BC3401: Mid-Term Quiz 2021

Duration: 1 hour

Read the following article published in the Financial Times earlier in 2021 and answer the two questions that follow:

(FINANCIAL TIMES) - Celebrations in China to mark the Chinese New Year of the Ox, which began last Friday, have been somewhat muted because of the coronavirus pandemic. The numbers of people travelling to visit relatives this year are down sharply, depriving family gatherings of a measure of joy.

But it is not all gloom. The authorities in several cities have given away tens of millions of yuan as new year "red packets" that can be downloaded onto a smartphone. Beijing and Suzhou alone have doled out 200,000 red packets worth 200 yuan (S$41) each in a public lottery.

Such philanthropy conceals a harder-hitting agenda. By handing out the traditional red packets in the form of "digital renminbi", China's authorities are conducting trials for a crucial new technology that could lead the world's adoption of digital currencies and set global technical standards.

Although no official launch date has been announced, China is intent on becoming the first large economy to introduce a digital currency, showcasing its position as the global leader in payments technology to the world at next year's Winter Olympics. Cambodia launched a digital currency, the Bakong, late last year.

"Chinese policymakers are by far the most advanced in their thinking about a digital currency," says the head of Asia business at a leading Wall Street bank who declined to be named. "They are thinking about things that the rest of the world is nowhere near thinking about yet."

"The digital renminbi will put every transaction onto the radar of the People's Bank of China," the banker adds.

China's digital plan dovetails with broader ambitions for its currency as Beijing hopes the technology will help promote the renminbi internationally and weaken the US dollar's supremacy. While bankers say the focus initially will be on using the digital currency in the domestic economy, it will probably be used for trade settlement in a number of years, several Chinese analysts say.

But the other objectives behind China's virtual currency present a sharp contrast with public discussion about the issue in many other parts of the world. While in the United States cryptocurrencies are steeped in the language of libertarianism, in China the digital currency project is tied up in the Communist Party's drive to maintain control over society and the economy. The technology is partly designed to reinforce its surveillance state.

China's digital renminbi is a "central bank digital currency", making it in some ways the opposite of cryptocurrencies such as bitcoin. Cryptocurrencies are often decentralised; they are not issued or backed by governments. The "e-yuan", by contrast, is part of China's top-down design. It is issued and regulated by the central bank and its status as legal tender is guaranteed by the Chinese state.

Its digital format enables the central bank to track all transactions at the individual level in real time. Beijing aims to use this feature to combat money laundering, corruption and the financing of "terrorism" at home by strengthening the already formidable surveillance powers of the ruling Communist Party.

Beijing also hopes, analysts say, to use the digital renminbi as a means to reassert state control over its fintech industry and a vast e-payments market that is dominated by two huge private companies, Ant Group and Tencent. The technology could in effect become a rival to their cashless payments platforms.

China's government is already engaged in a multi-pronged effort to rein in the power of the new payments firms, which led to Ant cancelling a planned US$37 billion (S$49 billion) initial public offering at the end of last year.

Dr Samantha Hoffman, senior analyst at the Australian Strategic Policy Institute (ASPI), says social control is a priority for Beijing. "The (digital renminbi) is heavily about the party's ability to exercise control," she says.

Fintech takeover

China's strategy is to popularise the digital currency by running city-level trials this year and next, having it ready for use by the time it hosts the Winter Olympic Games late next year, officials have said. This timetable puts Beijing far ahead of a long tail of national governments that are starting to experiment with the idea.

Some 60 per cent of more than 60 central banks surveyed by the Bank for International Settlements last year said they were "conducting experiments or proof-of-concept" studies on digital currencies, up from 42 per cent in 2019. Among these, 14 per cent are moving towards pilot programmes, the survey found.

In China, as elsewhere, the ramifications of adopting a digital currency are huge. It is not just that the digital renminbi stands to replace cash. It also presages the construction of a new payments system that threatens to undermine the market position of Alipay and WeChat Pay, the two most popular and privately owned platforms, run by Ant Group and Tencent.

The main reason for this is that the digital renminbi is distributed directly to the e-wallets of users by state-owned banks, thus setting up payments channels that circumvent Alipay and WeChat Pay.

