Barefoot Innovation Podcast with Randal Quarles
Chairman (Cynosure Group); former Chairman, Financial Stability Board; former Vice Chairman for Supervision, Federal Reserve Board

*Note that transcripts may contain errors.

Jo Ann: We have an especially exciting show today because my guest is Randy Quarles, who is chairman of Cynosure Group, and is best known, I think, as being the former vice chairman for supervision of the Federal Reserve board, as well as the former chairman of the Financial Stability Board. Thank you for joining us today. We're so excited to have you.

Randy: Thanks, Jo Ann. Thanks for having me. Great to be here.

Jo Ann: So you stepped down from your public life not long ago, and so have had a very recent experience at the fed leading of all the financial supervision work through COVID and more. So I'm really thrilled to be able to have you to impart some words of wisdom, some reflections that you may have based on that experience and the rest of your best experience. I think a good place to start, people know who you are, but it'd be great if you would just take a moment to tell us a little bit more about your background and the perspective that you bring to these topics.

Randy: Well, thanks. I started out in life as a lawyer. I began as a associate at a law firm called Davis Polk & Wardwell in New York City, which is one of the main financial services law firms in the country. JP Morgan, Morgan Stanley were our principal financial services clients, a bunch of foreign banks. So my career, my expertise naturally evolved into financial services.

Randy: When I was about a sixth year associate, the treasury, the US treasury was casting, about to put together a team to think about the structure of financial regulation in light of the savings and loan crisis, and they had a senior academic who was going to be the undersecretary, a man named Bob Glauber. They had a midlevel investment banker, who's on the team, who'd worked with Nick Brady, a man named Jay Powell. They brought somebody from the hill to the team, a guy named John Dugan, and they were looking for about a sixth year associate from one of the big New York law firms to round out as the junior person on the team, and they asked the usual suspect law firms who each nominated a person. We went down and interviewed, and eventually, they chose me to join that team. So I was in the treasury-

Jo Ann: Quite a lineup of people.

Randy: It was. We became very good friends, and they were wonderful people to work with. I didn't realize how closely my career would end up tracking Jay's or coinciding with his at a number of times. So that was a wonderful time working in the treasury for a couple of years there at the end of the Bush 41 administration with that group. I went back to my firm as a partner now, but once you've served in a role like that, your name gets on a list. When the Bush

43 administration began, Paul O'Neill asked Nick Brady, "Whom should I bring back? Whom should I think about bringing back?" and they brought me back in an international role at first at the IMF and then assistant secretary for international affairs. Then I was the acting undersecretary for international affairs, and the undersecretary for domestic finance, which brought me back to the financial services issues that had been my core.

Randy: Then after that, I went to the Carlisle Group as a private equity investor, and then I left the Carlisle group to form my own private equity firm that invested in a broad range of companies, although a heavy focus on financial services. So all of that was the experience that I brought to the fed when they asked me in 2017 if I would join as the vice chair for supervision.

Jo Ann: That's great. So I am going to take the opportunity, since I have you here, to ask you a little bit about the economy. We're in a moment when inflation is doubling economies throughout the world, and there's much talk about the potential of recession, and we have a lot of turbulence in some parts of the financial marketplace. So I'd love to get your take on the moment we're in. We won't hold you to any predictions, but when we think about the disruption and the war, supply chain disruptions, war in Ukraine, that's a complicated time, any thoughts to share?

Randy: So it is a complicated time. I guess, a few thoughts I would share. One, so the US economy still with the challenges that you've discussed and notwithstanding right now the high levels inflation that the fed is trying to get on top of, it's really a very strong, sound economy. The fundamentals of the economy remain very strong. We're not looking at anything like the 1970s. There's often a lot of public discussion about, jeez, high inflation, high energy prices. Doesn't that sound like the 1970s? The dynamics of the '70s were quite a bit different than what's driving the current environment.

Randy: I think the second thing I'd say is that people look at the high inflation and they say, "Can the fed get on top of this?" particularly if it's inflation that's driven by supply constriction as opposed to excess demand. A year ago, I think I would have agreed with the view that the fed's tools were not well-designed to address the inflation that we were beginning to see because it was principally driven by supply chain disruptions.

