

# **Two Failures from One Decision: Credit Creation Collapse and the CBDC Foreclosure**

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## **Abstract**

The domestic and geopolitical consequences of the U.S. stablecoin legislative framework have been analyzed separately. This paper establishes that they share a single origin and compound each other. The first consequence is mechanical: the 100 percent reserve architecture required by the GENIUS Act transfers dollars from the credit-creating banking system into sterile reserve instruments, contracting the credit available to businesses, households, and communities. Federal Reserve modeling estimates this contraction at between \$65 billion and \$1.26 trillion in lost deposits and lending, with the upper bound occurring if stablecoin issuers gain direct Federal Reserve master account access. The contraction operates alongside the inflationary mechanisms documented in earlier papers in this series, producing stagflationary conditions that the Federal Reserve's tools cannot address without contradicting each other. The second consequence is strategic: the same legislative period that produced GENIUS also prohibited public digital monetary infrastructure through Executive Order 14178 and the Anti-CBDC Surveillance State Act, permanently foreclosing the instrument that would have preserved monetary policy transmission, retained seigniorage as a public function, and provided a sovereign counterpart to the digital currencies that more than 130 countries are currently developing. The private stablecoin architecture the legislation enables competes against sovereign digital currencies in a geopolitical contest in which private financial interest and sovereign commitment are not equivalent factors. The two failures are not independent.

They are the domestic and international dimensions of a single decision: to vest the digital monetary layer in private hands and prohibit public alternatives.

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## The Same Root Cause

The U.S. stablecoin legislative framework, GENIUS and CLARITY, reinforced by Executive Order 14178 and the Anti-CBDC Surveillance State Act, produces two distinct structural failures that are rarely analyzed together. The first is domestic and mechanical: the architecture systematically destroys the credit creation capacity of the banking system while simultaneously generating fiscal inflation, producing stagflationary conditions that no existing policy framework is equipped to address. The second is geopolitical and strategic: the United States has permanently foreclosed its public monetary infrastructure option at the precise moment its principal competitors are building sovereign digital currencies. These are not separate policy mistakes. They are two consequences of a single decision: to vest the digital monetary layer in private hands and prohibit public alternatives.

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## Part I: Credit Creation Collapse

### How Banks Create Money

The banking system does not merely intermediate savings. It creates money. When a bank receives a deposit, it holds a fraction in reserve and lends the remainder. That loan creates a new deposit at another bank, which lends again. Each cycle expands the money supply beyond the original deposit. This fractional reserve credit creation is the mechanism through which the private sector accesses mortgages, business loans, consumer credit, and working capital. It is also the primary channel through which monetary policy reaches the real economy; rate changes affect borrowing costs, which affect investment and consumption.

Stablecoins do not participate in this mechanism. They are 100% reserved instruments. Every dollar backing a stablecoin is held in Federal Reserve reserves or short-duration

Treasury instruments. It is not lent. It does not create new deposits. It does not generate credit. The GENIUS Act explicitly limits permitted reserve investments to a narrow class: T-bills, Fed reserves, qualifying bank deposits, and similar instruments, none of which constitute real economy credit creation. As the Bank Policy Institute noted in its analysis of GENIUS, the law structurally prohibits stablecoins from replicating banks' credit creation function. The reserves underwrite the stablecoin; they do not fund a mortgage.

This creates a direct and quantifiable consequence: every dollar that migrates from a bank deposit into a stablecoin represents a permanent reduction in the banking system's capacity to create credit.

## The Federal Reserve's Own Estimate

A December 2025 Federal Reserve study, "Banks in the Age of Stablecoins" (Wang, 2025), estimated that stablecoin adoption would reduce bank deposits and lending by between \$65 billion and \$1.26 trillion, with the upper bound occurring if stablecoin issuers gain direct access to Fed master accounts. The Treasury Department has estimated \$6.6 trillion in deposits as structurally at risk, a figure cited by the American Bankers Association in its advocacy on GENIUS Act implementation. The ECB, analyzing the same dynamic for the euro area, found statistically significant evidence that increases in stablecoin attention cause measurable declines in retail deposit ratios and contractions in bank lending to firms.

These are not speculative projections. They are modeling outputs from central bank economists using existing adoption trajectories. The Federal Reserve's own research division has documented the credit contraction mechanism. The legislation passed regardless.

## Regional and Community Banks as the First Casualty

The deposit migration dynamic does not affect all banks equally. Large systemically important banks, JPMorgan, Citi, Bank of America, have the scale, technology infrastructure, and regulatory relationships to adapt. Some are already developing proprietary stablecoin or tokenized deposit products. JPMorgan's JPM Coin and Citi Token Services represent institutional pivots to capture rather than lose the stablecoin infrastructure layer.

