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China's Central Bank Digital Currency: What It Means for ASEAN

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SYNOPSIS

The People's Bank of China (PBOC) is at an advanced stage of conducting pilot studies with its digital currency. What will a digital yuan entail domestically for China, and what concerns and opportunities could it create for ASEAN?

COMMENTARY

THE COVID-19 pandemic has accelerated the speed at which the definition of money is being transformed by private digital currencies. Beyond the domain of central banks, a new cohort of private-sector agents, including social media companies (Facebook), e-commerce firms (Alibaba, Tencent), and peer-to-peer networks issuing cryptocurrencies (Bitcoin and Ethereum) are actively engaged in creating digital currencies. The pandemic resulted in a rapid shift from cash to online shopping and payments using digital currencies that have grown enormously in volume and diversity.

Such digital currencies raised concerns about government-issued currency being challenged by private digital currencies. For example, Libra – offered by Facebook which has a client base of over 2.7 billion users – could eventually pose serious threats to central banks' monetary management. The growing risk of cyber attacks disrupting the payment systems, and overseas digital currencies potentially displacing domestic currencies, have all underpinned the urgency for countries to evaluate the feasibility of issuing digital currencies through their central banks (CBDC).

The PBOC's CBDC

The Chinese government and the People's Bank of China (PBOC) consider internationalising the yuan an important objective as China grows stronger economically. In April 2020, the PBOC became one of the first major central banks to conduct a trial run of its Digital Currency/Electronic Payment (DCEP) in four Chinese cities, with plans to expand the tests to major metropolises.

The project was fast-tracked in response to the COVID-19 pandemic. Unlike many other CBDCs under consideration, whose use will be confined to wholesale transactions between financial institutions and the central bank, the DCEP will be a retail digital currency issued through banks and payment service providers to individual digital wallets approved by the PBOC. It will allow users to transact online or offline without bank accounts.

Structured as a replacement for cash, the DCEP is a centralised, government-issued, universally accessible digital fiat currency, the converse of a Bitcoin. The DCEP is structured to meet several strategic economic and political goals of the Chinese government. It is programmable, and consequently transactions can be completely monitored and recorded in government ledgers.

The PBOC may be also concerned about the overwhelming dominance of the two major private sector players, AliPay and WeChat Pay that handle 93 per cent of mobile payments in China. A failure of their networks could result in serious instability, jeopardising the health of the financial system.

DCEP and ASEAN

As China gains economic strength, the PBOC will aim to internationalise the yuan to reduce the dominance of the US dollar as reserve currency. Since 2016, when the IMF included the yuan in its special drawing rights (SDR) basket as an official reserve currency, the yuan has achieved some, albeit, limited progress in gaining acceptance. By the end of June 2020, two per cent of total reserves were denominated in the yuan, compared to 62 per cent in the US dollar.

Deeply connected with China's economy through trade, investment, travel and people-to-people links, ASEAN may be the first region to drive international usage of the e-yuan. By mid-2020 ASEAN had become China's biggest trading partner. Can China use its deepening economic engagement and growing clout to pressure Southeast Asian entities to use the yuan for transactions in trade?

China's sheer weight in international trade will encourage the use of the DCEP by overseas businesses and countries. While most ASEAN trade with China is denominated in US dollar, the role of the yuan in the region and beyond is increasing.

China can deploy numerous levers to expand the use of the e-yuan, including through the Belt and Road Initiative (BRI) which invests in more than 68 countries, and by encouraging yuan-denominated lending at the Asian Infrastructure Investment Bank (AIIB). The PBOC is pushing for a shift from the West-dominated SWIFT system to China's own Cross-Border Interbank Payments-System (CIPS) for settlements.

A digital yuan will allow China to bypass sanctions, enabling users to avoid the scrutiny of the SWIFT system that monitors cash flows on behalf of Western law enforcement and international agencies. Oil exports from Russia, Iran, and Venezuela can be paid in the DCEP, thus circumventing US sanctions.

Four Constraints on Yuan Internationalisation

However, four factors can constrain the internationalisation of the yuan:

• The yuan's acceptance as a reserve currency will depend on trust and confidence placed on the currency. Trust is shaped by the currency's stability and track record over time, especially during periods of turbulence. So far, during periods of stress, the Chinese government has tended to revert to an interventionist mode with capital and currency controls, which will dissuade transactions or reserve holdings in the yuan.

• Prospects for internationalisation will be shaped by the liquidity and depth of China's financial and capital markets, and the availability of financial instruments to hedge against currency and other risks. On these counts, although financial markets are growing rapidly in China, the yuan is not just behind the US dollar, but some other hard currencies as well. Global players in ASEAN, be they multinationals, international portfolio investors, or banks, expect to operate in a multi-currency environment with easy access to liquid, global currencies.

• Prospects for the yuan will be brighter when there is stability and economic growth. However, enduring geopolitical concerns including anxiety about China's aggressive postures in the South China Sea, and other strained bilateral relationships; the tensions with Taiwan, and the US-China trade war, will deter investors from considering yuan.

• The programmable nature of DCEP and complete loss of privacy, coupled with the ability of the PBOC to monitor and control the end use of money may be a deterrent for market participants considering the DCEP.

ASEAN's Options

To maintain autonomy in its choice of currency for international trade and finance, ASEAN needs to scale up collaboration among its members. The ASEAN Digital Integration Framework (ASEAN DIF), integral to the ASEAN Economic Community 2025 blueprint could provide a platform for enhanced discussions on initiatives for safeguarding financial stability.

To address the challenges arising from DCEP, ASEAN finance ministers and central banks could consider establishing a region-wide platform encompassing common global standards and protocols that will enable ASEAN to interface with digital currencies developed elsewhere in the world, including the DCEP.

Since ASEAN trades actively with other economic powers including the European Union, the United States, Japan, and South Korea, the need for competitiveness and autonomy would suggest that ASEAN maintain flexibility in its choice of currency usage. Most large businesses are diversified across several regions. They will have a strong preference for hard currencies and the lower risk and fungibility they offer in global markets.

In the long-term, when the DCEP has acquired a track record and gained public confidence, it will undoubtedly gain traction in global trade and finance. In the interim, the US dollar will remain dominant in international transactions. Ultimately, the risk associated with holding the yuan as opposed to the US dollar will shape decisions.

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