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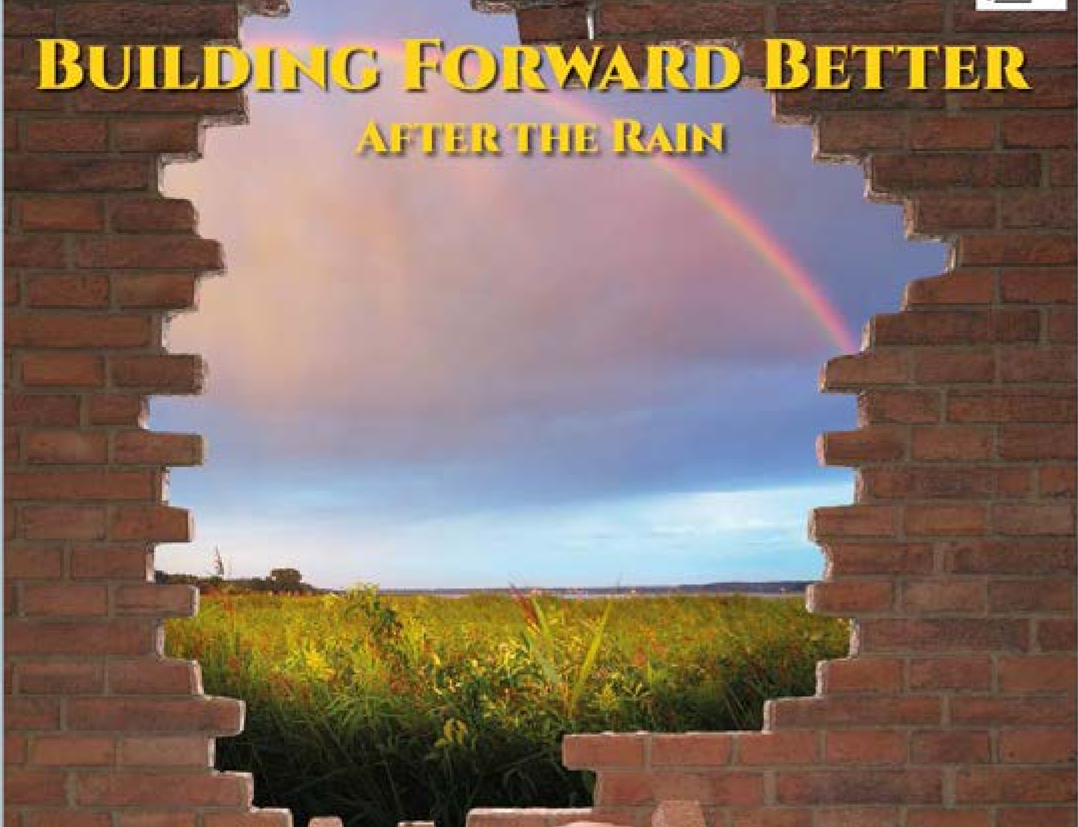

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CHINA AND DIGITAL PAYMENTS

SO WHAT IF CHINA IS INNOVATING?

