EUROMONEY

How Facebook can win the global currency battle

Peter Lee | Thursday, August 29, 2019

Regulators, politicians, competition authorities and central bankers have all been outlining objections to the Libra project from the first day Facebook announced plans to let its 2.4 billion users exchange payments in a new virtual currency. Don't be taken in. Facebook wants the burden of compliance with all those KYC, AML and CFT rules. Being able to identify what its users are paying for is a treasure trove. The banking system and the world's central banks, as the more enlightened already see, had better gear up for new competition.

At meetings of the G7, at the gathering of world central bankers at Jackson Hole, across this year's IMF and World Bank confab, indeed wherever financial policymakers assemble, Facebook's Libra project remains the hot topic. Can it succeed? How will it work? What does it mean?

Financial types have been earnestly debating the nature of money, reform of the payments system, the prospect for societies going cashless or even card-less, for years now, ever since the great financial crisis and the rise of fintech. Suddenly it's all getting real.

Libra could be the project that takes virtual currency away from the crypto nerds and the masters of the established financial order, and finally drops it into the lap – or onto the phone – of a quarter of the world's population.

In the process, it might just create a new world currency, something reminiscent of the European currency unit, first created in 1979 and used as the unit of account for the European Community until the advent of the euro itself 20 years later. Libra could be a bigger, global version of this and one that people (not just a few sovereign and multilateral bond issuers) use in everyday life, to pay for coffee, groceries or a ride on the subway. It could also allow expatriate workers to remit funds to their home countries safely and cheaply.

Trade wars look poised to give way to currency wars. A return of FX volatility may be good for banks. But it might make a virtual stablecoin, backed by a reserve basket of government bonds and bank deposits in the world's leading fiat currencies, a highly desirable way of ironing out volatility for users who just want to store and transmit value. Especially so if they are based in a weakening currency like sterling and want to pay for goods normally denominated in a strengthening one like the US dollar.

Much attention will focus on the on and off ramps to Libra: the mechanisms for users to exchange fiat currency into Libra and Libra back into fiat. But conceptually it's not hard to grasp how such a global currency stablecoin could be adopted by a vast network of users and co-exist with national currencies.

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>
> \- Dave Hodgson, NEM Ventures

In July, the IMF published a paper by Tobias Adrian and Tommaso Mancini-Griffoli on the rise of digital money that goes even further. It argues that the two most common forms of money today could even be surpassed. Even if that doesn't happen, the authors say, cash and bank deposits will certainly face a battle with e-money, electronically stored monetary value denominated in, and pegged to, a common unit of account such as the euro, dollar or renminbi – or a basket of these, as with Facebook's newly proposed Libra stablecoin.

"Across the globe countries are tackling inflation, expensive remittances and financial exclusion. Digital currencies, in particular stablecoins, are being explored by private sector firms with the aim of solving these issues," says Christophe De Courson, chief executive of Olymp Capital, one of the earliest investment fund managers in Europe dedicated to the blockchain and digital asset class. "It's becoming increasingly evident that they may succeed, as the [IMF] report correctly points out – big tech firms and fintech startups are experts at delivering convenient, attractive, low-cost and trusted services to a large network of customers."

The banks knew it was coming, but thought they had a stranglehold on the fintech challenge, keeping an eye on them all, buying the best, dragging their heels to deliver a fast, low-cost domestic and especially cross-border payment mechanism to businesses and their customers.

"Traditional finance, in particular, has become bloated, inefficient and inappropriately costly; and frankly it's time for a change," says Dave Hodgson, director and co-founder of NEM Ventures, the venture capital and investments arm of the NEM blockchain ecosystem.

"Digital currencies allow for the efficient and cost-effective transfer of value between two parties, and aren't reliant on national borders. This makes them largely resilient to attempts at national control and manipulation, while also removing systemic inefficiencies within the current financial systems, namely with layers of intermediaries.

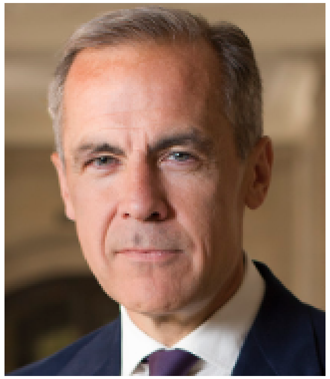
"I can receive an Amazon parcel from the USA to Europe, faster than I can remit funds via Swift to pay for it; that's not good enough."

Now big tech has finally made its move.

Warnings

Every week since the announcement there have been headlines warning of opposition to Libra from central banks, legislators, data regulators and competition authorities. And there are rumours that some of the 27 other companies Facebook persuaded to join it in the Libra Association – including Visa and Mastercard, a clutch of tame NGOs, some venture capitalists and other networks like eBay, Uber and Spotify – may be getting cold feet. As Euromoney went to press, it wasn't clear whether these founding members had progressed beyond signing letters of intent and putting down the $10 million table stakes to operate validator nodes on the Libra blockchain.

But with each knocking headline, instead of dying out, interest in the project only grows. How big could it be and how does it all play out from here?



Mark Carney, Bank of England

Mark Carney must have surprised his peers at Jackson Hole in late August. When the Bank of England governor's turn finally came to speak on the chosen topic for the latest annual symposium of central bankers, the growing challenges for monetary policy, he actually had something to say.

