

China's Digital Currency

What This Could Mean for Foreign Companies



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The rise of the greenback

The first greenback was printed in 1914 with the creation of the Federal Reserve Bank. During World War II, under America's "Lend-Lease" arrangements, President Roosevelt supplied the Allies with munitions and other goods with payment in gold. Already the world's largest economy since 1890, America soon became the largest holder of gold.

Under the 1944 Bretton Woods Agreement, the US rallied other countries to link their currencies to the dollar supported by its Gold Standard. This ended the dominance of the Sterling Area, hastening the demise of the British Empire.

As a result, the US dollar was officially crowned the world's reserve currency, backed by the world's largest gold reserves. Other countries accumulated reserves of US dollars, which they invested in US Treasury bills as a safe store of money.

Later, with rising inflation and a looming gold run, President Nixon abruptly ended the Gold Standard on August 15, 1971. However, as the US held unparalleled sway in the world's economy and financial market, the dollar's reserve currency status remained unchallenged.

Today, more than 61% of all foreign bank reserves and nearly 40% of the world's debt are denominated in US dollars. Even America has squandered its "unipolar moment", as Fareed Zakaria claims in his July/August 2019 *Foreign Affairs* article, the dollar remains supreme.

China's "dollar trap"

As China opened up and became integrated with the world trading and financial systems, it has been caught in a "Dollar Trap", having to convert massive surpluses into secure, internationally convertible US treasuries. Notwithstanding the global financial crisis of 2008-09, dollar hegemony was strengthened, rather than weakened, argued Eswar Prasad,

Chair Professor in International Economics and Senior Fellow at the Brookings Institution.

Over the years, the US has been enjoying the dollar's "exorbitant privilege" of almost unlimited money-printing ("quantitative easing" in central bank parlance). As Richard Nixon's Treasury Secretary John Connally famously said in 1971, "The dollar is our currency, but it's your problem."

Niall Ferguson, the Senior Fellow at the Hoover Institution, pointed out in the *New York Times Magazine* (March 13, 2005), that China and other East Asian economies are paying a kind of "tribute" to America by financing the latter's chronic current account and budget deficits in the form of under-priced exports and low-interest US treasuries. According to Ferguson, even America's "War on Terror" was, in a way, financed with a multibillion-dollar overdraft facility at the People's Bank of China (PBoC), China's central bank.

Over the years, the US has been weaponizing the dollar's ubiquity to impose unilateral "long-armed" sanctions on foreign states and individuals deemed hostile to American interests. In recent months, China is bearing the brunt of such sanctions.

Additionally, the Federal Reserve has been using the dollar's "exorbitant privilege" of opening the spigot through "quantitative easing", a euphemism for massive "money printing". President Obama's huge financial largesse at the last global financial crisis and President Biden's current \$1.9 tn stimulus package come to mind.

The time has come for the renminbi (the Chinese yuan)

China became the world's second-largest economy in 2010. As the world's largest trader and manufacturer, it is deeply woven into the world's supply and value chains. Seven of the world's top ten container ports are in China.

Across the globe, a vast array of products is made in China or requires critical inputs from China in terms of materials, parts, components, or logistics.

Arvind Subramanian, Senior Fellow at the Washington DC-based Peterson Institute for International Economics, pointed out in 2011 that the world is living "in the shadow of China's economic dominance". More currencies were moving in tandem with the renminbi instead of the dollar.

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threatening the dollar's hegemony. Mindful of America's dwindling domestic savings and a gaping current account deficit, Stephen Roach recently warned in the *Financial Times* that the dollar's "exorbitant privilege" is about to end.

China's digital sovereign currency

China is now actively pursuing a digital sovereign currency. Unlike a speculative cryptocurrency, the digital renminbi is a national currency fully backed by the state. It's a natural development as China has become by far the world leader in digital payment systems, accounting for 44% of global volume.

Driven by the latest blockchain technology, China's digital currency doesn't require a bank account, with huge poverty-relief potential for the massive

"unbanked" poor across the globe. With full state control, the digital currency helps to combat illicit financial transactions while its financial data facilitate the formulation and execution of monetary policies.

China's digital sovereign currency is being tried out in a host of localities including Shenzhen, Chengdu, the Xiong'an New Area near Beijing, and various venues for the 2022 Winter Olympics.

