THE RISE OF A SOVEREIGN DIGITAL CURRENCY IN CHINA

By Assad Raza

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In February 2021, the People's Bank of China conducted the third test of its digital currency across several major cities in China. Later that year, the People's Bank of China banned all cryptocurrency transactions and mining of private sector currency like Bitcoin in China. China's ban comes as cryptocurrencies become more popular because they lower costs and accelerate transactions by cutting out commercial banks and other financial institutions. This ban has forced consumers to shift their transactions to their government-issued digital yuan, eliminating the anonymity that usually comes with cryptocurrency from the private sector. This push to the digital yuan is a U.S. national security risk for three reasons: it facilitates Chinese state surveillance of U.S. entities such as businesses; it allows both well-meaning and malign actors to circumvent the existing banking system (including sanctions); and it constitutes the latest step in Chinese endeavors to undermine the dollar's place as the leading international currency.

According to aBank of International Settlements (BIS) 2021 survey, 86% of the 65 central banks surveyed are exploring a central bank digital currency (CBDC), with 14% moving towards pilot development. In early 2021, central banks from China, Thailand, United Arab Emirates, and Hong Kong explored facilitating cross-border foreign exchange among their countries to bypass the traditional dollar-based exchange process and fees. The chaos of the covid-19 pandemic also accelerated cryptocurrency's investment internationally. But China has been ahead of the pack in the development of CBDC, starting way back in 2014, with recent trials across several provinces. It is the second CBDC in the world to launch (after the Bahamian sand dollar).

One major risk with any CBDC is the potential for domestic government surveillance and financial censorship. In *China's Digital Currency: Adding Financial Data to Digital Authoritarianism*, authors Yaya J. Fanusie and Emily Jin emphasize that China's CBDC will improve its capability to monitor illegal activities like money laundering – but it will also enhance their data collection of private transactions and strengthen their authoritarian power over Chinese citizens. In fact, a national digital currency in China will also supplement their national surveillance programs targeting dissenters and increase human rights abuse of certain ethnic minorities. This surveillance may also be applied to international partners conducting business within or outside their borders.

The move toward government crypto has popular support in some places though. For example, 32% of Nigerians use cryptocurrency like Bitcoin because transactions are cheap and can be done through cellphones. In addition, several Nigerian businesses that import products from China used Bitcoin instead of the Central Bank of Nigeria because of these low-cost advantages. One goal for China is to force international partners to use their digital currency for cross-border transactions, for example to streamline transactions between countries participating in the Belt and Road Initiative. These transactions would allow China and their business partners to bypass the dollar-based foreign exchange process and increase their control over the entire system. At the same time, China may compel those reluctant to shift from the dollar-based system to adopt a Chinese CBDC to conduct business with them for their goods and services across borders, thus putting those companies and governments' privacy and security at risk only to do business with China. And there is an increased risk this data can be misused by the Chinese government for their interests.

Another risk of this digital currency is China's ability to facilitate illegal transactions and avoid U.S. imposed sanctions. The *Treasury 2021 Sanction Review* claims that "technological innovations such as digital currencies, alternative payment platforms, and new ways of hiding cross-border transactions all potentially reduce the efficacy of American sanctions. These technologies offer malign actors opportunities to hold and transfer funds outside the traditional dollar-based financial system. They also empower our adversaries seeking to build new financial and payments systems intended to diminish the dollar's global role." Consequently, China's CBDC may also be used by adversaries like North Korea or multinational corporations that do not work with the U.S. but work with China to conduct business outside the U.S. financial system, therefore creating another international payment system for adversaries to conduct transactions outside the regulated traditional dollar-based process.

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Justin Muzinich, former U.S. Deputy Secretary of the Treasury (December 2018–2021), claims that a Chinese digital currency can become a platform for adversaries to purchase weapons. In *America's Crypto Conundrum: Protecting Security Without Crushing Innovation*, Muzinich wrote that if a foreign company that does no business in the U.S. wants to sell weapons to North Korea, both parties can use China's CBDC to conduct transactions without going through any commercial banks. This increases an adversary's military capabilities and enables them to avoid any sanctions imposed by the U.S., ultimately undermining the power behind U.S. sanctions. Moreover, this may damage the entire global financial system, as China sets the example for other countries to bypass the traditional dollar-based system.

As the primary U.S. competitor, China continues to invest in its economic power to meet its strategic interests. For this reason, the U.S. must be aware of the strategic risks associated with China's ambitions for creating a national digital currency. This move creates conditions for the yuan to compete with the traditional dollar-based system or, worse, become an alternate financial system that adversaries can use to purchase weapons and sanction evasion. Experts disagree on the likelihood and timeline of the yuan's replacing the dollar, but that does not make it less of a strategic threat. In sum, China's CBDC provides the Chinese Communist Party with another means to collect data and monitor their citizens' financial activity. Moreover, this information, combined with other surveillance data, can be used to discipline individuals or groups for noncompliance to government demands. These privacy infringements may also apply to multinational corporations and developing countries dependent on China's CBDC to conduct business with them. This puts U.S. national security at risk, as most of these countries have relations with the U.S., and several multinational corporations are U.S.-based firms. For all the reasons mentioned, the U.S. must continue to closely monitor China's implementation of its CBDC. If not, the digital yuan can threaten the traditional dollar-based system and U.S. influence as countries see it as a more cost-effective alternative over time.

Assad Raza *is an active-duty U.S. Army Civil Affairs officer serving at the Western Hemisphere Institute for Security Cooperation (WHINSEC). He holds a Bachelor of Art in psychology from the University of Tampa, a Master of Art in diplomacy with a concentration in international conflict management from Norwich University, and a Master of Military Art and Science from the U.S. Army Command and General Staff College.*

The views expressed in this article are those of the author and do not necessarily reflect those of the U.S. Army War College, the U.S. Army, or the Department of Defense.

Photo Description: Miscellaneous digital currencies **Top (L-R):** Ark, Iota, Bitcoin, Neo; **Bottom (L-R):** Dash, Ethereum, The Graph, Binance Coin; **Center:** Notional Digital Yuan

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