Most before him had discussed the now depressingly familiar limits on monetary policy to stimulate demand or boost inflation in a world of already low or negative policy rates and negative government bond yields. Federal Reserve chairman Jerome Powell had further pointed out that the Fed simply has no tools to combat lower growth stemming from weak investment, thanks to rising trade uncertainties.

This seemingly innocuous remark so enraged the initiator of those trade tensions that the man who appointed Powell promptly described the head of the Federal Reserve as one of America's greatest enemies. (US Treasury secretary Steven Mnuchin later had to explain that on this we should probably be taking president Trump seriously but not literally.)

Rather than repeat the confessions of impotence, Carney offered some bigger ideas both about what has gone wrong with the international monetary and financial system and how eventually it should be rebuilt.

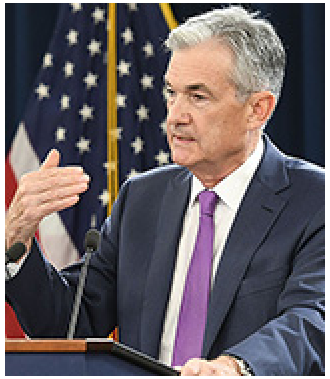
His core observation, not an entirely original thought, is that the dominance of the US dollar – as the currency in which a high proportion of trade is invoiced, in which central banks around the world hold reserve assets and in which companies borrow and institutions invest – is a growing problem. Even though the US share of global GDP has declined in recent decades, the rising prominence of its currency is increasing the risks of a global liquidity trap and lowering the global equilibrium interest rate.

As the old global order splinters and protectionism rises, each financial market panic leads to accumulation of safe haven assets in the dominant global currency. That contributes to central banks being powerless today.

The primacy of the dollar also amplifies the speed and impact with which increasingly frequent convulsions in developed market economies transmit to emerging ones. The dollar is the currency of choice for at least half of international trade invoices, around five times greater than the US share of world goods imports and three times its share in world exports.

This dominance of the US dollar is surprising given the transformation of the global economy in recent decades. At the time of the Latin American debt crisis, Carney pointed out, emerging market economies made up a little more than a third of global

GDP. Since the last Fed tightening cycle, their share of global activity had risen from around 45% to 60%. And by 2030, it is projected to rise to around three quarters.



Jerome Powell, Federal Reserve

Yet increasing reliance on the US dollar means that developments in the US have significant spillovers into both the trade performance and the financial conditions of countries even with relatively limited direct exposure to the US economy.

Greater currency diversification of the international monetary and financial system would be a benefit. However, transitions in the leading currencies for central bank reserves, trade invoicing and international capital markets are extremely rare.

The only obvious potential challenger to the US dollar is the Chinese renminbi. China is the world's leading trading nation, overtaking the US at the start of this decade. This is just starting to appear in trade invoicing. The renminbi is now more common than sterling in oil future benchmarks, despite having no share in the market before 2018, said Carney. And the greater use of the renminbi in international trade is also leading to its growing use in international finance.

But much remains to be done in the liberalization of foreign exchange and other controls for the Chinese currency to achieve the status of a leading store of value and a major reserve currency for other central banks. And this is where Carney gets really interesting.

"History shows that the rise of a reserve currency is founded on its usefulness as a medium of exchange, by reducing the cost and increasing the convenience of international payments," Carney said. "The additional functions of money – as a unit of account and store of wealth – come later and reinforce the payments motive."

And that brings us straight to digital e-money and the new cryptocurrencies.

"Technology has the potential to disrupt the network externalities that prevent the incumbent global reserve currency from being displaced," said Carney.

He points out that the relatively high costs of domestic and cross-border electronic payments are encouraging innovation, with new entrants applying new technologies to offer lower-cost, more convenient retail payment services.

"The most high profile of these has been Libra – a new payments infrastructure based on an international stablecoin fully backed by reserve assets in a basket of currencies including the US dollar, the euro and sterling. It could be exchanged between users on messaging platforms and with participating retailers."

Is the governor of the Bank of England now saying that the blockchain-based virtual currency that regulators and politicians have been attacking ever since Facebook first announced it in late June – not a single of unit of which has yet changed hands and which won't launch before next year at the earliest – could become a global reserve currency and challenge the mighty US dollar?

Not quite so fast.

"There are a host of fundamental issues that Libra must address, ranging from privacy to AML/CFT [anti-money laundering/combating the financing of terrorism] and operational resilience," said Carney. And there are good reasons why policymakers are on guard. "In addition, depending on its design, it could have substantial implications for both monetary and financial stability."

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> - Mark Carney, Bank of England

The Bank of England and other regulators have been clear, Carney emphasized: "That unlike in social media, for which standards and regulations are only now being developed after the technologies have been adopted by billions of users, the terms of engagement for any new systemic private payments system must be in force well in advance of any launch.

"As a consequence, it is an open question whether such a new synthetic hegemonic currency would be best provided by the public sector, perhaps through a network of central bank digital currencies."

How could any human heart not thrill to the idea of a synthetic hegemonic currency, especially one in which world central banks cooperate?

And this is the core of Carney's message: that even if it does not become a challenger to the US dollar itself, Facebook's Libra could perhaps be an inspiration or a model for central banks to work together on a new global reserve currency. One that might support better global outcomes than either the prevailing dependence on the US dollar or the risky transition to a new hegemonic reserve currency like the renminbi.

