sees a digital yuan as one step towards establishing the yuan as a strong currency in global trade and finance, aspiring to the benefits currently reaped by the US and the USD.

Given the structural changes in the global economy, and taking the idea of Libra one step further, Mark Carney recently suggested a "Synthetic Hegemonic Currency" provided by "the public sector, perhaps through a network of central-bank issued currencies". In his view, this could be a remedy for current drawbacks of the USD hegemony and could prevent turmoil in a potential shift to a new global reserve currency like the yuan.[8]

5. Conclusion

What about Europe? On the microeconomic level, Libra could 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 macroeconomic and political flipside, though, could be a loss of sovereignty.

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[6] Chinadaily.com, Central bank unveils plan on digital currency, 9 July 2019.

[7] For more information on the announced setup of the e-yuan see Coindesk, New head of China's digital currency says it beats Facebook Libra on tech features, 6 September 2019.

[8] Bank of England, The Growing Challenges for Monetary Policy in the current International Monetary and Financial System, Speech given by Mark Carney, Governor of the Bank of England, 23 August 2019.

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