StrategyInsights

The Central Bank of… Facebook?

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Cryptomania

Ask anyone about cryptocurrencies and you're probably met with one of two responses: "what?" or "bitcoin?". Having been around for just over a decade, crypo-mania reached fever pitch towards the end of 2017 when the value of a load of different cryptocurrencies and other digital coins exploded in number and in value. Bitcoin famously rose over 5,800% from late 2014 to its peak on 18 Dec 2017.

Market narrative likened the crypto-craze to the first recorded speculative bubble of the Tulip mania in the 1630's. Data from that time is limited, but by some accounts the value of tulip bulbs traded by merchants rose by 6,000% in the space of 3 years. But in 1637, the value crashed spectacularly, falling by over 99%. They say history never repeats, but it often rhymes. After its meteoric rise, the value of bitcoin obediently crashed, losing 83% of its value from the peak in a year, by 14 Dec 2018.

We have blogged about bitcoin, other cryptocurrencies and digital coins previously. I won't labour the differences between coins and cryptocurrencies but I focus on the latter. There is much debate about whether cryptocurrencies like Bitcoin are currencies or commodities.

On the one hand, cryptocurrencies are like any other commodity, being worth whatever the next person is willing to pay for them. Unlike traditional commodities (platinum, oil, wheat, gold etc), cryptocurrencies have limited use cases. They cannot be consumed, so the supply and demand dynamic has no fundamental basis and little other than "desirability" that can drive pricing.

There is potentially more credibility to them being considered as currencies which at their core are a medium of exchange. The challenge here is that most currencies are one way or another associated with another form of fundamental value, being the credibility of the government of the issuing country's central bank. The balance between tax receipts, budget deficits and inflation rates forms the basis of valuing traditional currencies. In the crypto world, there is no government by definition, there is no central purpose for collection (tax) or distribution (budget spending) and so the premise of fundamental value is again immensely challenging to fathom.

But that could all be about to change…

Introducing Libra

In a 12 page white paper, "An Introduction to Libra", the Libra Association set out a bold vision for the democratisation of financial services and introduce a new cryptocurrency called Libra that will be used to facilitate financial transactions.

Unlike most other cryptocurrencies, I took notice with this one. The Libra Association was created by teams from Facebook who also created the Libra Blockchain[1]. The team has since been legally separated into a new entity called Calibra and the Libra Association has expanded to become a non-

[1] A blockchain is a term used to define a public, digital record or ledger of transactions where authenticity of the record of transactions is not maintained by a trusted party (like a bank), but instead by the majority of members of the network that contribute to the public record. Transactions are recorded on the blockchain only when transactions are matched with cryptography. In theory, this ensures trustworthiness of the public ledger.

profit organisation headquartered in Switzerland with a formidable list of founding members from a wide variety of industries:

- **Payments**: Mastercard, PayPal, PayU (Naspers' fintech arm), Stripe, Visa
- **Technology and marketplaces**: Booking Holdings, eBay, Facebook/Calibra, Farfetch, Lyft, Mercado Pago, Spotify AB, Uber Technologies, Inc.
- **Telecommunications**: Iliad, Vodafone Group
- **Blockchain**: Anchorage, Bison Trails, Coinbase, Inc., Xapo Holdings Limited
- **Venture Capital**: Andreessen Horowitz, Breakthrough Initiatives, Ribbit Capital, Thrive Capital, Union Square Ventures
- **Nonprofit and multilateral organizations, and academic institutions**: Creative Destruction Lab, Kiva, Mercy Corps, Women's World Banking

The introductory problem statement in the white paper identifies a number of the problems associated with cryptocurrencies and then goes on with proposed means by which to solve them.

What is it?

One of the biggest issues with cryptocurrencies has been their volatility, which has limited their widespread adoption as users have seldom known how much currency would be required to pay for things. The cryptocurrency market then introduced so called "stable coins" that were tethered or pegged and so guaranteeing their value, such as having a fixed exchange rate versus the US Dollar. Libra fits into this class of cryptocurrencies but what makes it different is its tether is to a basket of different currencies and furthermore that Libra will only be created (minted) when traditional fiat currency is received by the Libra Association from the buyer, at which point it pledges to buy an equivalent amount of the currencies underlying the basket.

