



The People's Bank of China has already launched the pilot of the digital yuan as it moves to disengage its foreign trade from dependence on the US dollar.
PHOTO: REUTERS

Can a CBDC become a global currency?

Implementation would be challenging, as there must be a political will among central banks and global commercial banks to reach a consensus. **BY GORDON CLARKE AND EMIR HRNJIC**

WHILE the overwhelming majority of central banks in the world are actively exploring a Central Bank Digital Currency (CBDC), the People's Bank of China (PBOC) has already launched the pilot of the digital yuan.

The PBOC has also been following an expansionist policy for several years regarding use of its currency for settling international transactions with around 30 offshore clearing centres around the world, as China moves to disengage its foreign trade from dependence on the US dollar.

According to the latest SWIFT data from 2020, most SWIFT transactions are settled in euro (37.8 per cent) or the US dollar (37.6 per cent), while the RMB (the exchangeable version of the yuan) was only used in 1.7 per cent of transactions.

While it seems like a long shot that RMB could replace the US dollar or euro as a leading global currency in the near future, it is an open question whether digital yuan (or any CBDC) could bring benefits to global trade.

WEAKNESSES OF GLOBAL CURRENCIES

Regardless of the industry or the nature of goods and services, there are numerous weaknesses in the current system of global currencies in cross-border trade.

When a country's currency is used as an international trading currency, it has to be "out there". In general, this implies that the country is buying more from the rest of the world than it is selling, while the balance is held and used by other nations for their cross-border transactions. This creates a fiscal deficit, which may create a problem for heavily indebted countries.

Global use of a physical currency creates a huge temptation for forgers, especially for the US dollar which has not traditionally been well designed to resist forgery. Hence, some series of US dollar notes are rarely accepted abroad.

Moreover, it creates artificial shortages of physical currency, especially for poorer countries.

In the Maldives, for instance, physical dollar shortages are common because visitors draw local currency in cash from ATMs and then exchange excess amounts for hard currencies when leaving the country. Since local companies often deposit the hard currency in overseas banks, this leaves the local banking system short of hard currency for international trade.

Finally, de-risking by major international banks makes it increasingly difficult for domestic banks in small countries to acquire and maintain correspondent banking relationships

for major currencies like the US dollar, which are essential in the current system of trade settlement. More accessible alternatives would aid development.

CBDC TO THE RESCUE?

While blockchain-based cryptocurrencies like bitcoin have excessive volatility and dubious reputation, the blockchain technology is undoubtedly innovative and potentially greatly beneficial in circumstances where sensitive information needs to be efficiently and securely shared among large numbers of users such as in cross-border payments.

Crypto company Ripple, for example, has already built up a network of 300 major banks across more than 50 countries conducting blockchain-based cross-border transactions.

So, what would have to happen for one or more CBDCs to become an acceptable medium for settling international trade transactions?

Just like fiat currencies, CBDCs have a central bank's backing. They will be exchanged in FX markets, and via on-line exchanges such as Coinbase, and they can enable settlements between individuals and businesses. They can be more secure, less volatile and more energy efficient than private cryptocurrencies.

Additionally, they can streamline trading via smart contracts whereby both information and payment travel together under the control of programmable governance rules.

If two parties to a transaction wish to use, say, the digital yuan as the medium for settling their transaction, the only constraints are whether the buyer has access to the currency and whether there's a mechanism for adding the transaction to the digital RMB blockchain.

That's where the constraints may arise because a CBDC blockchain is controlled by the central bank and hence the central bank has to provide access to the mechanism that adds the transaction, either directly or via the domestic banking system. If parties are in different countries, this will depend on the policies of central banks.

ALTERNATIVE TO SWIFT?

The cost of international funds transfers is another important factor. Using SWIFT for payments is increasingly efficient, but still expensive. Since SWIFT only provides the messaging, transfers require correspondent banking relationships to manage settlements. Ripple, for example, does not require correspondent banks, as its members settle in the Ripple XRP token and pay out in their own domestic currency.

Once CBDCs are available as an alternative to SWIFT, however, we can expect major changes,

even if SWIFT retains a messaging role. Since CBDCs settle directly without a third party, they would enable faster transactions across the world at low cost, thus facilitating trade. Small trading nations would be at less of a disadvantage as the global trade playing field could be levelled a little.

So, the main requirements for global trading currencies can be met by blockchain-based CBDCs at lower cost, with quicker execution and less risk.

Cryptocurrencies of major trading nations could be trusted as they are transparent and exchangeable at a known stable rate that can be negotiated in advance. Moreover, trading via cryptocurrencies addresses the weaknesses discussed above.

It could remove the requirement for settlement using correspondent bank accounts. This in turn removes some fiscal risks of a reserve currency nation as the issue of the global cryptocurrency can be controlled without requiring an adverse trade balance.

Furthermore, appropriate blockchain technology can virtually eliminate the risk of forgery and various types of fraud.

Issue can be managed instantly by any central or commercial bank that needs it, so that small country physical shortages would no longer be a problem.

Finally, an arrangement between powerful CBDC issuers, perhaps via the Bank for International Settlements (the central banks' policy forum), could avoid dominance of any one currency, while a standard basket of currencies could be used for global trade. This would avoid control by a single nation and facilitate open markets.

A CBDC based on the Singapore dollar, which already represents a basket of major global currencies, might be a good place to start.

Regardless of numerous benefits, actual implementation would be more challenging, as there would have to be a political will among central banks and global commercial banks to reach a consensus. Rules which reduce the dominance of big players would give everyone a fairer chance, but at the moment, the big guys have too much power and prefer a skewed playing field.

■ Gordon Clarke is managing director of Monetics, a Singapore-based payments consulting firm. Emir Hrnjic is head of fintech training at Asian Institute of Digital Finance (AIDF) at National University of Singapore (NUS). The opinions expressed are the writers' and do not represent the views and opinions of AIDF or NUS.