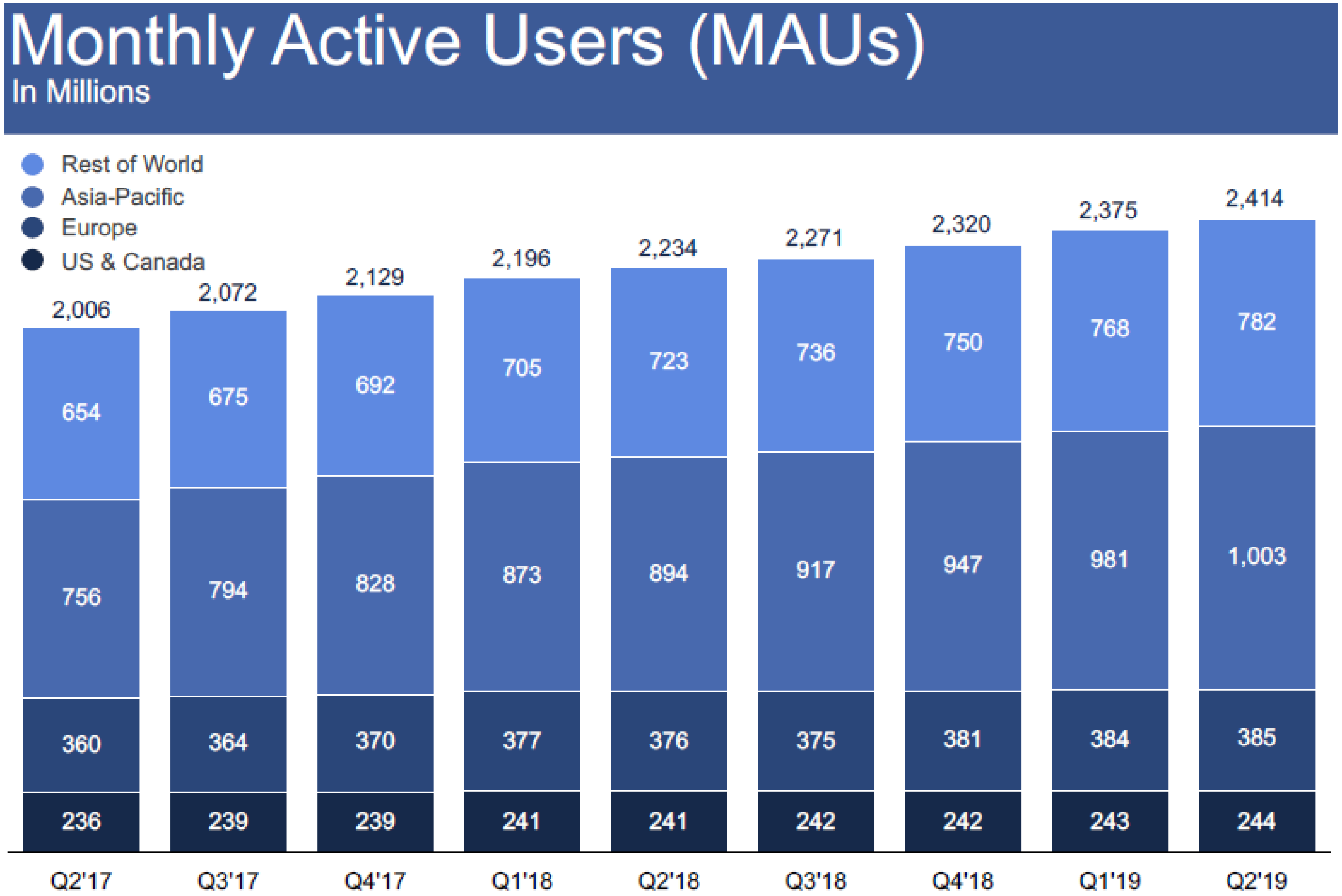
Lightning rod

In one way Libra has already succeeded. Before it becomes a currency, Facebook's idea for a new global currency is right now a lightning rod, conducting the ambitious hopes of the cryptocurrency crowd and the heightened anxieties of regulators and central bankers around the world – like nothing before it.

Bitcoin they could not quite ignore but certainly ridicule and dismiss. It simply lacks the processing scale ever to replace conventional money and its brand has been poisoned by hacks of exchanges, association with illegal activity and lurching volatility. It may be a vehicle for speculative trading, as if another one were needed, but it is not a medium of exchange – nobody uses it to buy stuff – nor is it a unit of account or a particularly reliable store of value.

Bitcoin has been running since the depths of the financial crisis in 2009. Eight years later, in 2017, a much-cited Cambridge University study suggested it had attracted between 2.9 million and 5.8 million active users.

Facebook is only five years older than bitcoin. It was founded in 2004. At the end of June 2019, it had 2.41 billion monthly active users, of which 1.59 billion are on it every day. And there are 2.7 billion monthly users of all its services, including WhatsApp, Instagram and Messenger. Around 2.1 billion people use at least one of those every day. Libra will be made available across not just Facebook itself but those other apps. So, more than a quarter of the people on the planet may soon be just a couple of taps away from Libra at least once a day.

