Global Counsel

Digital Yuan's Currency Statecraft

Blog post by Summer Analyst Genevieve Ding, 17 August 2021

China, the pioneer of paper money, is poised to shape the future of finance once more with the People's Bank of China's (PBOC) accelerated push to launch the world's first major central bank digital currency (CBDC). A CBDC is a digital tender of a country's fiat currency that typically utilises permissioned blockchain networks to privilege network access and activities to the central bank. This allows governments to leverage upon the rise of digital transactions and the technological backbone behind cryptocurrency to enhance payment systems and support monetary policy.

In 2021, 60% of central banks are experimenting with CDBCs, while 14% were deploying pilot CBDC projects, according to a Bank for International Settlements survey. China's digital yuan (officially coined the Digital Currency Electronic Payment, or DCEP) project is one such experiment. DCEP is one of the most advanced CBDC initiatives globally, having supported more than 4m transactions with a total value of $229m and over $23m in circulation in 11 pilot areas throughout the country.

Besides piloting consumer-facing retail CBDCs in large cities and across borders in Hong Kong, the PBOC is broadening integration to business-to-business wholesale CBDC transactions, and plans to introduce DCEP to foreign visitors during the 2022 Beijing Winter Olympics. While domestic uptake for the DCEP remains slow, this can be scaled should Beijing decide to enforce policies to mainstream the DCEP, for instance, by mandating salary, tax and related payments in DCEP.

The strategic imperatives of DCEP are twofold. Domestically, the PBOC seeks to promote economic dynamism moderated by state control. In the international sphere, the PBOC seeks to position itself as a standard setter. The international aim is more aspirational, driven by Beijing's sense that CBDCs could be the next frontier of geopolitical technology competition. A more immediate aim is the reorientation of China's economy in a dual circulation model as detailed in its 14th Five-Year plan, which focuses on looking inward towards its domestic market and indigenous innovations to fuel growth and invite foreign investments. One interpretation of this is that the DCEP is Beijing's attempt at bringing critically important financial infrastructures more directly under the central bank's control, complementing recent regulatory sanctions taken against some of China's most dominant mobile payments companies such as Alipay and WeChat Pay.

Technically, DCEP is an early-stage central bank monetary technology optimised for surveillance. Its technical architecture is designed as a data processing network to enhance oversights in the financial system by ensuring visibility and traceability of transactions. This allows Beijing to enforce wider surveillance scrutiny over big tech's business activities, breaking down the data silos and associated market power of incumbent fintech firms. More importantly, as a digital ledger that records all transactions in the economy, DCEP offers better data for the PBOC in the crafting of monetary policy.

Abroad, China also sees potential in DCEP's ability to seamlessly link domestic and overseas capital markets without foreign interference. The PBOC already has plans to use the DCEP as a carrier to pilot cross-border regulatory sandbox programmes testing capital account convertibility between Shenzhen and Hong Kong. As a major offshore yuan centre and global financial hub, Hong Kong could support the inbound flows of overseas yuan and provide foreign entities with a streamlined channel for investment and financing through DCEP without dismantling Beijing's broader capital controls or risking financial stability to uncontrolled capital flows.

Moreover, as a cross-border payment system, DCEP plays a critical role in China's ambition to internationalise the yuan through standard setting. The PBOC has partnered with the central banks of Thailand, United Arab Emirates, and Hong Kong on a multilateral CBDC project to develop a proof-of-concept prototype to facilitate real time cross-border foreign exchange payments on distributed ledger technology. This first step marks China's international standard setting around the interoperability of CBDCs across currencies and jurisdictions, which could heighten the perceived value of DCEP as an alternative currency and parallel system to the US dollar's eminence in the Western-dominated SWIFT international payments system.

The geopolitical implication of China's DCEP are not lost on world leaders, who raised alarm at the 2021 G7 Summit on the possibility of a Beijing-led economic zone that could bypass Western sanctions. The Regional Comprehensive Economic Partnership (RCEP) and the Belt and Road Initiative (BRI) have enabled China to carve a viable economic space to the exclusion of the US and the EU. DCEP's interoperability between RCEP and BRI partners could encourage its uptake in these economies and further empower China to leverage its trading, investment, and financing capabilities to compete for political influence against the US and its allies in the region and beyond.

Domestically, DCEP's impact on banks and third-party payments systems will depend on its adoption rate and interoperability. Given the ubiquity of AliPay and WeChat Pay, it is integral for DCEP to be compatible with their wallets for widespread adoption. While it is still uncertain if and how these two payment platforms will integrate DCEP into their payment systems, patent applications on digital currency delivery filed by Ant Group and Tencent in 2020 indicate that they have been scoping out business strategies in the distribution of DCEP.

As DCEP gains in liquidity, it could domestically transform the competitive structure of China's mobile payment market and the revenue structure of payment service providers over the longer term. Internationally, it also has the potential to evolve into a currency of choice adopted by a bloc of countries held together by regional trade agreements. These are, for now, bold ambitions riddled with structural hurdles such as capital controls but should not be ignored by observers interested in this pillar of China's economic development strategy.