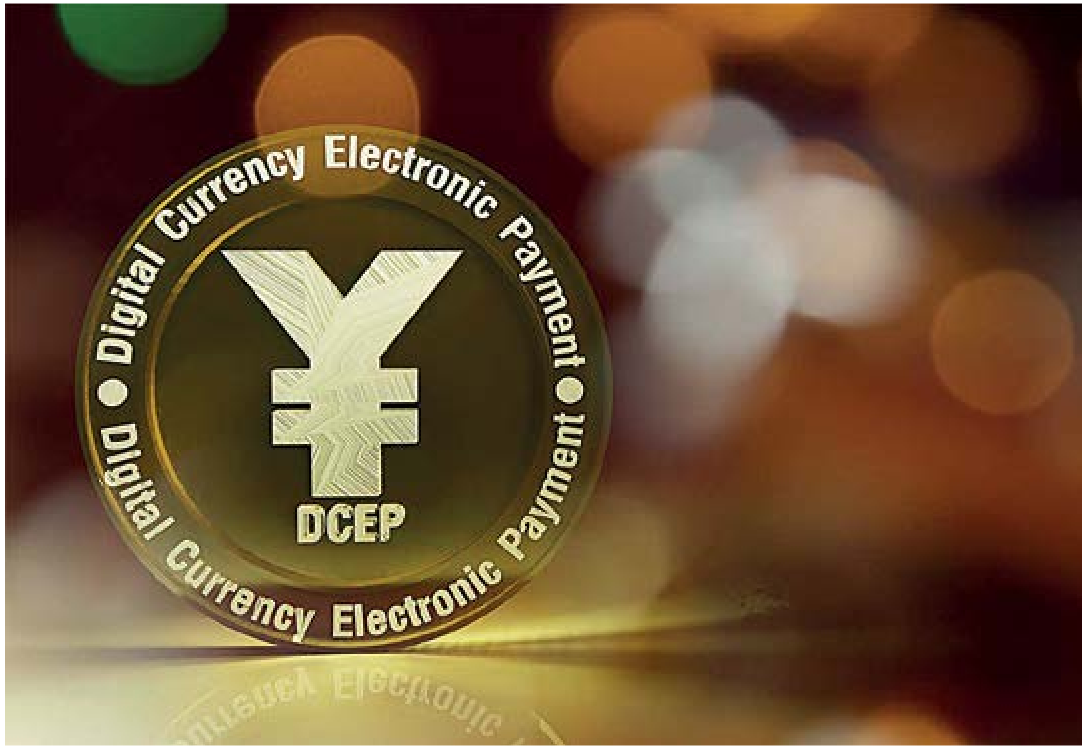
Michael Greenwald

THE convergence of a shifting international power balance and the digitalization of the world economy will have tremendous implications for two of the world's great powers—China and the United States—as they grapple with evolving, modernized systems. With its "Digital Currency Electronic Payment" (DCEP) program in its early trial stages and growing presence on every continent through its Belt and Road Initiative (BRI) and Digital Silk Road Initiatives (DSR), China has showed significant interest in taking over as a world leader in the coming years. The rolling impact of new technologies that revolutionize the global economy from automated supply chains to digital currency lead us to believe that the United States has a lot of work to do to adapt to the coming tide.

Though many stand on both sides of the aisle when it comes to determining the potential for a Chinese rise to international prominence, it is certainly difficult to argue the opposite point—that they are *not* relevant as a global power in today's world. China has laid substantial infrastructure across the globe in physical form (aiding the development of emerging economies and interconnecting global trade systems) and in social and political forms (developing long term relationships with global leaders and giving aid on the occasion of world crises). However, those who take the stance of China as a rising global power hypothesize various timeframes for when its true challenge to American prominence will occur.

Though some argue for a rapid change in global influence and a call to arms from the American side, it is incredibly hard to imagine some significant change occurring on the scale of less than five years. China has played the long game in its development, showing patience in seeking global partnerships, negotiating trade, building military presence, and developing technical prowess to become a modernized economy—why would that change now? In reality, China is in no rush to push the United States out of its global spotlight, even though it certainly seems to have high aspirations.

Michael Greenwald *is a Director at Tiedemann Advisors, a private investment management firm. He formerly held senior roles in the U.S. Department of the Treasury, served as Deputy Executive Director of The Trilateral Commission, and was a Visiting Fellow at the Harvard Kennedy School's Belfer Center and a Senior Nonresident Fellow at the Atlantic Council's Geonomics Center. You may follow him on Twitter @greenwald00.*



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INFRASTRUCTURE, INFLUENCE, AND FINANCE

There have been numerous monographs written on the various ways in which China has grown its influence in the world. However, it is critical to keep one thing in mind that determines all behaviors of an economic-focused entity: money.