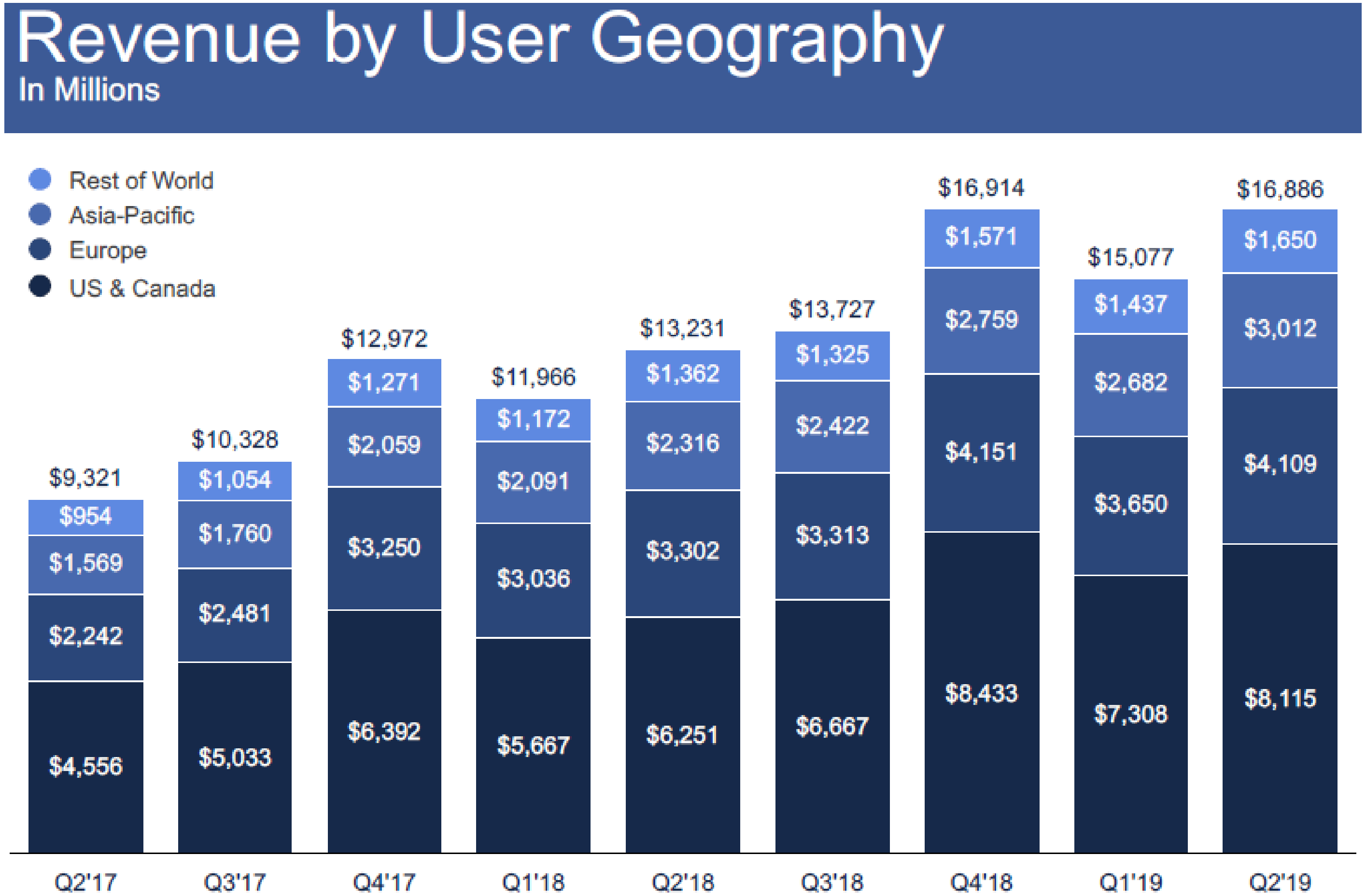


Source: *Facebook*

As more and more human interaction and economic activity takes place online, Libra is a virtual currency designed to be a stable payment mechanism for use across platforms and apps.

And if a significant portion of those 2.1 billion daily users are tempted by the promised ease of use of the Calibra wallet and the low cost of sending money across borders in seconds – like sending a WhatsApp message or a photo – then that changes the how money moves and even what money is. The banking system, as it stands today, is at risk.

Only 10% of Facebook users are in the US and Canada, with another 16% in Europe. Fully 74% are either in Asia Pacific or the rest of the world, even if those regions for now account for just under 28% of Facebook revenues. Facebook's leaders are absolutely driven. They are on a mission to monetize these users in new ways.



Source: Facebook

Euromoney talks to an old contact now working in a technology startup in Indonesia. "What I see around me is that the people here pay for every day goods and services in one of two ways. They either use cash or they use digital cryptocurrency. As an expatriate arriving with my bank account set up and my credit cards, I'm feeling quite left behind."

And while China won't allow Libra to flourish there for now, Hodgson at NEM Ventures points out: "It's also worth noting that in Asia the concept of digital money is well established with services such as Alipay and WeChat."

For now, the overwhelming majority of Facebook's revenue comes from advertising, particularly mobile advertising. But it is moving more directly into commerce and along with that into payments.