Randy: I think the evidence over the ensuing year has made pretty clear, certainly to me, that this is principally an excess demand driven inflation. The data at the beginning of last summer, there were lots of reasons to think that, A, there were only isolated items in the basket that we used to measure inflation that were showing inflationary pressure, although those were severe and so they were leading to significant increases in the headline aggregate number, but it wasn't really a comprehensive aggregate demand driven inflation.

Randy: By last fall, if you looked at various measures of supply in the economy, throughput through the ports being one that's easy to talk about and think about because the narrative of last summer was there aren't enough people to take things off the boats at the ports, and so there are these log jams and bottlenecks that are interfering with goods getting into the country, and that's contributing to inflation because there's not enough supply to meet demand that is returning to pre-COVID levels.

Randy: By September, it was clear that the throughput at the ports was above pre-COVID levels already, and there were still bottlenecks and the log jams, but that's because the demand for goods through the ports was significantly higher than pre-COVID. It hadn't returned to pre-COVID. It was higher than pre COVID. By the end of the year, measures of throughput through the ports were at record levels in history, and we still didn't have enough supply to meet demand.

Randy: I think with the benefit of hindsight, it's clear that the various fiscal stimulus programs that were put in place in response to COVID were much more effective than we had imagined that they would be, and as a consequence, there were three of them, has stimulated demand to a level that is outside the capacity of really even a pre-COVID productive capacity of the economy to supply.

Randy: The good news is that that's exactly the thing that the fed can get on top of. The fed can't make more computer chips and it can't unload things at the ports, but it can bring demand back into a relationship with a supply that is close to productive capacity, and they've shown that they can do that. The interest rate tool, I think, is going to be more effective in this cycle than it has been in some previous cycle.

Randy: So I guess that's the third thing I would say is that some economists, some folks who look at economic history say when inflation has been this high in the past, you've had to raise interest rates very high in order to contain it. I don't think that that's going to be required in this instance because we have an economy and a financial system that fuels that economy that has grown used to such low rates of interest for such a long time, and relatively modest, absolute increases in an interest rate from 0% are huge percentage increases in the cost of debt service, which is what then begins to constrain economic activity back down to a level that matches the ability of the productive side of the economy to supply it.

Randy: So it's a fairly common view that interest rates will need to rise to between 3.5% and 4% by the first quarter of next year in order to bring this under control. That's about where I am as well. That's well below what a lot of the traditional formulas would tell you interest rates would need to get to in order to constrain an inflation that's this high, but I don't think we're going to need to get there because of what I think would be the exceptional effectiveness of the interest rate tool in this particular cycle, given the economy in which it's operating.

Randy: I guess the last thing I would say on the international side is that we're, in many ways, in a more fortunate position than Europe and the UK, especially Europe with respect to inflation because they really are facing ... If you look at their inflation dynamics, they passed much less fiscal stimulus in response to COVID. Their fiscal stimulus was, A, smaller, B, it was more targeted, C, it was differently structured. So they did not end up with the amount of extra juice to demand that we did, but they are much more affected, obviously, by the disruptions in their energy supply that are coming from the conflict in Ukraine. I guess we can call it a war in Ukraine.

Randy: So when you look at the difference between their headline inflation numbers and their core inflation numbers, core inflation being you strip out food and energy, they're huge. So their headline inflation numbers are about where ours are, a little bit higher by some measures, but their core inflation numbers are way below where ours are, and that indicates that their inflation is really being driven by these food and energy prices that, unfortunately, that's not going to be temporary.

Randy: You strip out food and energy in looking at inflation because those are volatile over the course of the year, but if you have something secular and major and structural that's happened to affect those prices, then it doesn't really make sense to say, "Well, look at core inflation." The only thing you can say is, "Well, the core inflation means that we haven't overstimulated demand to drive the price of everything up, but we still have a huge problem in the prices of food and energy, which are critical inputs into the economy." Critical things that consumers have to purchase will be higher for a long period of time, and there's nothing that the central bank can do about that, and constraining demand for everything in order to be able to match the interrupted supply of food and energy because of the war in Ukraine would be a huge economic mistake. So they've got a much bigger challenge than the United States does with respect to their inflation position.