The financial system based around the United States that helped it rise to dominance after World War II has been envied by the world's other aspiring powers. It is fairly easy to see that the international system, incentivized by strong international trade and exchange of currencies, has been of tremendous benefit to the United States. As this system has gone through various ebbs and flows, it has shown some of its volatility, which numerous countries from Russia to China to Iran blame on its U.S.-centricity. This has led the call for a global financial system that no longer relies so heavily on the U.S. dollar as its preferred currency for foreign exchange reserves or cross border trade. America has gained much of its economic prowess and international trust from its long standing as the world's global partner in these everyday financial processes. However, a long-term shifting of the preferred international currency could erode this strength over time.

The importance of being relevant in the modern global economy as an economic power cannot be overstated. As China builds out its physical infrastructure across the world, it is keeping an even gaze on the push for a less centralized global financial system. With the development of its DCEP program, Beijing is showing its ability to adapt to rapidly occurring changes in technology, as well as a desire to lead.

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With these things in mind, it is important to focus our approach to the "China problem" on how it can influence the financial system across international groups of which it is a member. While Beijing can certainly affect the way exchange occurs in its bilateral partnerships, its true long-term goals will only be achieved through a large scale changing of the international preference for the U.S. dollar.

As noted by former U.S. Treasury Senior Official Brian O'Toole, "for the digital yuan to truly compete, China needs to take a more hands off approach with its banking sector, especially with regard to foreign banks working in China, and loosen its capital controls. The attraction of the U.S. dollar is how simple it is to use and how deep the market is. That isn't true in China and Beijing doesn't get there without those big money supply questions being answered." This point is echoed by Atlantic Council Geoeconomics Center Senior Fellow JP Schnapper-Casteras, who said that "on the European front, one question is when major retailers or consumer chains start accepting DCEP—either through AliPay / WeChat or through another app or bonus/trial program." He explained that these factors should also be in consideration with whether DCEP is bought, sold, or promoted on exchanges where other stablecoins are listed.

There are certainly roadblocks ahead for the internationalization of the digital yuan, however they are by no means insurmountable over time.

SIX AREAS TO WATCH

Slowly but surely, China is making inroads in its push for a more decentralized global financial system, an important element of which is Beijing's introduction of its DCEP program. There are six geoeconomic areas to watch in determining Chinese success in internationalizing its digital yuan. Each will be addressed in turn.

First, *the rise in the Chinese use of the digital yuan*. Tens of millions of people in China are currently using the digital yuan thanks in part to initial giveaways by the People's Bank of China. The Director of the Atlantic Council's Geoeconomics Center, Josh Lipsky, sees a rapid upscaling in the use of the digital yuan, and attributes it to China's push to "reach over 1 billion digital yuan in circulation within 10 months, for the opening ceremonies of the Beijing Winter Olympics."

With the development of its DCEP program, Beijing is showing its ability to adapt to rapidly occurring changes in technology, as well as a desire to lead.

As of late April 2021, Beijing had injected $23 million worth of digital yuan (150 million RMB) into the Chinese economy. This gradual introduction of the digital currency is accompanied by its new acceptance as a form of payment by well-known retailers like JD.com. This retail giant has already begun using the digital yuan for things like B2C payments on its website, B2B payments to partner firms, cross-bank settlements, and payroll distribution. It is critical to watch how this number grows over the next year leading up to the Winter Olympics, and what other strategic pilot or partnerships programs are developed for its use.

Second, *BRI digital yuan payments*. As China further develops its BRI, we can anticipate that it could begin to call for cross border exchanges and debt payments to occur by way of its DCEP system. To quote Lipsky again: "longer term, the true test of internationalizing is whether the yuan is used to settle bilateral debt between China and borrower countries. Serious progress in this project will be if the People's Bank of China continues to make arrangements with other central banks for digital currency exchange." With the ease of all BRI partners being on the same platform and utilizing the same currency, this shift could feel very natural and be to the benefit of those countries wishing to avoid the U.S. dollar. For reference to the expanding relevance of these relationships, one should keep in mind that around 140 countries have already signed memoranda of understanding with China in the context of the Belt and Road Initiative.