In trials so far, users have been able to withdraw e-yuan via ATMs into their smartphones' e-wallets. Then they pay for items by holding their smartphone app close to an e-yuan point-of-sale device. Such a system represents a clear alternative to Alipay and WeChat Pay, which are estimated to have a combined worldwide active user base of around US$1.9 billion.

"The wide use of the digital renminbi will affect the market position and profit model of third-party payments platforms like Alipay and WeChat pay," says Mr Wang Yongli, a former vice-president of Bank of China, one of China's largest state-owned banks.

This is no small matter. Alipay and WeChat Pay not only form the backbone of China's payments system in an economy that is already largely cashless. Their business also supports the share prices of Tencent, which is one of the world's 10 largest companies with a capitalisation of more than US$920 billion, and Alibaba, which owns a stake in Ant Group.

A sense that the popularisation of the digital renminbi could come at the expense of Alipay and WeChat Pay is reinforced by Beijing's messaging through state media coverage. In a dispatch from the streets of Beijing during Chinese New Year, a reporter from CCTV, the official television station, said using e-yuan was "more convenient" than other payments systems.

"The digital currency will deal a blow to Alipay and WeChat as it could replace them," says a director at a large state-owned bank. "It is likely that the government will use administrative power to promote the use of digital renminbi to undermine the monopoly on consumer data held by the technology firms."

In fact, such administrative powers are inherent to the e-yuan itself. Because the digital renminbi is legal tender, no merchant can refuse to accept it, and merchants will, therefore, be obliged to install e-yuan terminals and payments systems after the currency is formally launched. The same is not the case for Alipay and WeChat Pay, which merchants are at liberty to refuse.

State media reports also trumpet a function of the digital renminbi which they say makes it as versatile as cash: the capacity for offline payments. If there is no Internet connection, users can still transfer money between two offline devices by using what the state media calls "dual offline technology".

This feature uses a type of near-field communications technology similar to Bluetooth, analysts say. It is not yet clear how reliable such systems - or the digital renminbi more generally - would turn out to be but Mr Mu Changchun, head of the central bank's Digital Currency Research Institute, has said the dual offline technology has been "comparatively successful".

China regards its centralised banking system as a crucial instrument of the party-state's economic power. Whenever its control is threatened, as it was by the flowering of a freewheeling peer-to-peer lending sector as recently as 2016, the authorities move decisively to reassert their influence. Only some 29 of as many as 6,000 peer-to-peer lenders now remain following Beijing's clean-up campaign.

Similarly, the extraordinary success of Ant Group, before its share offering was axed, was seen as a threat by a powerful lobby of Chinese state-owned banks.

While it is clear that the digital renminbi payments ecosystem has been designed to run independently of Alipay and WeChat Pay, it is likely that the two private payments platforms will nevertheless also be used for e-yuan transactions, analysts say. Thus, for a while at least, the private platforms will be enlisted to promote the digital renminbi's rise.

"The increase of the digital renminbi's market share will come at the expense of WeChat Pay and Alipay," says Mr Zou Chuanwei, a specialist in digital currency at Wanxiang Blockchain, a research institute in Shanghai. "The government is tightening regulatory control over fintech groups, and the digital currency's replacement of Alipay and WeChat Pay will hurt their consumer lending business," he adds.

Tool of control

Fifteen centuries after China invented banknotes, the nature of money is set to fundamentally change. Back then, in the Tang Dynasty (AD618 to AD907), paper money was little more than an IOU and became known as "flying cash" because, unlike metal money, it had a tendency to blow away.

But the digital renminbi presents a step change. It is far more than just a medium of exchange. Beijing sees it both as a bulwark against the potential encroachment of foreign digital currencies, such as the Facebook-led Diem, and as a tool to facilitate mass surveillance of the Chinese population.

Last year, Mr Mu of the Digital Currency Research Institute argued that the digital renminbi would prevent Facebook's Libra - the original name for Diem - from encroaching on China's monetary system. Such thinking followed similar soundings from 2018 when central bank researchers warned that the advent of digital tokens - called stablecoins - linked to the US dollar could damage Beijing's efforts to internationalise the renminbi.

But aside from acting as a bulwark against unwanted foreign cryptocurrencies, Beijing's ambitions for the digital renminbi derive from a deep-seated impulse towards social control, analysts say.