It's not that Facebook's early claims for Libra as a way to help the financially excluded and the unbanked 31% of the world was pure hype. It may do that. But it obviously isn't the full story, as David Marcus, head of Calibra – the Facebook subsidiary designing the new global cryptocurrency – explained to the Senate banking committee.

"We expect that the Calibra wallet will be immediately beneficial to Facebook more broadly because it will allow many of the 90 million small and medium-sized businesses that use the Facebook platform to transact more directly with Facebook's many users, which we hope will result in consumers and businesses using Facebook more.

"That increased usage is likely to yield greater advertising revenue for Facebook."

If customers browse the clothes and other products that influencers promote on Instagram, the next step for Facebook, after it has taken premium advertising revenue from those clothes stores and designers for highly-targeted ads, is to enable customers to buy on Instagram and to pay. In a way, Facebook wants to become Amazon.

Mark Zuckerberg, Facebook

Mark Zuckerberg laid this out on Facebook's second quarter earnings call at the end of July. "Instagram Shopping will improve the experience of browsing and shopping from your favorite brands and creators, while also giving emerging creators a powerful new way to build a business and sustain their community. Facebook Marketplace gives people a way to buy and sell goods in a trusted network with real identities. Hundreds of millions of people are already using Marketplace monthly."

In Facebook Marketplace, the company is perhaps competing more with eBay. And it's not stopping there.

"We're also building ways for people to interact with businesses through messaging like WhatsApp Business," said Zuckerberg, "because people don't like having to call businesses and would rather engage asynchronously over messaging if possible."

Payments is not just the obvious next step, it is possibly the biggest step.

“When I look at the kinds of private interactions we can make easier, payments may be the most important for the long term,” said Zuckerberg.

The company continues to test payments on WhatsApp in India and is close to launching in other countries.

“We’re very focused on payments with fiat currencies as well and making it so that when you pay in one service, whether it’s WhatsApp or in Instagram Shopping or in Marketplace, your credentials can be shared and there’s a shared payment system across all those things. So that’s certainly a big area for investment,” Zuckerberg explained.

Facebook’s reputation remains under a cloud thanks to previous privacy failures and the Cambridge Analytica scandal. It recently announced a $5 billion civil penalty with the Federal Trade Commission (FTC), the largest ever imposed on a company anywhere for violating consumers’ privacy and one of the largest penalties ever assessed by the US government for any violation.

The order outlines a new system of independent control, multi-layer accountability and personal responsibility over Facebook’s practices, and substantially limits Mark Zuckerberg’s unfettered say in privacy decisions, according to the FTC. In fact, for the next 20 years, anytime Facebook makes a privacy decision, multiple independent watchdogs will be looking over its shoulder.

But for all that, the business is humming, with revenues 28% up on the second quarter in 2018.

“The platform remains highly valuable for users as they enjoy the many free services Facebook offers, like staying in touch with friends, finding communities with shared interests or starting a new business,” says Christopher Rossbach, CIO of private investment firm J Stern & Co. “Payments could become a further growth initiative, creating another reason to login and interact with the Facebook family of apps. Facebook’s huge addressable audience of 2.7 billion monthly active users across all its apps increases the potential for broad adoption for the cryptocurrency with the integration of Facebook’s Calibra wallet into each of the apps.”

> As large technology or financial firms could leverage vast existing customer bases to rapidly achieve a global footprint, it is imperative that authorities be vigilant in assessing risks and implications for the global financial system
>
> - Mario Draghi, ECB

What can the guardians of the old financial system do about this?

Central banks used to be all powerful, particularly, it seemed, when they nursed the developed world through the worst of a recession caused by financial market collapses that nearly broke their excessively financialized economies. Today they bemoan the inability of monetary policy to drag economies towards self-sustaining growth.

“Today, the combination of heightened economic policy uncertainty, outright protectionism and concerns that further, negative shocks could not be adequately offset because of limited policy space is exacerbating the disinflationary bias in the global economy,” said Carney.

What comes next is further irrelevance if a large scale monetary system emerges that bypasses national currencies. And governments, too, worry about loss of power over the money their populations use.

That is why, long before it even launches, Facebook’s blockchain based cryptocurrency, which is to be fully backed by the Libra reserve of cash and equivalent high quality fiat-currency assets, has had regulators and legislators hyperventilating with anxiety.

'National security issue'

The day before David Marcus testified to Congress in July, US Treasury secretary Steven Mnuchin, made it clear that: “The Treasury department has expressed very serious concerns that Libra could be misused by money launderers and terrorist financiers.”

Casting the Facebook project in with bitcoin and other virtual currencies, Mnuchin declared: “This is indeed a national security issue.”

Pressed for his view on Libra one week later at the press conference after the ECB’s governing council meeting in late July, president Mario Draghi said it didn’t even come up but then unleashed a torrent of anxieties.

Mario Draghi, ECB

“On Libra, we didn’t discuss that in this meeting of the Governing Council, but we did discuss this quite extensively in the G7. The bottom line of this discussion is that there is interest of course by the G7 governments, and I believe by all the governments in the world, for this development. But there was a pretty unanimous view that there are concerns as well as interest and we and they better first address the concerns. These concerns are concerns about cybersecurity, anti-money laundering, terrorism financing, use of these currencies for criminal purposes. All this is linked also to the anonymity. How would this work? At the same time, concerns about privacy. I mentioned cyber risks. Tax evasion, monetary policy transmission, financial stability and the global payment system. How would this change the global payment system?”