The thought is that if China can convince current trade partners and emerging market economies to utilize its digital yuan, Beijing can reduce the number of transactions that occur in U.S. dollars. According to one recent account, through DCEP China can "harness the market share and technological innovation of private financial firms" and "gain better access to information about the financial activities of [...] consumers." Over time, this technology may facilitate the escalation of China in the global financial regime. If other countries sign on to China's first mover innovation, we will also see the "Communist Party of China exercise greater control over private transactions, as well as wield punitive power over Chinese citizens in tandem with the social credit system." Although this will not be the sole factor in determining the future of a U.S.-led global economy, it highlights China's anticipatory focus on the future and the actions already being taken to dismantle the current system. According to an April 2021 analysis by the Geoeconomics Center at the Atlantic Council, "China has (already) begun cross-border testing a bank-to-bank version of the digital yuan with the UAE, Thailand, and Hong Kong."

The thought is that if China can convince current trade partners and emerging market economies to utilize its digital yuan, Beijing can reduce the number of transactions that occur in U.S. dollars.

Three, *OPEC turning to the digital yuan*. As it gains increasing influence in trade groups such as OPEC through its partnerships with Iran and Venezuela (among others), we could see China's oil imports start to be purchased utilizing the digital yuan. In 2021, we see a direct linkage between oil prices and the value of the U.S. dollar. Researchers at Mansfield Energy write that massive inflation could be the result of a move away from the U.S. dollar in foreign currency reserves, which would ultimately force the United States to cut government spending and finally get a grip on the ever-growing trade deficit.

Though America has long had the privilege of spending and borrowing without the fear of default, the long-term implications of a shift away from the use of the U.S. dollar in the oil market would play a central role in the reconsideration of domestic economic decisions. The use of a digital yuan in a traditionally U.S. dollar-denominated commodity market would bypass the need for an intermediary, which also has significant impacts on the U.S. sanctions program. Since the U.S. has frequently turned to financial sanctions as a way to reign in the behavior of adversaries China, Iran, and Russia, this is a particularly attractive concept for adversaries of the United States. This analysis is buttressed by the fact that China and Iran just signed a 25-year comprehensive cooperation agreement that details an extended promise of oil for infrastructure development. With this type of agreement in place between two American adversaries, the development of the digital yuan looks particularly threatening.

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Four, *Europe turning to the digital yuan*. As China speeds up its digital yuan development program and begins to see success at a domestic level, the EU may call on it for help in developing their own programs. Since BRI is designed to be extended all the way into the European Union, this idea does not seem so far off. In a modernized world, interconnected technical systems for trade and finance will be deemed critical to development. As we have seen in different areas of the globe from southeast Asia to Africa, emerging economies view the importance of infrastructure development as essential to their success as a country—so essential in fact, that they are willing to open their doors to immediate Chinese investment and a potential future default on their debts which has occurred in Sri Lanka, Zambia, Laos, and Tajikistan (to name a few).

While EU member states are also looking for other partners to expand the EU's own economic markets and infrastructure, there are not many formidable trade partners that offer as comprehensive a development plan as China. The United States has certainly been a long-time economic partner of the United Kingdom and the EU; however, Washington's relatively slow process for passing legislation and its newfound taste for imposing sanctions on other economic partners, at times has made it a thorn in the side of even friendly trade nations. On the other hand, China is able to achieve rapid acceptance in negotiations and development as a result of its authoritarian government structure with few of the pesky democratic oversight processes that America has to manage. China's value as an economic partner to EU member states was made clear by the December 2020 Comprehensive Agreement on Investment (CAI) and the entrance of two-thirds of EU member states into the China-led Asian Infrastructure Investment Bank.

With this kind of economic and financial relationship growing, along with the value that the EU places on a continued relationship with China, it seems the stage is set for a wider-scale shift to the use of the digital yuan. If the Chinese have a steel grip on infrastructure development and financial investment in the region, they could simply coerce European countries into using the digital yuan for paying their own debts. On top of this, it is important to note that every debt contract China has signed since 2014 "has incorporated a sweeping confidentiality clause that compels the borrowing country to keep confidential its terms or even the loan's existence" and "obligate the borrower to exclude the Chinese debt from any multilateral restructuring process"—as Brahma Chellaney put it in a recent essay he wrote for *The Hill*. Both of these features could have significant implications for undermining the public trust in countries with close economic relationships to China and forcing them to remain dependent on China in times of financial stress.