The proportions of different currencies underlying the basket are not specifically identified at this stage, but they are described as being stable currencies with credible governments and central banks.

So we can imagine what a Libra might look like. It would be like exchanging £100 and instead holding some proportion of US dollars, euros, sterling, Swiss francs and possibly some Japanese yen and Chinese renminbi. It's easy to feel comfortable about holding most of these currencies and not worrying that they may suddenly become worthless.

Essentially, Libra is unitising that collection of currencies and guaranteeing that its value will be linked directly to that basket and hence remain relatively stable. The composition of the basket may change over time and so the value of Libra may change versus any individual currency (like sterling), in the same way that any individual currency can change in value versus other individual currencies – British holiday makers know this only too well!

This isn't the first "stable coin" to be developed. Indeed, a cryptocurrency project called Basis shut down in December '18 despite having over USD100 million of funding and support from Google's venture arm GV, Silicon Valley venture capital firm Andreessen Horowitz, Bain Capital Ventures, billionaire hedge fund manager Stan Druckenmiller and former Federal Reserve Governor Kevin Warsh. The cause for shutting down and returning capital to investors was having to apply U.S. securities regulation.

That's where Libra looks different again. Calibra was created as a regulated subsidiary of Facebook and the white paper discusses regulation and engagement with regulatory authorities aiming to innovate on compliance and regulatory fronts to improve the effectiveness of anti-money laundering. It doesn't sounds like regulatory requirements have been ignored here.

Why bother?

If in essence Libra is nothing more than a repackaged good, why is there all the hype? This is where I struggle with it.

We can already conduct financial transactions online with near instantaneity, making payments for goods received from all over the world and for a massive variety of services using our own native currencies. What possible additional benefit would come from first making a currency conversion to Libra? For most people in developed markets, the answer is "probably none".

What's more, there is a structural disincentive to hold Libra for any longer than necessary for the transaction in question. By design, on receipt of traditional fiat currency, the Libra Organisation will dutifully purchase the basket of underlying currencies and hold those with regulated custodians/ banks. But any "interest received on those deposits will be used to cover the costs of the system, ensure low transaction fees, pay dividends to investors who provided capital to jumpstart the ecosystem (read "The Libra Association" here), and support further growth and adoption. The rules for allocating interest on the reserve will be set in advance and will be overseen by the Libra Association. Users of Libra do not receive a return from the reserve."

These days we barely receive any interest on cash and equivalent savings at banks so one could argue it makes little difference or that the difference is de minimis versus the service received. But again, users will not earn any interest on their holding of Libra meaning its "value" is severely limited for developed market consumers where our currencies are already fully integrated into the online world.

So why bother? The project is young, information is scant and so speculation is rife.

It could be this is an attempt by corporations to escape national borders by moving transactions out of the banking domain of regulated currencies and into a global digital domain. This introduces all sorts of questions. Who would be regulating the behaviour of the corporations maintaining this digital domain? For currencies chosen to be part of the currency basket of Libra, how would the monetary policy transmission mechanism of that currency's central bank be affected? For example if the Bank of England drops interest rates to encourage economic activity in the UK, would UK economic activity conducted online from the UK still benefit from the interest rate drop?

It could also be an attempt to hoover up billions of "unbanked" individuals. These are individuals without a bank account. Accenture estimates one third of the world's population is unbanked and that bringing unbanked individuals and businesses into the formal banking sector could generate about USD380 billion in new revenues.

That sounds like a slightly more plausible explanation.

What does it mean for your portfolios?

At this point, really not a lot. Libra is not designed to be volatile and so going out to buy some in the hope of a quick buck is not going to work.

This is a highly credible foray encouraging mass adoption of cryptocurrencies. But there are a thousand challenges for the Libra Association to overcome. We will be monitoring its progress, but our first inclination is that this is geared more towards improving the ease of doing business in emerging markets. We'll be looking out for the companies that stand to benefits the most from that.

PS – Facebook is one of them.

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