As its transactions are instant and transnational, the digital currency would be attractive for international bilateral trade settlements with China, including projects in the "Digital Silk Road" of the Belt and Road Initiative.

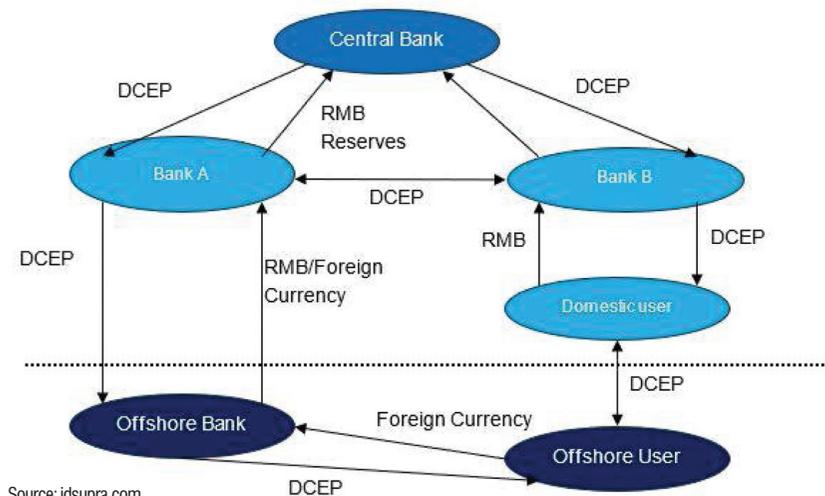
Admittedly, the latter has been facing increasing headwinds from host countries, such as debt unsustainability, ecological neglect, non-transparency, and corruption. But China's authorities are learning fast. Working more closely with international organizations like the World Bank and broader stakeholders in host countries, China is making significant headway with Belt and Road projects,

Cassandras and Covid-19 notwithstanding.

What is more, the digital currency doesn't depend on the US-controlled SWIFT (Society for Worldwide Interbank Financial Telecommunication) banking system. It is thus immune from dollar-based US sanctions. Nevertheless, to help internationalize the Chinese currency, a joint venture has recently been concluded between SWIFT and both the Digital Currency Research Institute and the China National Clearing Centre within the PBoC.

According to a July 2019 McKinsey report, China has become more self-sufficient while the rest of the world, particularly Asian and resource-rich countries across the globe, have grown more dependent on China for intermediary parts, components, materials, trade,

China's Digital Currency and What This Could Mean For Foreign Companies and Financial Institutions in China



Source: jdsupra.com

and investments. This supply-chain connectivity is not easy to shift, anti-China decoupling notwithstanding.

While the US and Western allies are not about to warm to China's digital currency anytime soon, more and more countries in Asia, Africa, and Latin America are likely to embrace the convenience and opportunities of China's digital payment systems, made easier and safer by its sovereign digital currency.

This trend is likely to accelerate with the recently-minted Regional

Comprehensive Economic Partnership (RCEP), comprising a third of the world's population, a third of world GDP, and half of the world's manufacturing.

The developing world, accounting for 49% of world GDP in 2010, is expected to reach 60% by 2030. Its growing integration with China augurs well for widespread acceptance of its sovereign digital currency, speeding up the internationalization of the renminbi.

China's digital sovereign currency would also help drive China's "dual cir-

ulation economy"—accelerating both domestic consumption as well as international trade and investments. The synergistic strategy is formalized in China's new Five Year Plan (2021-25).

With faster post-pandemic recovery, China's economy is now surging ahead, including exports, investments, and domestic consumption. As Alibaba's "Singles Day" e-shopping bonanza successes show, digital payments will continue to transform retail sectors both in China and worldwide.

China's outbound tourism has occupied the world's top spot since 2013. Barring pandemics, it is estimated to be worth \$365 bn by 2025. Even with a trade war, Chinese outbound tourists are expected to make 160 million trips a year. China's e-payment system using the digital sovereign currency is therefore well-timed.

