Rise of sovereign digital currencies: domestic and global implications

Interest by central banks in issuing such currencies has partly been in response to greater competition from private cryptocurrencies, by Ramnissen’s Raam and Ruuie Cheng

The launch of a central bank digital currency (CBDC) in China has been much anticipated especially following the first public test of a prototype in four Chinese cities (Shenzhen, Suzhou, Xiong’an New District and Chengdu), as well as the recent release of the Draft Law of the People’s Bank of China (PBC) on October 23, 2020 giving the currency legal status.

While the Chinese CBDC (which is formally referred to as Digital Currency/Electronic Payment or DCEP) will be unrecognisable in terms of its sheer size and possible impact, a handful of smaller countries including the Bahamas (‘Sand Dollar’), the Marshall Islands (‘SOV’), Cambodia (‘Bakong’), Sweden (‘E-Krona’), Ukraine (‘Uahcoin’), Uruguay (‘e-Peso’) among others have also already moved forward to introduce their own CBDCs.

According to a survey of 66 central banks by the Bank for International Settlements (BIS) conducted in January this year, there has been an explosion in global interest in CBDCs. About 80 per cent of central banks around the world are involved in researching the impact of CBDCs, with many already having undertaken proof-of-concept of some form by testing the feasibility of introducing CBDCs.

At a global level, former governor of the Bank of England Mark Carney proposed the creation of a global digital currency (‘Single Holographic Currency’) in 2019 as a means of moving away from a US dollar-centric monetary and financial system.

**WHY THE GROWING INTEREST IN CBDC?**

Broadly, a CBDC refers to digital currency issued by the central bank that is usually accepted as fiat currency for general purpose use. There are multiple reasons for the growing global interest in CBDCs.

Interest by central banks in issuing CBDCs has partly been in response to greater competition from private cryptocurrencies. The initial announcement of Facebook’s Libra and its potential far-reaching monetary and financial impact (given its ability to reach its well over two billion users) in particular seems to have created a greater sense of urgency among central banks giving the possibility of currency substitution away from fiat currencies.

CBDCs will also hasten the transition towards a cash-free society with Covid-19 giving a significant boost to digital payments and further reducing the demand for cash-based transactions. CBDCs are expected to improve efficiency of payment systems given that the costs of payment processing of cash can be relatively high.

In cases where the private sector has come to dominate the payments systems in countries like China where around 90 per cent of mobile payments are handled by just two providers (Ant Group’s Alipay and Tencent’s WeChat Pay), there may be concerns about systemic risks for payments in the event of a disruption to any one of these two platforms. In such a case, the motivation for a CBDC would be to strengthen and build the central bank electronic payments system as a means of mitigating the dominance of few large private players in the payments network. In addition, CBDCs could reduce opacity of cash transactions while alleviating risks of tax evasion, illicit payments and money laundering.

In terms of stabilising the economy, CBDCs can potentially enhance the effectiveness of monetary policy and strengthen pass-through of policy changes to other interest rates. An interest-bearing CBDC could also help overcome the ‘zero lower bound’ on policy rates to the extent that the central bank is able to charge negative nominal interest rates to boost spending. CBDCs could also make fiscal stimulus more effective by allowing for better targeting of any government transfers to households and firms in an economic downturn.

**CONCERNS ABOUT CBDCS**

Notwithstanding the global central bank interest in retail CBDCs, there are valid concerns that its introduction could lead to a diminished role of commercial banks and the existing private payment systems. The Chinese CBDC model suggests a way forward by creating a two-tier system whereby the central bank issues the digital currency (in parallel with notes and coins) but is distributed to the public by payments companies and commercial banks via mobile wallets.

While the introduction of CBDC could promote financial stability and reduce the role of systemically important banks (SIBs), there is a genuine risk that the introduction of retail CBDC could lead to a run on banks during periods of stress as households convert bank deposits into CBDCs. This in turn could lead to a contraction of bank funding and current overall liquidity.

Apart from this, there are also very valid concerns regarding data privacy and data protection when managing the transactions data (though the data per se could significantly assist in policy making). These concerns have weighed heavily on many central banks and have precluded a more rapid introduction of CBDCs worldwide.

**CHINA’S DECP AND THE INTERNATIONAL MONETARY SYSTEM**

While China’s CBDC appears to focus on domestic transactions, there have been suggestions that it could also facilitate the internationalisation of the RMB, a policy that the Chinese government has been promoting over the last decade with modest results to date.

Could the DCEP make a dent in the global dominance of the US dollar, which still constitutes more than 60 per cent of global foreign exchange reserves and global debt issuances, 40 per cent of global settlements and trade invoicing and the majority of global foreign exchange turnover?

While China’s Digital Currency/ Electronic Payment appears to focus on domestic transactions, there have been suggestions it could also facilitate the internationalisation of the RMB. PHOTO: REUTERS

The US dollar’s hegemonic global role is often attributed to the country’s dominance in the global economy and the country’s large and diverse economy, and is important to keep in mind though that the US dollar’s dominance is not solely due to economics but also due to US leadership in global affairs, the quality of its institutions and adherence to rule of law. As some of these strengths appear to have eroded over the last few years, as has the role of the US on the global economic and geopolitical stage, there is clearly much greater appetite than before for a credible alternative to the US dollar.

While there is a clear push factor away from the US dollar, the DCEP on its own will unlikely promote internationalisation of the RMB (currently stuck at around 2 per cent of global reserves and international payment settlements) unless capital controls are relaxed. Even then it will take a huge leap of faith for global businesses to be willing to trust the Chinese authorities with all the transaction information that can be accessed. On its part, the PBC will need to be able to guarantee a degree of anonymity for CBDC transactions while balancing this with anti-money laundering (AML) and counter-terrorism (CFT) requirements.

The most practical way forward would be to encourage developing countries with strong trade and investment ties with China, especially those participating in the Belt and Road Initiative (BRI), to use the DCEP to invoice transactions with China as a means of promoting the international use of the RMB. Over time the DCEP could help establish a parallel network to the Brazil-based SWIFT system in which the US dollar reigns supreme and the US government has chosen to use as a geopolitical weapon from time to time. If not for the coronavirus, 2020 might have been known as the year of the coming-of-age of CBDCs. Once the Chinese DCEP is eventually launched, it will no doubt add further to global interest in CBDCs. If the DCEP takes on a more international role, it is unlikely anytime soon to dethrone the US dollar’s hegemony. However, it would not be surprising if other major economies such as Japan, Eurozone and the UK follow suit with their own CBDCs, failing which the global market shares of their respective currencies might be further compromised.

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