Forget Stablecoins

By Burkhard Drees and Sunil Sharma

Why central bank digital currency is the only monetary foundation that will work.

Every major financial crisis of the modern era has a common thread: private money failed. Whether it was the bank runs of the 1930s, the collapse of money market funds in 2008, or the implosion of stablecoins in 2022, the pattern is always the same. Private actors create instruments that look and feel like money—stable, liquid, redeemable on demand—until suddenly they are not. The run begins, confidence evaporates, and the state steps in to prevent catastrophe.

This is not an accident. It is the logical consequence of a monetary architecture that assigns to private institutions the contradictory task of simultaneously creating money and financing risky lending. Banks issue demand deposits—instruments that must be redeemable at par on demand—while using those same funds to make long-term, illiquid loans. This dual function is the original sin of modern banking: it makes banks indispensable and fragile at the same time.

Digital technology was supposed to change all of this. Instead, it has made the problem worse. Stablecoins, the most prominent form of private digital money, have introduced new layers of runnable instruments onto a system already prone to panic. They promise the stability of money while remaining, at their core, private liabilities vulnerable to the same dynamics that have toppled banks for centuries. The digitization of finance has not solved the fragility problem. It has amplified it.

THE STABLECOIN ILLUSION

Proponents of private stablecoins often argue that innovation requires private money. The claim is that blockchain-based payment rails, programmable finance, and the broader architecture of decentralized systems depend

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
www.international-economy.com
editor@international-economy.com

on privately issued tokens rather than public currency. The assertion is that central bank money is too slow, too bureaucratic, too analog to serve the needs of a digital economy.

This argument, however, misidentifies where the genuine innovation lies. In any payment system, the monetary unit itself—the medium of exchange that settles transactions and stores value—is not the source of technological creativity. The innovation lives in the infrastructure: the protocols, the interfaces, the settlement mechanisms, the programmability of contracts. These can all flourish on top of publicly issued digital money just as easily as on top of privately issued tokens. Indeed, they can flourish more safely.

A stablecoin is, at its core, a promise. It is a promise by a private entity to redeem a digital token at par into currency—one dollar for one token, always, on demand. But private promises can be broken. They depend on the creditworthiness of the issuer, the quality of the reserves backing the token, and the confidence of holders that everyone else will remain confident. When that confidence falters, the run dynamic takes over. The TerraUSD collapse of 2022 demonstrated this vividly: a stablecoin with a market capitalization of $18 billion evaporated in days. The losses were not hypothetical. They were real, and they fell on real people.

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While TerraUSD was an algorithmic stablecoin, even well-collateralized stablecoins backed by high-quality assets carry residual risk and have faced difficulties keeping their pegs. In a panic, the quality of collateral becomes contested. Redemptions accelerate. Fire sales of reserve assets depress prices, impairing the very collateral that was supposed to provide stability. The mechanism is familiar because it is the same mechanism that makes banks fragile: the attempt to provide a liquid, par-valued instrument on top of assets that are themselves illiquid or risky.

DIGITIZATION AS STRESS TEST

There is a temptation to view digital innovation in finance as a series of incremental improvements—faster payments here, lower costs there, new products for underserved markets. This view is incomplete. Digitization does not merely change the speed and cost of financial activity. It fundamentally alters the architecture of the system in ways that expose and amplify structural weaknesses that were previously obscured.

Consider what digitization actually does to financial dynamics. It increases the speed at which information spreads and decisions are made. It lowers the friction involved in moving money. It enables massive coordination among dispersed actors in real time. Each of these properties is genuinely valuable for normal economic activity. But in a crisis, they are accelerants. A run that once took days as depositors queued at bank branches can now occur in minutes as account holders tap their phones. The 2023 collapse of Silicon Valley Bank—driven partly by social media panic and instant digital transfers—offered a preview of this new topology of bank runs.

More fundamentally, digitization concentrates critical monetary functions on private platforms at a scale and with an interconnectedness that the system was never designed to handle. When the payment infrastructure of an economy runs through private digital platforms—whether traditional banks, fintech companies, or stablecoin networks—the failure of those platforms is not merely a financial problem. It is a breakdown of the basic plumbing of economic life. The systemic risk is not incidental to this architecture. It is inherent to it.