"The digital renminbi is likely to be a boon for CCP (Chinese Communist Party) surveillance in the economy and for government interference in the lives of Chinese citizens," wrote Mr Yaya Fanusie and Ms Emily Jin in a report last month for the Centre for a New American Security, a Washington-based think-tank.

They say that deploying e-yuan will set the central bank up to mine a huge trove of data on its citizens' economic activity. This dovetails with a government fintech plan issued in late 2019 that foresaw a fusion of financial data to promote the construction of a "nationwide integrated big data centre".

"If the central bank can successfully roll out the digital renminbi, it indeed would be a crucial tool for domestic control," says Ms Jin. "People could still try to circumvent the monitoring capability of (the currency), but I'd imagine that would be incredibly difficult, given that the system would allow the central bank to track real-time transactions."

If such capabilities do materialise, the People's Bank of China could take on enhanced powers of discipline enforcement and would have the ability to take punitive action by blocking transactions if the situation called for it.

Dr Hoffman of the ASPI, which published one of the first in-depth reports on the digital renminbi last year, says: "Through the (virtual currency), the party-state would have visibility over all financial transactions. The transactions are fully traceable, and there will be no such thing as true anonymity for users."

Exemptions from scrutiny?

The level of anonymity that will be accorded to Chinese citizens who use the digital currency remains an officially grey area. Mr Mu, speaking at a conference in Singapore last year, said a system of "controllable anonymity" would be rolled out.

"We know the demand from the general public is to keep anonymity by using paper money and coins... We will give those people who demand it anonymity in their transactions," Mr Mu told the conference. "But at the same time, we will keep the balance between the 'controllable anonymity' and anti-money laundering, CTF (counter-terrorist financing) and also tax issues, online gambling and any electronic criminal activities."

Dr Hoffman says such ambiguity raises concerns. "Requirements like anti-terrorist financing or anti-money laundering are normal for central banks, but what is different in China is who is scrutinised," she says. "The definition of a terrorist includes the party's political opponents."

Such concerns could hamper Beijing's longstanding aspirations to promote the use of its currency internationally as part of China's long-range ambition to free itself from having to settle most of its trade transactions in the US dollar.

"If the Communist Party will get insight into every trade we do through the digital renminbi, then I think a lot of people outside China will prefer not to use it," says one businessman in Hong Kong who declined to be named.

Nevertheless, China is pressing on with its internationalising verve. It agreed last month to form a joint venture with Swift, the Belgium-based global system for cross-border payments, in a move that observers say is aimed at promoting use of the digital renminbi.

The new entity, called Finance Gateway Information Services, is charged with integrating information systems to facilitate the roll-out of the digital currency, according to people familiar with the venture. Other shareholders in the venture include China's Cross-Border Interbank Payment System, a competitor of Swift that handles trade settlement in renminbi. Swift said the venture was not related to the digital renminbi but was "compliance focused".

However, even bankers within China's state-dominated system say optimism about the international uptake of the digital renminbi must be tempered by reality. "A bigger goal of ours is to challenge the dominance of the US dollar in international trade settlement," says the director at a state-owned bank. "But progress towards this will only be gradual."

The reasons behind such expectations of slow progress derive from an old-fashioned, analogue problem. Foreigners have little incentive to hold renminbi as long as access to China's financial markets remains complex and opaque to all but specialist investors.

"(A digital renminbi) would not banish many of the problems holding the renminbi back from more use globally," said Mr Maximilian Karnfelt, an expert at Merics, a Berlin-based think-tank on China. "Much of China's financial market is still not open to foreigners and property rights remain fragile."

Answer the following questions:

1. When a nation (such as China) pushes for a digital currency, what are the main considerations it should have to ensure that it becomes a success? (i.e. what are the necessary antecedents should the nation have in place before rolling out such an initiative?)

   [30 marks]

2. How will the e-yuan roll-out impact e-payment providers such as Alipay and WeChat pay? How should such companies react to the competition?

   [20 marks]

Submit your answers in an MS Word document at BC3402 main course site under [→ Assignments → Mid-Term Quiz] before 8pm SG Time, 16 Mar 2021 (Tuesday).