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Five, *SWIFT expanding its relationship with the digital yuan*. The gradual integration and greater use of the digital yuan would inherently also mean the beginning of deeper assimilation into the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system. Enhanced multilateral trade occurring through the digital yuan will naturally push many large-term projects into motion. Though we will likely not see these changes occurring rapidly across the international financial system, as with everything they do, the Chinese are willing to be patient for influence and economic gains. Notably, in mid-January 2021 SWIFT and the People's Bank of China established a joint venture with its clearing center and digital currency research institute. This is a significant sign of progress toward the strategic geopolitical aims of China.

Sixth, *the wave of momentum striking U.S. dollar denominated foreign reserves*. I have written elsewhere that the long-term impact of adopting Central Bank Digital Currencies (CBDCs) could be a wave of foreign central banks retreating from the use of the U.S. dollar as the preferred reserve currency. According to a statistic found in an April 2021 *Wall Street Journal* article that cited the International Monetary Fund (IMF), "the U.S. dollar's share of global reserves has decreased to its lowest level since 1995. The currency now stands at 59 percent of global reserves as of December 2020." To further highlight this trend, Russian officials issued a statement in early April 2021 that disclosed how a complete launch of that country's own digital ruble could be targeted for 2023. Unsurprisingly—one account informs us—the Russian "CBDC will also have a two-tiered system, akin to China's digital yuan, wherein the central bank distributes the CBDC to third-party firms like commercial banks that then distribute the CBDC to users." This is a great example of the cascading benefits a first mover (China) has in this space, as other countries tack themselves on to its existing infrastructure.

This type of long-term thinking has proved beneficial for the rising global power in the past, requiring substantial creativity and adaptability from the policymaking perspective of the U.S. Treasury Department. At the heart of this geoeconomic battle between the U.S. and China is the question of whether the creation of a digital U.S. dollar will move the needle in competition with China, or whether it will simply put the U.S. at the dawn of a new race in digital currency wars. In the current environment, it seems that America is not going to gain any ground by sitting back and observing China's progress toward a viable CBDC. Instead, it is critical that American policymakers begin taking significant steps to develop a digital U.S. dollar that will allow it to compete in future digital currency arenas.

Again to quote Lipsky: "China will take notice when the U.S. starts actually deploying a digital U.S. dollar—and asking other countries to accept payments that way. Until then, China knows it have a major head start."

True Impacts

In the near future, we will not see an unseating of the United States from the center of the financial system. Being at the crux of the global economy for so many years, the United States has entrenched its position. However, as the digital yuan is developed and the international community modernizes its infrastructure, it could present substantial opportunities for growth. In turn, this will provide an alternative to U.S. dollar-based transactions, which will likely transition to a more diversified use of these two currencies in the broad scheme of international trade/cross border transactions.

While some may be tempted to push off the increasing influence of China in the global economy and shrug off the idea of eroding U.S. influence on the international financial system, we must also think about the adaptation and development of norms for emerging technology. As we well know, authoritarian regimes have vastly different terms of agreement for using their technological innovations. A China increasing its global influence means a China more integrated into international decisionmaking bodies for standards and regulations when it comes to technology. Currently, the digital yuan is already being used in three cities in China, five years after its initial phases of development. As stated earlier, money is essential to the decisionmaking of every economic body and will always hold vast potential for extending influence. The digital yuan is on its way to being a critical technology of influence abroad.

A China increasing its global influence means a China more integrated into international decisionmaking bodies for standards and regulations when it comes to technology.