What digitization demands, therefore, is not better regulation of private digital money. It demands a fundamental rethinking of monetary architecture—a shift from tinkering with financial instruments to redesigning the institutional structure within which those instruments operate.

SEVERING THE KNOT: CENTRAL BANK DIGITAL CURRENCY

The core insight of a serious monetary reform agenda is simple to state, even if difficult to implement: money creation and credit creation must be separated. The instability of the current system flows directly from their entanglement. Banks create money when they make loans. The money they create—demand deposits—must be redeemable at par on demand, which makes banks inherently fragile. And because banks are both the creators of money and the providers of payment infrastructure, their fragility is systemic.

A central bank digital currency, properly designed, offers the mechanism to cut this knot. In a CBDC-only monetary system, money consists exclusively of a digital liability of the central bank. Demand deposits as currently constituted—private, par-valued claims redeemable on demand—are abolished. All private payment instruments are inadmissible. Money creation becomes explicitly a public function, and private lending activity does not create money.

This is not a radical nationalization of finance. It is a reassignment of functions. Retail payment services would still be provided by private actors—Payment Interface Providers—who offer customer-facing services without holding customer funds on their own balance sheets. Laws and rules for data collection, storage, and access will have to be written and promulgated. Customer balances would

remain central bank money at all times, held directly as CBDC. The private sector would innovate on top of a publicly provided monetary foundation, the medium of exchange; it does not have to provide the digital token itself.

Lending, meanwhile, continues through private credit institutions. The crucial difference is that these institutions fund themselves through equity, investment shares, and debt instruments of varying maturities—none of which is redeemable at par on demand. Investors in these institutions explicitly bear credit and liquidity risk. Losses are absorbed through contractual priority rather than public guarantees. Incentives for prudent lending are sustained by the market discipline imposed by staggered debt rollover risk on the lender's funding side. Credit institutions can fail without disrupting the payment system, because the payment system no longer depends on their solvency.

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ADDRESSING THE OBJECTIONS

Will credit become scarce? The most common objection to separating money creation from credit creation is that it will reduce the availability of credit or raise its cost. This concern deserves serious engagement, but it overstates both the role of demand deposits in bank funding and the social value of the current arrangement.

The relationship between deposit funding and lending is less direct than commonly assumed. In the United States, demand deposits represent roughly 20 percent of bank funding, while loans account for approximately 50 percent of bank assets. Central banks would, in a CBDC-only system, recycle CBDC funds to credit institutions, providing a source of funding that replaces, at least in part, the function currently served by demand deposits.

More importantly, some of what appears to be a cost advantage of deposit-funded lending is actually a subsidy embedded in the current system. Deposit insurance and implicit government guarantees behind bank deposits—the expectation that the state will prevent bank runs and bail out depositors—reduce funding costs in ways that are not economically justified. Eliminating this subsidy would make lending decisions more judicious. If lending rates rise marginally, that reflects the removal of a distortion rather than a social loss. And if fewer financial crises occur, funding costs over the long run may actually fall.

Will central banks meddle in credit allocation? A second concern is that CBDC would draw central banks into credit allocation decisions, compromising their independence and distorting the economy. This concern conflates the provision of funding with the making of lending decisions. In the proposed system, the central bank can lend CBDC to credit institutions broadly—similar to central banks currently supplying reserves to the banking system—while individual lending decisions remain decentralized and private. The central bank's indirect role in credit allocation would not differ fundamentally from today's arrangements.

Can credit crises still destabilize the economy? A more subtle concern is that even without a monetary collapse, a severe contraction among credit providers could cause profound economic damage through the disruption of credit intermediation. This is a legitimate worry, and it deserves an honest answer: yes, credit crises can still occur in a CBDC-only system.