Regional and community banks have no equivalent adaptation pathway. They depend on local deposit bases to fund local lending; small business loans, agricultural credit, residential mortgages in non-metropolitan markets. Their competitive advantage is relationship banking, not technological infrastructure. When deposits migrate to stablecoins, they cannot follow. The Federal Reserve has specifically flagged that stablecoin adoption would disproportionately impact transaction accounts held by younger, digitally-native customers; precisely the demographic that regional banks most need to retain for long-term deposit stability.

The structural outcome is credit contraction concentrated in the communities where regional and community banks are the primary or sole source of financial intermediation. The markets least served by large institutional banking lose their credit access first.

## The Stagflationary Divergence

Working Papers 1 and 4 established two simultaneous inflationary pressures embedded in the stablecoin architecture: the reward token layer generates purchasing power erosion invisible to CPI, and the captive T-bill buyer loop underwrites unlimited fiscal spending that re-injects dollars through government expenditure. Both mechanisms push prices upward.

Credit creation collapse pushes in the opposite direction on output. Contracting bank lending means fewer mortgages originated, fewer business loans extended, less consumer credit available. Investment falls. Hiring slows. Real economic output contracts. This combination, rising prices alongside falling real credit and output, is the definition of stagflation.

Stagflation is the monetary policy condition that existing tools are least equipped to address. The Fed's response to inflation is rate hikes, which reduce borrowing and slow the economy. The Fed's response to contraction is rate cuts, which stimulate borrowing and expand output. When both conditions are present simultaneously, the two responses contradict each other. The Fed raised rates aggressively in 2022-2023 to address post-pandemic inflation and caused significant stress in the banking system. It could not simultaneously cut rates to address credit contraction without abandoning the inflation fight.

Under the stablecoin architecture, this is not a cyclical risk. It is a structural condition. Fiscal inflation is permanent, built into the T-bill captive buyer loop. Credit contraction is permanent, built into the 100% reserve requirement that prohibits lending. The Fed's tools address one or the other. The architecture produces both, simultaneously, by design.

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## Part II: The CBDC Foreclosure

### What a CBDC Would Have Solved

A central bank digital currency, a direct digital liability of the Federal Reserve held by consumers, would have addressed the core transmission problem described in Working Paper 4. If consumers hold Fed-issued digital dollars, the Fed can pay interest directly to those holders. Rate decisions transmit immediately to consumer behavior. The IOR channel is not severed at the consumer layer because the consumer is the direct counterparty. The credit creation problem would also be mitigated: CBDC does not require private bank intermediation, and design choices about interest rates and holding limits could actively discourage deposit flight from the banking system while preserving public monetary transmission.

A U.S. CBDC would have preserved seigniorage as a public function. It would have required no private issuer to capture the float. It would have carried the full faith and credit of the United States government, with no run risk equivalent to the money market fund dynamics described in Working Paper 1. It would have been the natural public infrastructure layer for digital dollar transmission.

### The Prohibition

On January 23, 2025, President Trump signed Executive Order 14178, prohibiting federal agencies from establishing, issuing, promoting, or taking any action to develop a CBDC within the United States or abroad. The order mandated immediate termination of all ongoing CBDC development initiatives. In July 2025, the House passed the Anti-CBDC Surveillance State Act by 219-210, which would enshrine the prohibition in statute, preventing the Federal Reserve from issuing a CBDC directly to individuals regardless of

future executive branch preferences. Both actions occurred during the same legislative period that produced GENIUS and CLARITY.

The policy architecture is explicit and internally coherent on its own terms: private digital money receives a comprehensive regulatory framework; public digital money is prohibited. The GENIUS Act provides formal pathways for private stablecoin issuance. The Anti-CBDC Act closes the public alternative. The two pieces of legislation are not independent; they are complementary, and their combined effect is to guarantee that the digital monetary layer belongs to private actors permanently.

The stated rationale for the CBDC prohibition, financial stability risk, individual privacy, and U.S. sovereignty, collapses under examination. The same Congress that prohibited a public digital currency on privacy grounds simultaneously authorized a private digital currency architecture in which every consumer transaction is permanently recorded on a public blockchain, accessible to issuers with OFAC compliance obligations, and censorable by private entities without judicial process. The privacy argument applies with greater force to the instrument that was permitted than to the one that was prohibited.