Jo Ann: Extremely interesting. Thank you. I want to ask you a couple things about maybe legacy and lesson learned from your tenure at the fed, and then turn to talking about some of the newly developing issues on where we're headed. You were vice chairman of the fed during COVID and also chair of the financial stability board. Beyond what you've already said, I'd be really interested in hearing your thoughts on lessons to take away from this experience and maybe be able to apply to the next crisis, whether it's, I think, you were overseeing much of the credit facility emergency situation, as well as the financial industry supervision responses as well. So do you have key takeaways from that?

Randy: So I do. I think there are important lessons learned. I worry that we've only learned some of them. So the credit facilities, well, actually, let me start with the steps that we took on financial regulation, which I think were inarguably successful and were different than the approach that much of the rest of the world took. We had some advantages as to how we could take this approach. So

I'll try to squeeze all of this into something that's appropriate for less than a four-part miniseries, but the first issue that we faced was the inability of the financial system really to intermediate. The treasury market closed down. There were a variety of reasons for that.

Randy: Part of it was simply that everybody wanted cash. They were selling. So they were selling everything, even things that were very close to cash because they wanted cash. In any market where there are only sellers and no buyers, that market cannot clear. There's no regulatory framework you can create that will do that. So the fed had to step in and be the buyer in order to eliminate that disruption in markets.

Randy: Again, with the benefit of hindsight, I think we maintained that program for much longer than what's necessary of buying $120 billion of treasury and agency securities among, but the first thing was that critical issue of getting the markets to clear, but an element of that was the constraints that we had put through our leverage capital restrictions on the large banks who own the large dealers, and that did affect in times of stress the liquidity that the system could provide.

Randy: So I do think that a lesson to be drawn from, we created emergency exceptions to the supplemental leverage ratio and the enhanced supplemental leverage ratio in order to create more headroom for the dealers to operate. We were running into a situation, and we had the ability to do that under the law, we were running into a situation where we might have needed to have some flexibility under the core leverage ratio that sits at the bottom of the stack of various leverage ratios that apply to banks of different sizes.

Randy: The law doesn't allow us, the Collins amendment doesn't allow us to create even a temporary exemption for that in the event of a financial stress. I proposed to the chair of the Senate banking committee who was saying, "What can we do that would be helpful?" I said, "Well, the ability to make a temporary exemption in times of stress so that we could do with the core leverage ratio what we did with the enhanced supplemental leverage ratio and the supplemental leverage ratio would be helpful. Indeed, we may need it." It turns out that we came very, very close to eating it, and then didn't, but that was politically extremely controversial. It was touching a religious icon, and it didn't really matter how much one said. This is four times of stress and temporary, and would immediately be put back in when the stress was relieved.

Randy: So I think the fed has to grapple with the fact that the leverage ratio framework is useful, but has been calibrated too tightly. When the calibrations of the supplemental leverage ratio and enhanced supplemental leverage ratio were set, the basic one, of course, is set by law, but the fed was estimating that reserves in the banking system at the end of 2021 would be $25 billion, and that's because reserves are also subject to the leverage ratio. That's very

important in determining, "Well, what constraints are we actually putting on the banks by calibrating the leverage ratio this tightly?"

Randy: Well, of course, reserves at the end of 2021 were $4.5 or $5 trillion. I mean, they were almost 200 times as much as had been projected at the time that the leverage ratio was calibrated. So it's clear that that recalibration needs to be done. It's not at all clear politically how it can get done. I'm hopeful that maybe in the spirit of only Nixon could go to China, maybe a Biden-appointed vice chair for supervision will be able to structure a recalibration that gives people comfort that this isn't gutting the leverage ratio, but that it does allow the system to function better.

Randy: The final thing on the regulatory side I'd say is what we did with dividends and distributions from the banks because we were under a lot of pressure to say, "We don't know how this is going to evolve. You need to stop the banks from making any dividends." Many jurisdictions in the world, Europe, UK, immediately said, "Banks cannot issue any dividends until we know what's going on."