But the character of those crises is fundamentally different. Credit institutions in this system face rollover risk—the possibility that they cannot refinance maturing debt—rather than the instantaneous collapse triggered by runs on demand deposits. Rollover crises are slower moving, more observable, and more amenable to orderly resolution. Credit institutions can be allowed to fail because their failure does not threaten the payment system. Resolution can be made stricter and swifter. The lender-of-last-resort function performed by central banks can be preserved but exercised with more restraint through collateralized lending to solvent institutions within pre-established limits, rather than through open-ended bailouts driven by the fear of systemic payment collapse.

Size and concentration constraints on credit institutions remain important. A credit institution large enough to dominate the lending market will have systemic consequences. Anti-trust and competition policy must be appropriately calibrated to prevent the emergence of credit intermediaries too big to be allowed to fail.

MONETARY POLICY IN A CBDC WORLD

One of the most elegant features of a CBDC-only monetary system is the simplification it offers for monetary policy transmission. In the current system, the policy interest rate—set by the central bank—must be transmitted through multiple layers of intermediation before it affects the borrowing and saving decisions of households and firms. The process

is indirect, subject to frictions, and relies on uncertain pass-through mechanisms. And, importantly, it is impaired during financial crises precisely when effective transmission is needed most.

In a CBDC-only system, the interest rate on CBDC becomes the economy's risk-free benchmark, transmitting directly to every holder of digital currency—every household and firm in the economy. Because the payment system is insulated from private balance-sheet stress, a financial crisis in the credit sector does not impair monetary policy transmission. The central bank retains effective control over the risk-free rate even when credit markets are under stress, and it has better control over the supply of money.

THE ARCHITECTURE OF RESILIENCE

The argument for CBDC is ultimately an architectural and governance argument. Being complex and adaptive, a resilient financial system must be modular—composed of components that are connected but not too tightly coupled. The current system fails this test: the payment system, the money supply, and the solvency of private financial institutions are so intertwined that stress in any one component propagates immediately and catastrophically through the others. This is why financial crises require massive public intervention. The alternative to intervention is not merely financial loss but the breakdown of the payment infrastructure on which the entire economy depends.

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A well-designed CBDC architecture achieves modularity by design. The payment system is insulated from credit risk because it runs on central bank money rather than private liabilities. Credit institutions can fail without triggering payment system collapse. Financial distress in the credit sector may still cause economic pain—through tighter credit conditions, reduced investment, and slower growth—but it does not manifest as a systemic breakdown of money and payments. The shift is profound: from a regime centered on *ex post* crisis management of a fundamentally unstable system, in which the state intervenes repeatedly to prevent collapse, toward one focused on *ex ante* structural resilience, in which the conditions for collapse are removed by design.

This is not a utopian vision. It does not promise the elimination of financial instability. Credit cycles will continue. Poorly managed institutions will still fail. Asset prices will still fluctuate. But the specific, destructive dynamics of monetary collapse—the bank run, the payment system seizure, the disintegration of confidence that turns financial stress into economic catastrophe—can be structurally prevented rather than merely managed after the fact.

THE ONLY STABLECOIN THAT ACTUALLY PROVIDES STABILITY

The digital age has prompted a proliferation of private monetary instruments, each claiming to offer the stability and convenience that money requires. Stablecoins, in particular, have attracted vast capital and political attention, presented as the natural monetary unit of a digitized economy. But stablecoins—however sophisticated their design, however high-quality their collateral—remain private promises. And private promises are redeemable only so long as confidence holds.

Central bank digital currency is the only monetary instrument that is genuinely structurally stable. It is publicly issued and publicly guaranteed. It is risk-free in the only meaningful sense: its value is not contingent on the solvency of any private issuer. It possesses the "no-questions-asked" property. It aligns monetary policy with payment infrastructure. And it provides a stable foundation on which private innovation can flourish without embedding new systemic risks into the monetary core.

The central question of monetary architecture in the digital age is not whether digital money will exist. It will. The question is what form it will take, and who will create it. The answer is not complicated: in a world where private digital money amplifies the fragilities that have plagued monetary systems for centuries, the role of public money becomes more important—not less. CBDC is not a threat to financial innovation. It is a necessary precondition for such innovation.

The ultimate stablecoin is not issued by a private company. It is issued by the central bank for the benefit of the economy as a whole. Everything else is a risky workaround. ◆