This is hand-wringing stuff.

Thank goodness Draghi had managed to calm down later that day when he wrote to German MEP Markus Ferber, a member of the committee on economic and monetary affairs. “The European System of Central Banks (ESCB) is closely monitoring innovation in the financial sector, including stablecoin projects such as Libra,” Draghi assured Ferber, highlighting the G7 working group on stablecoins, chaired by ECB executive board member Benoît Cœuré.

“As part of this group, the ESCB carries out a comprehensive assessment of the potential risks of stablecoin initiatives to financial stability, operational and cyber resilience as well as their potential impact on the tasks of central banks, including ensuring the safety and efficiency of payment systems and the smooth conduct of monetary policy” wrote Draghi.

He acknowledged Facebook’s size – its average monthly users compare to the US with a population of 327 million and the eurozone with a population of 341 million – while attempting to assert some notional authority over its move into cryptocurrency.

“As large technology or financial firms could leverage vast existing customer bases to rapidly achieve a global footprint, it is imperative that authorities be vigilant in assessing risks and implications for the global financial system. Stablecoin initiatives must ensure public trust by meeting the highest regulatory standards and be subject to prudent supervision and oversight.”

> I believe that if America does not lead innovation in the digital currency and payments area, others will
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> - David Marcus, Calibra

For his part, Mark Carney had already covered much the same ground when the Bank of England released its latest financial stability report in mid-July. But he was also honest enough to discuss why Libra, or something like it, might be needed and why the monetary system remains vulnerable to disruption because it serves people poorly.

"We've got to recognize that this is trying to solve a series of issues that exist in the system. It's way too expensive to do domestic payments. It's way too slow and that hurts consumers and businesses. It stifles innovation. And it's far too expensive to send money cross border and there are huge financial inclusion issues related to that and cost related to that. So, while we're trying to address all these issues we have to absolutely acknowledge the problem that they're trying to solve and if it's not this, we better have some answers for what else it is."

It has always seemed to Euromoney that the likely outcome for Libra is binary. It either comes to nothing or it succeeds massively.

Carney agrees. "If it's successful it becomes systemic because it would involve a very large number of users," he said. "And, you know, if you're a systemic payment system it's five sigma. You have to be on all the time. You can't have teething issues. You can't have people losing money out of their wallets."

Euromoney read the Libra white paper and all the documents Facebook has published on the Libra reserve, the Libra blockchain and the Libra Association so that you don't have to. But we came away with far more big concepts than firm details of how it will work.

While Libra will not run on any of the existing public blockchains, Facebook has said that in the long run, it hopes to open up the Libra blockchain as a permission-less one that anybody can participate in. It's hard to see how that can fly.

Much has been made, not least by secretary Mnuchin, of regulators' opposition to anything like the anonymous or rather pseudonymous bitcoin blockchain.

Steven Mnuchin, US Treasury

Mnuchin says the Treasury has made it clear to Facebook – as well as to other providers of digital financial services – that they must implement the same AML and CFT safeguards as traditional financial institutions and register with the US Treasury's Financial Crimes Enforcement Network (FinCEN).

For his part, David Marcus confirmed in his prepared testimony to Congress that the Libra Association will happily do this, although he seemed to be rather stretching his credibility with an initial appeal to patriotism. "I believe that if America does not lead innovation in the digital currency and payments area, others will," said Marcus, cheekily allowing the thought to hang in the air that an attack on Facebook is somehow an attack on America.

He rather undermines this by explaining that the Libra Association will be headquartered in Geneva and so it will be supervised by the Swiss Financial Market Supervisory Authority (Finma), which is positioning itself to promote Switzerland as a crypto centre. But it will also register with FinCEN

When Calibra is available, Facebook has already told users they will need a government-issued ID to sign up for an account and that identity verification is important to both comply with laws and prevent fraud. Calibra's website explains in its frequently asked questions that: "Facebook and WhatsApp account information are also used when available to verify identity and prevent fraud."

Are all sides here performing a Kabuki dance? Regulators may be forcing Facebook to travel in exactly the direction it already wants to go.

Euromoney has been debating with bank chief executives all year the question of who has the best and most valuable insights into consumer behaviours. Is it the social networks that can see what you're talking with friends and browsing on the internet? Or is it the banks that can see where you spend your money in increasing detail?

New financial technology promises soon to break down not just what businesses bank customers have transferred payments to but also what individual items were in their shopping baskets.

> Knowing your customer is not the sole province of Facebook and Google. I would rather be JPMorgan. Banks know everything about what you do with money
>
> \- John Reed, CaixaBank

John Reed, former chief executive of Citigroup and today a director of Spain's CaixaBank, told Euromoney in June: "Knowing your customer is not the sole province of Facebook and Google. I would rather be JPMorgan. Banks know everything about what you do with money, where it comes from, what you spend it on, your taxes. When I was running Citi, we didn't have artificial intelligence and machine learning, but we knew when people got paid, what they would spend. Sometimes we might know they were heading for divorce before they did, because we could see their partners going crazy on their credit cards. If you really want to know consumers, I would go through the financial door."