Randy: Fortunately, since our distribution system from the banks are structured a little differently than Europe and the UK in that there's a smallish core dividend that's paid and is basically promised to investors, and there's a much larger return of capital that comes from repurchases of shares every quarter, we could stop the banks from repurchasing their shares, and we structured that so that they came out and made a statement that they were voluntarily ending the repurchase of their shares. It was, in fact, voluntarily because I'm not sure we had the legal ability to stop them from repurchasing their shares, but we did show up and say, "Nice little bank you've got there. It would be a shame if anything happened to it," and they voluntarily stopped their distributions, but we then began stepping up the stress testing of the system.

Randy: Most jurisdictions in the world said, "We don't know how to stress test in this environment. We're just telling all the banks stop all distributions. We're not going to do any stress tests, and we'll see how all of this shakes out."

Randy: We said, "Stop the, clearly, optional share repurchases, but we're going to keep stress testing the system repeatedly as this situation evolves, and as long as our stress tests show that the banking system is resilient, you may continue to issue your basic dividends."

Randy: I think that, again, with the benefit of hindsight, it's clear that that was the better approach. The cost of capital for European banks is higher than it was before, and the cost of capital for US banks did not suffer as much as it would have if the message that was sent from the COVID event to the markets was, "If the regulators get spooked, they can just cut off your distributions." This is a category of asset that you cannot count on distributions from even if they have done everything that was required to be able to maintain these distributions through a tough time.

Randy: They kept higher levels of capital and higher levels of liquidity precisely, so they can weather a storm, and if the storm comes, if the captain is just going to say, "Ah, forget it." So I think it was a huge burden on the fed staff, the folks who do our stress testing. We did essentially seven stress tests over the course of the year in the space in which we would have done two.

Randy: I can't overstress how dedicated and intelligent and burdened the fed staff was in doing that, but as a consequence, I think that our financial system is better off in the long term. The cost of capital for our system is lower, and we demonstrated what I hope will be a template for other jurisdictions to follow in the future, and not to say, "We're just going to stop stress testing and take the most restrictive position possible," but rather say, "We're going to actually step up stress testing so that we can make decisions in the light of even more information and hope that those decisions are better calibrated and tailored."

Randy: So you asked about the credit facilities too, and you triggered a long soliloquy. So I hate for this to be such a long soliloquy. So on the credit facilities, let me quickly say a lot of people thought I wouldn't support the credit facilities and the various facilities that the fed introduced to respond, there were about 12 of them, some of them were what I would call traditional provision of liquidity. They were similar to what had been developed in 2008. They were providing liquidity to financial markets and financial institutions.

Randy I don't find those very controversial. It's why the fed exists. I find them less controversial even than some folks who wear my political jersey who think that it's a socialization of a privatization of profit and a socialization of risk. I think that's a misunderstanding of how the fed responds when it provides liquidity in financial stress. It's why the fed exists. I think that it's an appropriate action.

Randy: Much more controversial, the setup facilities that the fed implemented in the face of COVID that provided credit directly to the real economy, whether that was two municipalities, whether it was two corporations, whether large corporations or small corporations. That was much more controversial. A lot of folks thought I would oppose them. I think Jay was worried that I was going to end up opposing them. We spent a lot of time talking about it.

Randy: I think that that was an appropriate emergency response to the peculiar, and one would hope almost highly unlikely to repeat itself situation that we faced in March of 2020, where you had governments that were administratively closing down much of the economy. So it just wasn't clear how businesses were going to be able to survive. I mean, if businesses that had no revenue but nonetheless many of them had obligations, debt obligations, how could they survive? It's a reasonable governmental response to find some way to provide that liquidity.

Randy: The lesson, however, that I would have hoped that we would have learned from the process and the template that I'd hoped to create but was unsuccessful in creating was that once the fed had stood up those crisis credit facilities, they

really should be moved into a different vehicle, a congressionally authorized vehicle with separate governance, democratically accountable governance on how they should operate.