There are four essential questions to consider at the moment. First, *how fast can DCEP scale*? In mid-September 2020, the Deputy Governor for the People's Bank of China, Fan Yifei, stated that "in accordance with the renminbi's legal repayment provisions, digital renminbi is used to pay all public and private debts within the territory of our country, and no unit or individual may refuse to accept it if the conditions for acceptance are met." In this statement, he was essentially saying that digital renminbi will have to be accepted as a means of payment in the years to come, signaling the strategic views of this project.

Since its initial rollout and first pilot programs in late 2019, China has done things like file at least 120 patent applications for its CBDC, incorporate seven banks (both public and private) to deploy it, and integrated Alibaba digital markets into its use. Moreover, according to a November 2020 speech by the Governor of the People's Bank of China, Yi Gang, more than RMB 2 billion (nearly $300 million) had been spent using digital yuan in 4 million separate transactions in China. Though initial research and development efforts on the digital yuan had begun as early as 2014 and taken years to get off the ground, the actual implementation effort seems to have been planned well in advance. The scaling of the digital yuan has been rapid and its use has only been accelerated by the Chinese central government, which has required its utilization for the payment of certain government employees, like those in the transportation industry. As we know from broader studies of authoritarian governments and analyzing the efforts of Beijing over the last 70 years, implementing a process through a centralized power structure can be rapid; and it almost always holds the general support of the citizenry.

Second, *can China leverage the DCEP system over countries that are in debt to it*? As discussed above, China's approach to supplying infrastructure development, foreign investment, and debt has been accompanied by an update of its policy in dealing with other economies. From what has been publicly released about debt agreements and BRI memoranda of understanding, we can see that China is increasingly structuring economic relationships to make partner countries reliant on it—especially in times of economic stress.

The digital yuan is on its way to being a critical technology of influence abroad.

Though the coronavirus pandemic has made countries rethink their own supply chains and reliance on individual countries for essential products and services, countries around the world still have a distinct need for the development services China provides. Over time, we have seen numerous examples of this, as countries overlook the long-term implications of a debt agreement to get immediate infrastructure development and modernized technology. Thus, China has the unique ability to utilize what the U.S. previously held as its own economic weapon: a strong financial system that promises economic development in a structured, enduring relationship. This poses large problems and severe shifts to a system that has remained centered around the United States since the Marshall Plan and Bretton Woods Agreements of the post-World War II era.

Third, *what are the true implications for Western countries as China's influence in international regulatory bodies grows*? Whenever a critical inflection point like the present one presents itself to the powers of the world, timing becomes vital. Though it is absolutely necessary to ensure a financial technology is designed correctly to avoid potential vulnerabilities for hackers to exploit and to ensure reliability in its use, first movers in the technology field have proven the importance of speed in releasing new products. In the particular case of CBDCs—a "blue-water" innovation that was untapped until the beginning of 2020—there exists a tremendous opportunity for countries to exert influence on ethics, values, and standards of operation for the new method of digital banking transactions. China has already made substantial strides to get its DCEP pilot program out the door, while the United States has been relatively slow to make a similar commitment.

To truly understand the impacts that China can have on the privacy standards and ethical considerations of a new, widely accepted digital payment system, one only needs to think about two things: its current desire for constant domestic surveillance and transparency, and its ability to export advanced technologies in this field to emerging economies. In Africa, China has already begun to conduct deals with countries that are implementing its enhanced surveillance technologies, often built (according to reports) directly into telecommunications infrastructure like 4G and 5G cables. In fact, Huawei and other Chinese firms are responsible for over 70 percent of this infrastructure development on the African continent and have long-term relationships with many of the governments there.

The societal and economic model that China offers is the ability to develop rapidly while retaining hold on "baked-in" authoritarian restrictions. The inclusion of a digital financial payments system will only serve to further solidify the grip of authoritarian governments on their respective domestic populations.

Now, necessary with the innovation of any new technology is the need for legal requirements and standards—in this case, for governing the use of a digital currency. The international implementation of a Chinese financial technology like the digital yuan will result in a significantly different system of regulations and standards for tracking, privacy, and surveillance than one structured around Western values of freedom, liberty, and enhanced privacy.