With Libra, if regulators force Facebook to map users' payments activity against the identities already established on the social network and the company's other platforms, that potentially becomes a hugely powerful store of information for it to monetize, assuming of course that it seeks users' permission in compliance with new privacy laws.

Recent experience teaches that most users will happily give up their data in return for convenience and are even impatient to do so.

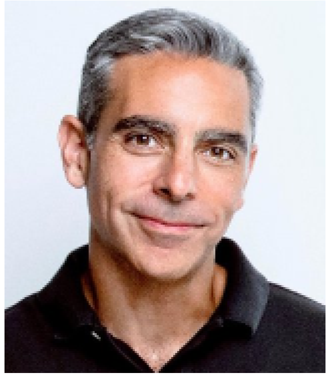
Facebook's paper on the Libra Reserve says that: "Like many other blockchains, the ledger of transactions on the Libra Blockchain will be publicly accessible so that it is possible for third parties to do analysis to detect and penalize fraud."

To penalize fraud, you have to be able to identify who commits it. Regulators may be shoving Facebook through a doorway it's desperate to cross. And to what other third parties might data go, assuming permission is properly obtained?

Reputation

For now, even while growing numbers of users continue to populate its platforms, Facebook's reputation is low. It may be peanuts given the company's cash generation, but even if you can wear a $5 billion "fine" (Mark Zuckerberg's word) from the FTC, it still does not look good.

When David Marcus appeared before congress, senator Sherrod Brown, a Democrat from Ohio, went straight to what has always been the key point, which is not trust in cryptocurrency but rather trust in Facebook. “Facebook has a long track record of abusing users’ trust,” he opened up. “You know that Mr. Marcus. Until recently, you headed Facebook Messenger when you were allowing other companies access to read Facebook users’ private messages.



David Marcus, Calibra

“Do you really think people should trust Facebook with their hard-earned money?”

And here is one of the delicious ironies of the Libra project. Facebook apparently imagines that it can re-cast itself as gamekeeper instead of poacher. The Lbra White paper explains: “An additional goal of the association is to develop and promote an open identity standard. We believe that decentralized and portable digital identity is a prerequisite to financial inclusion and competition.”

And of course, for anyone who can develop that and win widespread acceptance of it there will be a good financial return too.

However, what most intrigues Euromoney is the Libra reserve. It is this that underpins the notion of a new and stable global digital currency and gives it, unlike bitcoin, an intrinsic value from day one. Facebook, or strictly speaking its Calibra subsidiary, has made clear that the reserve will invest in a collection of low-volatility assets, including bank deposits and short-dated government securities in currencies from stable and reputable central banks.

Just for a moment, let’s wonder who inside the Libra Association gets to adjudicate which central banks are reputable and stable, while central banks and regulators make their pronouncements on Libra. Could Mark himself have a say?

As the value of Libra will be effectively linked to this basket of fiat currencies, there will be fluctuations in the value of Libra against any user’s native currency. It’s not clear whether the reserve basket will be constructed using a global GDP weighting, some other criteria or simply be based on the accumulation of fiat cash deposited by users switching out of their home currencies.

That last doesn’t look like a good way to construct the basket, especially if most early adopters of Libra are based in emerging markets potentially subject to heightened currency volatility.

Precedents

There are precedents here. The so-called world currency unit (Wocu), based on the idea of the European currency unit, is a notional synthetic basket licensed by a London-based fintech and used by international investors to benchmark and hedge exposures. It is made up from a GDP-weighted basket of the currencies of the 20 largest national economies as ranked by the IMF.

After its most recent re-weighting in May, the leading currencies comprising the Wocu were the US dollar (30%), Chinese renminbi (20%), Japanese yen (7%) with the euro making up 16% reflecting the combined economies of Germany, France, Italy, Spain and the Netherlands in the global top 20. Sterling accounts for 4%, the same proportion as India.

Rather than laying out parameters for a GDP-weighted basket, Facebook has only said that the makeup of the Libra reserve is designed to mitigate the likelihood and severity of fluctuations, and that it will be structured with liquidity as well as capital preservation in mind.

It is not clear who within the Libra Association will manage the reserve or whether management may be outsourced. But the Libra Association has said it will only invest in debt from stable governments, with a low default probability, that are unlikely to experience high inflation. The association plans to rely on short-dated securities issued by these governments that are all traded in liquid markets regularly accommodating daily trading volume measured in the tens or even hundreds of billions.

This will be important if the new currency achieves large scale because it will allow the size of the underlying reserve to be easily adjusted as the number of Libra in circulation expands or contracts.

Calibra says the reserve will not conduct its own monetary policy but rather simply mint and burn Libra in response to supply and demand as users exchange into and out of fiat currency. It invites comparison with a classic monetary board, such as that in Hong Kong.

Users will not directly interact with the reserve itself but rather with authorized resellers, who will be the only entities authorized by the association to transact large amounts of fiat and Libra in and out of the reserve. These authorized resellers will integrate with exchanges and other institutions that buy and sell cryptocurrencies with users, and will provide these entities with liquidity for users who wish to convert from cash to Libra and back again.

> Regulators are scrutinizing Libra and other cryptocurrencies and expressing significant concerns
>
> - Christopher Pallotta, Templum

Could these resellers one day become banks? Could they lend Libra to users? It's not at all clear.