Randy: An example I've used before, you may have heard me use, but it was quite sobering to me. It just happened that given the testimony schedule, I was the first member of the fed to testify after all of this began. They had previously scheduled my regulatory testimony. No one in the Congress wanted to talk about regulation at that moment. They wanted to talk about the credit facilities, and the only thing they wanted to ask about the credit facilities was, "Where's mine? You're lending to municipalities. What about my town? What about my business? What about my constituent? Why aren't you lending to that? When will you lend to that?"

Randy: It was the clear pressure for the politicization of the allocation of credit was there, and that's not something that the fed is designed to respond to. The pressures then to politicize the fed if it accepts the role of credit allocator I think would ultimately be irresistible.

Randy: So I had wanted us to very promptly move these credit facilities that we had created into a newly created vehicle that would be separate from the fed. The Congress would develop the governance of it so that when a Congressman said, "Where's mine?" there was a politically accountable group. I don't know whether it would've been wise to do or not. The decisions may or may not have been wise, but they definitely should not have been the feds' decisions as to subsequent lending out of these facilities.

Randy: I didn't get that done. Ultimately, the view was you create something like that, you'll never get rid of it, and the pathologies associated with a government body that was allocating credit would be bad, but I do worry that the next time there's a stress, the fed will go to the toolbox, they'll open it, and all these tools will be in there without any tag that I had hoped would be attached to them saying, "If you use this one, here's what comes next."

Randy: So I do think that's an important lesson to have been learned from what we did is that we need to think very carefully about what else goes with the use of the credit tools the next time the box is opened and they're pulled out to use.

Jo Ann: Thank you for sharing that. You all were facing unprecedented challenges and dealing with them with unprecedented action, and it's really interesting to hear your advice to, say, the next generations that's having to work with it. I want to turn to now where we're headed. You and I have known each other a long time, and the thing that prompted me to reach out to you recently to come on the show was I heard you at a conference where you were speaking about CBDC, Central Bank Digital Currency, and the digital dollar, and I interpreted your comments as being skeptical of whether we need a US digital dollar. I would love to hear your thoughts on where we are headed, where we should be headed

with CBDC in the world and in the US, and then also follow up with that by talking maybe about stablecoins.

Randy: Well, so let me begin with a preference to when we get to the part about stablecoins, my comments on CBDC, I think, sometimes sound Luddite, and I'm not at all. I think I'm actually quite excited and interested in a lot of the technological innovation around payments and currency that are happening right now. I think they're not only interesting, they're solving problems that have needed to be solved for a long time.

Randy: They're doing it efficiently and effectively, but that has led a lot of central banks to say, "Well, if they can do it, why can't we? We no longer pay for things with beads, and shouldn't we be moving the state money into the 21st century as well by making it electronic?" So I think that's results on a lot of confused perceptions so that I think it's unnecessary, and I also think that it would have really bad consequences if we were to do that.

Randy: So I mean, the first thing, obviously, to recognize, you and I recognize it, but it's just not widely thought about that almost all of our money is electronic, is digital, anyway, and almost all of our money doesn't come from the state. It doesn't come from central banks. So the big push for central bank digital currencies began in the summer of 2019 when Facebook announced that it was proposing to establish its stablecoin called Libra, and governments around the world began saying, "Well, we can't allow a private company to issue money. This is a threat to national sovereignty."

Randy: That's really confused. I was shocked that many, many finance ministers around the world were being quite passionate and vehement about we cannot allow a private company to issue money. All of our money comes from private companies. It comes from banks. It's issued by banks in the form of bank deposits, and we move it around with credit cards, and none of that touches the ... We're not involved with central bank money at all. The only central bank money that any of us have are the little pieces of paper in our pockets, which we use for almost nothing but tips these days. So the view that somehow these stablecoin developments and developments of private payments technologies were threatening national sovereignty I think is just an almost comical mistake.

Randy: The technological challenge of creating a central bank digital currency I don't think can be understated. There's a lot of investment and experimentation and failure that is going on in the development of stablecoins and these modern technologies. That's not something that the fed is designed to handle well. We begin developing a central bank digital currency, and I think it could be very like what we are seeing develop, which were my concerns originally when the fed approved the fed now process, which is the realtime small dollar payment system. I dissented from our approval of that system because my view was by the time the fed gets around to developing one, the private sector had developed one, and the private sector was working on developing others, by the

time the fed gets around to developing one, it will be a white elephant that will have been overtaken by events, and I think that's proving to be true.