THE AMERICAN RESPONSE

This brings me to the fourth essential question to consider at the moment, namely: *what can the United States do to adapt for the coming tide*? I laid out much of my answer in a March 2021 essay I co-wrote for *The National Interest* and will summarize the finding contained therein in what follows.

The international implementation of a Chinese financial technology like the digital yuan will result in a significantly different system of regulations and standards for tracking, privacy, and surveillance than one structured around Western values of freedom, liberty, and enhanced privacy.

Essentially, there are five key considerations that can be outlined for a U.S. response to the Chinese digital yuan. First, *set the course*. The Office of Management and Budget as well as the National Security Council should each issue a guidance on why maintaining an advantage on digital currencies is a national security priority. Although it was overlooked in the interim guidance issued in February 2021, this can still be done by outlining the purposes of the digital U.S. dollar and exploring the potential risks of a digital yuan in the next full National Security Strategy, due later this year.

While the Chinese government is hoping to scrape data from domestic transactions, perform domestic surveillance on its citizens, and maintain expanding control over internal institutions, the structure of a digital U.S. dollar system will be fundamentally different. In contrast to the Digital Yuan, it should be targeted at increasing financial inclusion, speed of service, and global competitiveness for democratic regimes in the financial technology sphere.

Second, *consider stakeholders*. After setting the objectives and guidance for the project, the designated interagency process will need to seek federal government and key private sector stakeholder consultation on privacy and civil liberties. As with any discussion about the implementation of a new technology in a democratic country, the enduring topics of privacy and civil liberties will be at the heart of the effort.

Partnerships between NGOs and the designated task force will be central in these debates to ensure a democratic procedure of developing standards for digital U.S. dollar use. In addition to privacy concerns, there will also need to be substantial cooperation between stakeholders that understand the intricacies of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). This work can be done with select groups in the U.S. Department of Treasury, the Financial Action Task Force (FATF), and other AML/CFT groups.

Third, *partner with other lending democratic states*. After developing the basic theoretical and technical framework for the digital U.S. dollar, Washington should use its traditional leadership role in innovation to partner with other democratic states to provide a substantial alternative to what China is offering. This work should be highlighted by a twenty-first-century Digital Bretton Woods convening.

Working group conversations between Chairman Jerome Powell, Christine Lagarde, and Janet Yellen—some which are already happening at the staff level—will help advance interwoven strategies for developing the digital U.S. dollar alongside the digital euro. Washington officials should also collaborate with our long-time transatlantic partners in the United Kingdom to develop a similar framework for the digital UK pound. The newly reenergized Quad—the United States, Japan, Australia, and India—will welcome an alternative to the growing regional influence of the digital yuan.

Fourth, *educate the public*. While a CBDC is similar to digital transactions today, many American citizens will be initially skeptical of using money issued directly from the Federal Reserve. By juxtaposing the differences in the U.S. system that will emphasize privacy and ease of use (think stimulus checks direct to your phone two hours after a bill is signed) stakeholders can gain the trust of the general public.

This can be done through a series of partnerships with private actors that publicly vouch for the new technology, as well as an open-source training program that is required for U.S. citizens with an account. Since every U.S. citizen will have access to a digital U.S. dollar account, the training can be implemented and run as soon as it is opened for the first time.

Fifth, *set a rollout deadline for before the end of 2022*. As with any project, there needs to be a timeline. Success in competition relies on adding pressure, goals, and guidelines for success. Americans have always thrived when competing in the technical space and this time will be no different.

To have a significant answer for the digital yuan at the 2022 Olympics, the United States needs to launch its program now. Having a viable system—and a counter to China—by the end of 2022 is a real possibility if public-private sector cooperation starts today.

Pay Attention

An important takeaway here is: pay attention to the slowly but surely approach. China's rise may be slow, but it is not without careful consideration and planning. This is made evident through its development of initiatives like the BRI and the DSR. The United States would be wise to weigh the long-term challenges associated with a shifting of global financial power and develop ways to remain the world's the preferred partner in the international economy.