## The Geopolitical Asymmetry

The CBDC prohibition does not occur in a vacuum. More than 130 countries are currently exploring or developing central bank digital currencies. China's digital yuan is operational and in active deployment across domestic and international payment corridors. The European Central Bank is advancing a digital euro through its preparation and realization phases. The Bank of England, Reserve Bank of India, and Bank of Brazil are all in active development.

The standard geopolitical argument for dollar-backed stablecoins is that they extend dollar dominance by providing a digital dollar instrument accessible to populations in weak-currency countries, pre-empting adoption of alternative foreign CBDCs. This argument has surface merit. In the short term, USDC and USDT do provide dollar access to populations with limited banking infrastructure. U.S. Treasury Secretary Scott Bessent has projected the stablecoin market reaching \$3.7 trillion by the end of the decade, framing this growth as a tool of dollar primacy.

The strategic error is the conflation of dollar reach with dollar credibility, and the failure to distinguish between private and sovereign monetary infrastructure in geopolitical competition.

A digital yuan backed by the People's Bank of China is a sovereign instrument with full government commitment, no run risk, and embedded into China's bilateral trade and Belt and Road financial relationships. USDC backed by Circle is a private instrument with shareholder obligations, run risk, OFAC censorship capability, and no formal government guarantee. In the event of a geopolitical stress scenario, whether sanctions conflict, financial warfare, or counterparty dispute, a sovereign digital currency and a private stablecoin operate under entirely different durability assumptions. Sovereign counterparties selecting a digital settlement medium for trade finance are not choosing between equivalent instruments. The United States has sent private stablecoins to a geopolitical competition that its adversaries are entering with sovereign weapons.

The longer-term credibility risk compounds this. As Working Paper 2 established, the stablecoin architecture generates domestic monetary dysfunction; inflation unmanageable, Fed impotent at the consumer layer, seigniorage privatized. A reserve currency derives its global standing from confidence in the issuing country's monetary institutions and credibility. The domestic architecture being built by GENIUS and CLARITY systematically degrades both. The dollar can be extended globally through stablecoin dollarization while simultaneously becoming less credible as a reserve instrument. These are not contradictory outcomes. They are the historical pattern of overextended reserve currencies approaching inflection points.

The CBDC would have preserved the option of sovereign digital monetary infrastructure. The United States did not merely choose not to build one. It prohibited itself from doing so; at the same moment it created the structural problems that a CBDC could have addressed, and at the same moment its competitors moved aggressively to build sovereign digital monetary capacity.

## The Decision and Its Permanence

Executive orders are reversible. Legislation is significantly harder to undo, and the political economy of reversal is adverse: the same lobbying infrastructure that produced the CBDC prohibition, documented in Working Paper 3 as \$119 million in crypto PAC

spending during the 2024 cycle, has a direct financial interest in preventing any future public alternative to private stablecoins. A public digital dollar competes with Circle, Tether, and the institutional stablecoin programs of JPMorgan and Citi. The entities that would lose market share to a CBDC are the same entities that funded the legislation prohibiting one.

The Anti-CBDC Surveillance State Act's statutory prohibition, if passed by the Senate and signed, would require future congressional majorities to reverse; in an environment where the crypto industry has demonstrated it can deploy nine-figure political spending bipartisanly to protect its legislative wins. The foreclosure, once statutory, is not technically permanent. It is, however, practically durable.

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## Conclusion

The two failures described in this paper compound each other in ways that neither analysis alone captures.

The credit contraction caused by deposit migration reduces real economic output. Reduced output against maintained or rising price levels worsens the inflation dynamic. Worsened inflation makes the Fed's rate response more aggressive. More aggressive rate increases stress the banking system further. Further banking system stress accelerates deposit migration to stablecoins perceived as safer. Accelerated migration deepens credit contraction. The loop is self-reinforcing.

Meanwhile, the CBDC that would have provided the Fed with a direct consumer transmission channel, breaking the loop at its source, has been prohibited. The instrument designed to extend dollar reach globally has been handed to private actors whose incentive is seigniorage extraction, not monetary stability. And the competitors building sovereign alternatives are doing so with precisely the public institutional commitment that the United States has legislated away.

The architecture does not produce these outcomes through malice or incompetence on the part of any single actor. It produces them through the compound effect of a political economy in which the private beneficiaries of a specific legislative design had the

resources to ensure its passage, the foresight to prohibit public alternatives, and the influence to frame both as acts of financial innovation and freedom. The United States has not merely chosen a path. It has legislated away its ability to choose otherwise.

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