In October 2020 the dollar lost its top position as the world's most used payment currency, falling behind the Euro since August 2013, thanks to perceived dollar value erosion, the emergence of more attractive Euro and renminbi-denominated assets, and aversion to greenback-based sanctions. With hostile American geopolitics, China is likely to park more of its hard-earned savings in other assets, including its bonds and some of the more viable Belt and Road projects. Thanks to a much faster rebound from the pan-

Comparison of Major Digital Currencies				
		Digital Renminbi	Libra	Bitcoin
Type		Central bank digital currency	Stablecoin	Cryptocurrency
Issuer		People's Bank of China	Facebook/Libra Association	Decentralized network
Status		Pilot launched in April 2020	In development	In use since 2009
Primary Usage		Consumer purchases	Consumer purchases	Speculation
Value Determination		Identical to renminbi	Pegged to multiple currencies	Market
Blockchain Used		Limited usage*	Centralized	Decentralized

*The extent to which the digital renminbi will rely on blockchain remains unclear

dem, China's economy is now expected to overtake the US five years earlier, by 2028, according to UK's Centre for Economics and Business Research.

All these developments by no means foretell the dollar's dethronement all at once. No other sovereign currency, let alone the renminbi, can remotely compare with the greenback's global financial width and depth. Even falling by 10% over the past two decades, the dollar still accounts for 62% of global currency reserves.

In a *Newsweek* article of October 29, 2020, Gordon Chang, a veteran China-basher, doubts whether China's Digital Currency Electronic Payment (DCEP or "digital Yuan") would ever cut as long as China's closed capital account renders its currency not fully convertible internationally.

Nevertheless, the rapid development of China's digital sovereign currency and its associated DCEP have raised alarm bells on Capitol Hill. A Council on Foreign Relations report of March 2021 concludes that China's "Digital Silk Road" is likely to cement China's position at the center of a more connected world, encompassing host countries' "telecommunications networks, artificial intelligence capabilities, cloud computing, e-commerce, and mobile payment systems, surveillance technology, and other high-tech areas, along with a Health Silk Road designed to operationalize China's vision of global health governance."

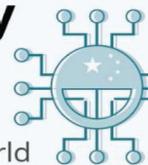
Congress is now expressing interest in the idea of a US digital currency and how a global Chinese digital payment system may circumvent American sanctions. President Biden has also begun to float the idea of a global infrastructural initiative of "allied democracies" to counter the influence of China's Belt and Road Initiative.

Dollar supremacy

Over decades, the US tends to be relying on its "exorbitant privilege" to finance its many commitments or policy directives. As a result, in terms of the real value measured in purchasing power parity, the dollar has lost some 96% of its value since 1913-14.

China First Major Economy to Issue Digital Currency

Central Bank digital currencies launched, under development or considered around the world



Adding to America's propensity to weaponize the dollar for sanctions against foes and friends alike, the trust in the dollar's durability as a safe and secure storage of value is beginning to erode. This is exemplified by a gradual process of sovereign countries wanting to repatriate their gold holdings held in the Federal Reserve's gold vaults. Amongst them are Germany, France, the Netherlands, Belgium, and Austria. China is the world's largest gold producer. The country keeps its gold reserves at home.

Outlook

Given a closed capital account and non-convertibility of its currency globally, China is under no illusion that the renminbi can supplant the dollar anytime soon as the world's most trusted reserve currency and as the currency of choice for capital markets across the globe. Similarly, China harbors no pipedream that its political ideology will be embraced by more than a handful of countries across the globe.

Nevertheless, with the waning of Pax Americana, the world is increasingly torn between fears and denialism, trying to avoid the unavoidable and refusing to accept a looming reality. A

more powerful, globally-connected, and self-confident China sees its time has come to return to the future where a large part of the world had been dominated by China and India, the two oldest Eastern civilizations, for millennia before the 17th century.

In a groundbreaking piece in *Foreign Affairs* of March 23, 2021, Richard Haass and Charles Kupchan acknowledge the heated rivalry between the US and China with their economies inextricably intertwined and both fearful of mutual nuclear destruction. A "New Concert of Powers" is proposed, a flexible balancing mechanism allowing for both competition and cooperation, similar to the Concert of Europe following the Congress of Vienna in 1815, which ushered in a century of relative peace in Europe.

Barring apocalypse, nature moistens everything on the quiet as the Chinese saying goes. Gradually, over time, China's digital sovereign currency could mitigate the dollar trap, accelerate the internationalization of the Renminbi and open an escape route from America's dollar-based sanctions. ■

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