China's central bank has taken the lead in digital currencies. What does it mean for businesses?

Firms can prepare by having digital wallets in place and planning interoperability for cross-border trade, write Jemma Xu and Dan Prud'homme

As if Covid-19 and the trade war hasn't done enough to upend global business between the US and China, yet another major transformation is afoot: the launch of China's sovereign (i.e., central-bank offered) digital currency (CBDC). By "digital currencies" we mean financial transactions that are recorded on blockchain ledger and held in digital wallets. While Facebook's Libra and other digital currency firms have been receiving increasing attention, private firms are in fact unlikely to truly dominate the digital currency trade. Instead, sovereign digital currency – namely, the "Digital Currency Electronic Payments" (DCEP) system managed by the People's Bank of China (PBoC), the country's central bank — has taken the clear lead in this space.

China's leadership in the digital currency revolution

Although privately-operated digital currencies are entering the market, sizeable regulatory, technical, and user hurdles continue to prevent their rapid and widespread adoption. Outside of China, digital currencies are taking the form of unregulated "stablecoins" offered by private companies. However, because the threat of regulation looms large, these private stablecoins are fraught with incredible risk. Moreover, it is uncertain if these currencies are even fully backed by fiat. These reasons alone leave many businesses and consumers unwilling to use such currencies. The basic challenge of setting up digital wallets and managing private digital keys also tend to turn people away from digital currencies.

In this void, China's DCEP offers the public confidence unobtainable by private digital currencies. DCEP is itself a stablecoin, but one backed 1:1 by the PBoC with fiat Chinese yuan/renminbi. Its system follows a "two layer" approach. First, and critically, because it is a sovereign digital currency, the PBoC is the only issuing party. Second, to expeditiously diffuse the currency, the central bank issues DCEP to select retail banks and non-financial institutions (e.g., Alibaba, Tencent, and Union Pay) in China with strong pre-existing mobile payment networks, who then merely distribute the currency to the general public. Businesses across China will be required by law to accept DCEP as payment.

Besides the regulatory legitimacy, many factors position DCEP to become the world's most widely used digital currency: the Chinese state's track record of rapid institutional innovation; Chinese public support of institutional experimentation; Chinese firms' strong competitiveness in digital ecosystems and capabilities to quickly adapt to changing technological paradigms and institutions; and a massive

Chinese population who quickly adopts new digital technologies, and in fact lead the world in adopting mobile payment applications.

Although central banks in several other countries have also been studying digital currencies, none have taken the lead to actually develop and rollout a CBDC at the scale occurring in China. DCEP will be used for purchases in all sectors across the country. To start, as of mid-2020, DCEP has been piloted in the Chinese cities of Shenzhen, Chengdu, Suzhou and Xiong'an – potentially reaching over 42 million people, more than Canada's entire population. Elsewhere in China, DCEP is already in the process of being piloted in the restaurant and hospitality sectors, with foreign multinationals such as McDonald's, Starbucks, and Subway already signing up to participate. Further, DCEP trials are already being conducted around China to reimburse public sector employees' travel costs. Yet other pilot initiatives, such as a commitment to use DCEP at venues for large-scale upcoming events in Beijing, are in place.

Meanwhile, the Chinese government recently proposed the creation of a regional digital currency backed by the Chinese RMB/yuan, Japanese yen, South Korean won, and Hong Kong dollar – with DCEP at the centre. And China's multi-trillion dollar Belt and Road Initiative (BRI) offers a network to extend DCEP in countries around the globe.

Implications for global strategy

Businesses should prepare for DCEP's rollout in two main ways. First, they must ensure that they have appropriate infrastructure in place to accommodate DCEP, such as digital wallets. Contracts with third-party financial custodians can also be helpful. On the upside, to facilitate swift legal compliance with DCEP – considering that its acceptance is being required by law in China – the Chinese authorities may integrate DCEP with popular existing digital wallets already widely used by many businesses in China, namely Alipay and Wechat Pay.

Second, businesses may need to explore interoperability options when conducting cross-border trade. Such action may be needed in the longer term if DCEP leads to an alternative international payments system vis-à-vis the current US-led system, which is a probable prospect.

Meanwhile, firms who timely prepare for China's DCEP rollout can seize several significant opportunities. First, as previously alluded to, the expansion of DCEP will facilitate the internationalisation of the yuan/renminbi. In doing so, the Chinese currency will provide a strong alternative institution to rival the current USD-dominated international payments system.

Second, by facilitating direct transactions between digital wallets, DCEP will eliminate sizeable banking clearing and settlements costs. In other words, 'payment is settlement' with no need for separate clearing and settlement processes.

Third, DCEP will offer firms new ways of raising capital and secondary trading via the issuance of digital securities and disintermediated trading on exchanges. Digital securities are regulated financial instruments such as equities or bonds where the transaction and shareholder details are recorded on the blockchain ledger. As a stable currency, DCEP will be used to reduce or eliminate the clearing and settlement processes associated with trading digital securities on secondary exchanges. In turn, this will provide firms and investors easier access to digital financial instruments.

Fourth, DCEP's development will catalyse fintech innovation, giving rise to hybrid products that draw on both traditional markets and digital currencies. Greater numbers of innovative structured products are appearing in the digital currencies market, where the underlying asset is a native digital currency, such as Bitcoin, but the payoffs are based on traditional structured products. DCEP will serve as a reliable alternative underlying-asset in the future, stimulating the creation of more hybrid financial products.

Fifth, and not least, aggregate demand may rise as a result of DCEP's rollout. DCEP adoption will allow governments to rapidly deploy "helicopter money" to the public without requiring bank accounts. This will empower the previously unbanked to form a new group of consumers.

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August 3rd, 2020 | Economics & Finance, Information & Technology | 0 Comments