Randy: I mean, we set out this fed now process, and now we're saying, "Well, actually, what we want to do is a central bank digital currency." We haven't even finished the fed now and we said, "No, the way we want to do immediate transfers is through central bank digital currency. So now we'll start that project," and that will take many years, and by the time we get to the end of that project, it'll be, "No, no, no. Actually, what's happening is over here we should be doing that." So again, the rapid innovation ... I love the fed as an institution. I use that word quite literally. I love the federal reserve, but it is not the place for rapid innovation. It's just not going to happen there.

Randy: So you might say in the face of all of that, "Okay. Well, maybe it's not necessary and maybe the fed won't do it super well, but what could it hurt?" Where I think it hurts is that if you do have a central bank digital currency that will reduce the friction in handling central bank money, and while it won't replace the ... If your intention is not to replace the private banking system, and the intention of many people who like the idea of a central bank digital currency, particularly on the very far left, is to replace the private banking system, but every single bank in the world, even those that are enthusiastically pursuing CBDCs have said, "No, no, no. We're not going to replace the private banking system," but by having a relatively frictionless central bank currency, more people will hold that than currently hold deposits.

Randy: The ECB, I think, their estimate is that a central bank digital currency will suck somewhere from 12% to maybe 20% of the deposits out of the private banking system. Now, unless you're going to accept that the economy shrinks by the amount of financial support that would be represented by having that degree of deposits withdrawn from the system, that money has to be reintermediated somehow, either the central bank will have to do the lending that the private sector financial system no longer has the deposits to do that missing amount or the central bank will have to put the money back into the private sector system and say, "You do the allocation because we're not super good at that, so we're giving you the money back," but in either case, there is no political system in the world that will allow that reintermediation to happen without some degree of politicization.

Randy: There will be instructions as to how the central bank is to make the lending that it is doing with the seigniorage that it's getting from the central bank digital currency, and those instructions will differ depending on who happens to hold the political reigns at the time, but all of them will be pathological or the legislatures will demand that strings be attached to the money that is put back into the private sector system. There are preferred borrowers and you will lend to those preferred borrowers either in larger volumes or at lower cost than you otherwise would have. Again, history tells us that that's a recipe for pathology.

Randy: So my view on central bank digital currencies is it's not necessary, and we'll talk about stablecoins. I think that's why it's not necessary, which is that the private sector is doing this. We'll do this, and it's perfectly adequate to do this. The central bank wouldn't be very good at doing this, and if it does it, there are serious costs that would come with having the central bank issue a digital currency. It's not a, "Oh, well, maybe it's not necessary and maybe we won't do it that well, but so what? We should do it anyway," because there will be costs that would be associated with it and we shouldn't incur them.

Jo Ann: What do you say to the argument that we're going to find it necessary to have a digital dollar, to have the dollar remain as the world's reserve currency? We've had Christian Carlo on the show a few times, and as you know, one of the arguments that he makes is that the world wants and should have a reserve currency that is packaged with the values of rule of law and anti-money laundering and so on, and geopolitically that the Chinese are aggressively pursuing the EU on and so on. Do you have a view on that?

Randy: I do. I mean, so I don't think ... I love Chris, and I am fully supportive of his support of new payments technologies broadly across the board, but on CBCDs, there I think that he is wrong. I mean, the dollar is the world's reserve currency for the reasons that you were citing. It's because of the rule of law. It's because of our deep financial markets. It's because of the investment opportunities in the United States that are still superior to anywhere else in the world. It's for a whole variety of reasons. None of which have anything to do with the form in which the dollar is held, and the entities that care about those things, the central banks of the world, large financial institutions of the world that are holding the dollar in large reserves, aren't holding large stacks of paper money. They are holding digital dollars.

Randy: I mean, the dollar is extremely digitized, and it is not ... Turning the form of digitization from the current technology to a new technology doesn't do that much for these large institutions at central banks. It's very helpful at a retail level, but it doesn't do that much for the large institutions that anchor the dollar status as a reserve currency around the world.