Established stablecoins, such as those linked to the US dollar and that claim to be backed one-to-one by an actual reserve of underlying fiat currency, have faced suspicions that they are only fractionally backed if they do not disclose the banks where these reserves are deposited. Calibra has only said that it will use a geographically distributed network of custodians with investment grade credit ratings to limit counterparty risk while avoiding the risks of a centralized reserve.

Presumably these custodians will be banks, although Calibra has not confirmed that.

One thing that it has made clear, however, is that users of Libra that might forego interest on fiat cash exchanged into the cryptocurrency will not receive any income from the Libra reserve. The reserve will earn income of course, but that income will go first to members of the Libra Association to pay operating expenses, which will no doubt include incentives to merchants and users to promote adoption.

How the Libra reserve works matters a lot. It looks like a money market fund with a variable net asset value and even though holders of Libra coins won't be earning any yield, they will be exposed to possible loss or gain when they exchange from Libra back into their native currency, assuming that Libra itself does not quickly become a universally accepted currency.

There is a notion abroad that securities regulators, having warned investors that most initial coin offerings were Ponzi schemes, are now embracing security tokens in expectation that conventional securities markets may come to run on distributed ledger technology, with increasing tokenization of equity, debt and other investments beyond currencies and commodities. Rather than fight the trend, securities regulators want to establish the fact that they have authority over anything that walks, talks and looks like a security.

James Kaufmann, a partner at law firm Howard Kennedy, says: "It is likely that Facebook's announcement to launch its Libra digital coin has added pressure to financial regulators at an international level to clarify their thinking on this subject."

Banking regulators

There is a popular notion that banking regulators are going to be tough on Libra even while securities regulators smooth the way for blockchain-based new issues and trading. Christopher Pallotta, chief executive of Templum, a fintech focused on development of market infrastructure for so-called smart securities, sees a line being drawn in recent weeks.

“Regulators are scrutinizing Libra and other cryptocurrencies and expressing significant concerns. On the other hand, regulators have taken a more balanced approach with respect to acknowledging the potential promise of digital securities,” says Pallotta. “With Libra, regulators are swinging a heavy hand and are seen as a barrier to product development. With digital securities, the talk is much more cooperative.”

But that’s not how it may work out. If Libra comes to be treated as a tokenized security representing ownership of a money market fund, that could set the project back. Banking regulators may look like they’re being tough, but they are doing exactly what Facebook wants.

Mike Corbat, Citi

Banks had better wake up fast. Mike Corbat, chief executive at Citi, at least sounded ready for the challenge of Libra when questioned on the second quarter earnings call.

“The way we think about it is that the market is moving and likely moving quickly towards 24/7, real-time, frictionless, ubiquitous global money movements and payments, and that’s just the reality and that’s going to happen, and I think we’re pretty well-positioned around that,” Corbat said.

JPMorgan is also ready. It announced JPM Coin, its US dollar stablecoin secured against client deposits, back in February.

“We’ve been talking about blockchain for seven years and very little has happened, and you’re going to be talking about Libra three years from now,” chief executive Jamie Dimon told analysts on JPMorgan’s second-quarter earnings call. “I wouldn’t spend too much time on it.”

Dimon set out the message US policymakers and global regulators appear already to have received loud and clear. “We don’t mind competition and the request is always going to be the same – you need one level playing field, and governments are going to insist that people who hold money or move money all live according to rules where they have the right controls in place.”

Almost as calm as Jamie Dimon is Mark Zuckerberg. He has his eyes on a big prize. And while he may just be pretending to be brave, it sounds like Facebook's chief executive intends to stick with Libra and roll with whatever jabs and hooks regulators throw, even if it takes longer than 2020 to get it up and running.

Jamie Dimon, JPMorgan

"We've opened a period of however long it takes to address regulators' and different experts' and constituents' questions about this and then figure out what the best way to move forward is," Zuckerberg told analysts on Facebook's earnings call. "And that's certainly what we're planning to do with Libra. We worked with the 27 other members of the association to publish the white paper to put the idea out there expecting that this is a very important and heavily regulated area and there were going to be a lot of questions. We're going to have to work through that.

"We are trying to provide a safe and stable and well-regulated product."

He didn't say anything about challenging the US dollar. But time will tell.

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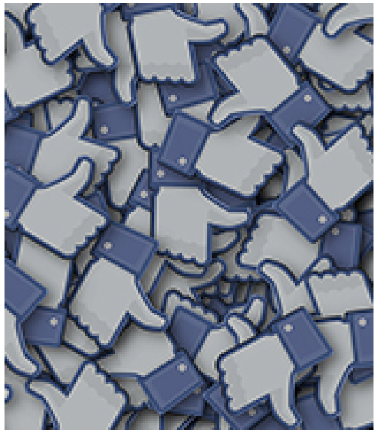

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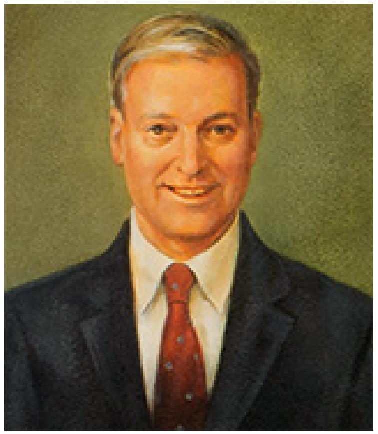

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