Randy: It is a common theme that we need to digitize the dollar because the Chinese are digitizing the renminbi, and we will fall behind globally if we don't. The Chinese are digitizing the renminbi as a way of increasing their ability to surveil their populace. That is hardly a reason for the rest of the world to want to adopt the renminbi. I mean, what is going to be appealing to another jurisdiction, to large financial institutions about saying, "Yes, let's ensure that we're using a currency that the Chinese government can push F4 on their computers and eliminate at any moment." That's not going to be appealing.

Randy: It's a little bit like saying the Chinese have started printing the yuan on purple paper and we have to keep up. We're still using green. Those aren't the things that matter. Those aren't the facts that matter. So I just think it's a category

mistake to think that e-yuan is somehow a threat to the global position of the dollar. The dollar's position as the dominant global reserve currency will continue to erode over time gradually as it has eroded over the course of my lifetime, modestly and gradually, but it's still going to be, at the time that I am carried out and laid in the ground, the dollar is still going to be the world's dominant reserve currency and probably through my children's lifetimes. Everything evolving and moderating somewhat, but there is not an existential threat to the dollar's reserve position from the Chinese e-currency.

Jo Ann: I have so many questions I'd like to ask you, and I know we're going to run short on time. So I want to have time for at least two of them. One is thoughts on regulating stablecoins, and the other is I want to turn, before we're finished, to a little discussion of the challenge that the regulators face in keeping pace with the technology transformation that's going on around them, but first, stablecoins. What are your thoughts there?

Randy: So stablecoins, I think that stablecoins, it's an exciting technology, very promising technology. The technology exists now to solve particularly with respect to cross border payments, the difficulties of time and cost and caliginous of the existing system that people have talked about and done some things about and wanted to do things about for decades and has never happened, and it exists now and can solve the problem. Stablecoins raised a number of very legitimate regulatory issues about the stability of the reserve, the nature of the claim of a coinholder on the reserve, and the stability of the reserve can be affected by whether it's a fractional reserve or not by the denomination of the assets in the reserve relative to the denomination of the coin, if you will, by the maturity structure of the assets like banking.

Randy: All of the things that can make a vehicle or an institution runable apply to stablecoin, but we also have decades, centuries of experience as to how to address those run risks, and I think they're eminently addressable for stablecoins. So the attitude of many jurisdictions in the world has been these structures potentially have risks so we should forbid them.

Randy: My view is given the significant benefit of these instruments, particularly stablecoin, I feel differently about first generation crypto coins like Bitcoin, and Ethereum, and so forth. That's a wholly different thing, but stablecoins, there are significant benefits for them. We should make them available. We should address these risks, which are eminently addressable, and then allow the private sector to move forward.

Randy: Now, the Biden administration has proposed a framework in which stablecoins would have to be issued by a regulated bank. Almost by definition, that would address the run risk. You would issue them out of an institution that is subject to the whole panoply of regulation that has been designed to address run risk. Well, good.

Randy: I don't think it's necessary. However, I think it's a little too restrictive. You could imagine a framework and my preferred framework would be one which would say, "If you issue them out of a bank, then you can issue them the way a bank could, including using a fractional reserve and all the rules that would apply to banking, liquidity, and resilience," but if they're not issued out of a bank, then somewhat similar to the framework that we had developed with some of the stablecoin issues who approached the fed while I was there, they did not end up issuing coins in this framework, but they could have would've been you have to have a non fractional reserve if you're not a bank, you have to have the assets all denominated in one currency so there isn't currency risk that's risking stability there, you have to have them all in extremely short-term government instruments, and the holder for consumer protection purposes has to have a direct claim on the pool of assets that is acting as the stablecoin reserve.

Randy: You create a structure like that and you say, "So you're not a bank. There are some disadvantages to that principally that you can't operate with fractional reserve," but that's a stable structure. It's similar to a money market fund structure, but a government money market fund structure, and while prime money market funds have issues and created financial stability issues both in 2020 and in 2008, government money market funds were not problems in either of those episodes. So I think you could have a framework that allow both of those.

Randy: The most important thing is for the official sector to describe that framework, to put it into place so that innovation can start happening in a safe way. Right now, you've got innovation happening, in many cases, in an unsafe way. You've got stablecoins out there who don't comply with any of those rules and are in quite unstable structures and have both the risk of immediate financial stability consequences, and tainting this asset class, which I think is actually fundamentally quite promising.

Jo Ann: Yeah. I'll mention for our listeners, we did a show recently with Michael Tsu, the acting comptroller of the currency entirely on stablecoins or pretty much entirely. I'll link to that in the show notes as well. Okay. I know we only have a few minutes left. I'll give you your choice. You can do one or both of these questions. I mentioned the question of how the regulators are going to keep up. I'm also really interested in your thoughts on how the banking system will remain competitive going forward.

Jo Ann: Are you worried about small banks in the digital age? How do you see the challenge of the financial regulators in creating an environment that's going to enable innovation? Given that, speaking myself as the former deputy controller of the currency, I never criticized the regulators, but I'm very mindful that these agencies are, as you said so well before, they're not built to move quickly. They're in an environment that's changing so fast. What would be your words of wisdom to the ecosystem on how to just deal with how much this world seems to be changing or so it seems to me?

Randy: So yeah, it's a really difficult question. The regulators, it's far too easy, even when the regulators are trying their hardest and they do try their hardest, but it's far too easy for them to address their responsibilities by inhibiting innovation, by requiring innovation to move at a pace that they can keep up with, if you will, and that leads to a self-reinforcing vicious cycle, if you will, which is, "Okay. Well, we need this to move more slowly so we can keep up with it. Now that it's moving more slowly, we don't have to move quite so fast, and now we're not moving so fast, so it needs to move slower." I mean, that's just the nature of human beings and the different responsibilities that people have, whether they're sitting on the side of the regulators versus the private financial system. So it's really important that that dynamic not develop.

Randy: One of the key things that has to happen, and I know is happening throughout the bank regulatory framework, is that more people have to be hired who understand technology and come from the world of technology. It's not just understanding technology, but it's also understanding the speed at which things are moving, the mindset of people who are coming new to the financial system. There are lots of people now who are engaging with the bank regulators, who have not spent careers in a bank. They've spent careers doing many other things and they arrive and it's just they're coming from entirely different cultures.

Randy: That was one of the big issues with Facebook and Diem, Libra as it was originally. There were a lot of substantive issues, but one of the biggest issues was that the two principles simply did not understand each other, came from entirely different worlds. So you've got to bring more people into the regulatory side from the technology world and not just from the financial world.

Randy: The regulators are trying to do that. It's moving slowly, but the main advice I would have on the regulatory side, I think, is that in this rapidly evolving world, the right mindset is to say, "What are our interests? How do we address our concerns, which are legitimate, in order to say yes?" We need to be trying to find a way to say yes, and address our legitimate concerns as opposed to, "We have concerns, and so we're going to say no," because in the world that we're living in now, a bank regulator saying no is only going to mean, "Well, that's going to move somewhere else and will happen somewhere else and probably in a less safe way."

Randy: So the mindset of the regulators really ought to be, "How do we say yes without giving up at all on addressing our legitimate concerns about this?" I think you're seeing in the stablecoin world, for example, as the regulators try to say yes, they're met on the other side with people who are saying, "If you'll say yes, we'll do that." Lots of stablecoin issues are saying, "You want us to be a bank? We'll be a bank." Circle offered to do that even before the president's working group paper had come out and said, "You want us to be a bank? We'll be a bank. Just give us a framework and we'll do that, but if you tell us no, then we'll find a different way to do it," right? It's not an option that you can just close this down.

Randy: The regulators will be more comfortable doing that the more they can bring in personnel that understand the technology world and that understand technology and that process is at the beginning.

Jo Ann: Well, that is a perfect note to end on. I want to thank you for an extraordinarily thoughtful and thought-provoking conversation. Randy Quarles, thank you so much for being with us today.

Randy: Thanks, Jo Ann. Thanks for having me.