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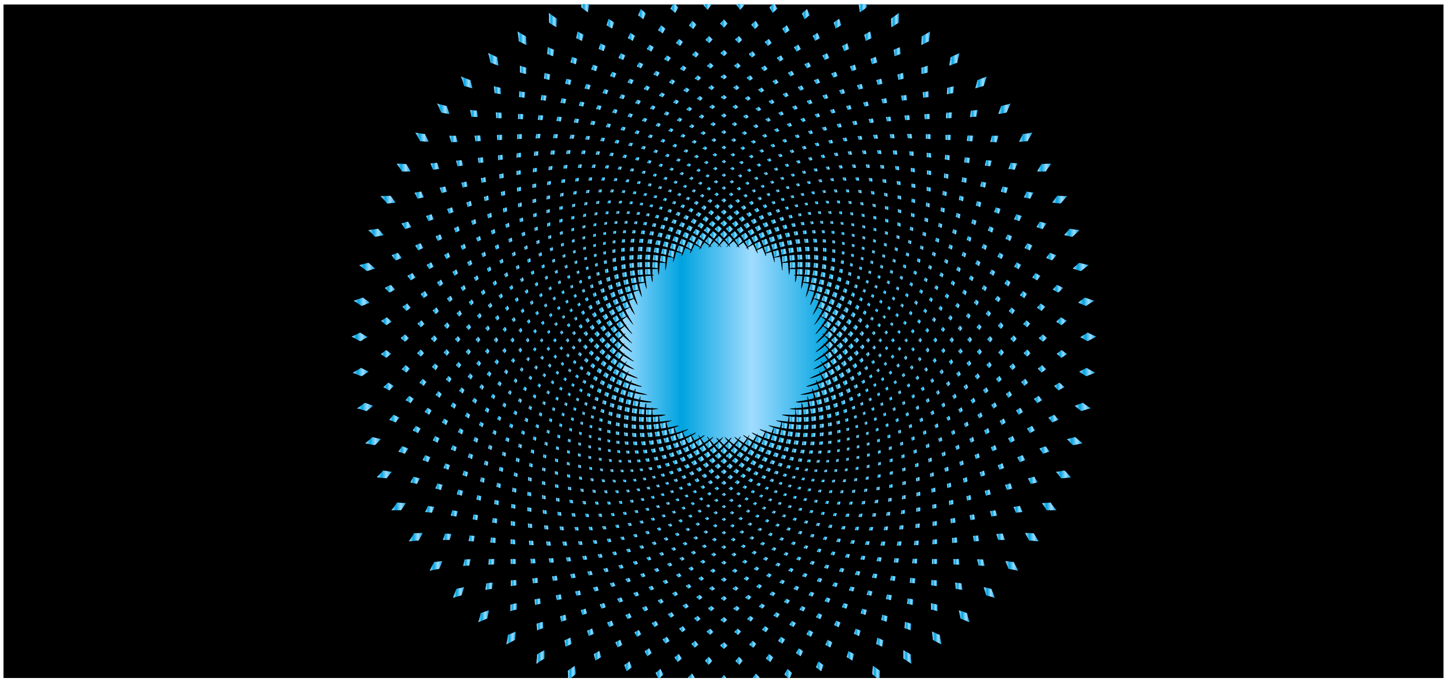

China's Digital Currency and Electronics Payment Project (DC/EP)

China's digital RMB is ready

China has been researching digital currencies and electronic payment systems since 2014 and stood up a focused Institute of Digital Currency in 2016 to accelerate the initiative. From January of this year, a number of announcements have been made through official media reporting progress and shedding light on details of the digital RMB project and its goals. The evolution of the digital RMB and China's payment systems is of critical importance to MNCs doing business in China.

China's digital RMB will be a form of M0 money (physical currency in circulation), and official reports claim it will completely replace paper money. Only the central bank, the People's Bank of China (PBoC), will be authorized to issue the currency, and it will issue the digital currency through retail banks and potentially through some technology and nongovernmental companies.[1] The inclusion of "technology and nongovernmental companies" in the distribution scheme strongly suggests that PBoC's digital currency is likely to have a transformational impact on China's two dominant incumbent electronic payment systems. At another level, among the risks of doing business in China generally has been complexity and costs of both domestic and cross-border settlement, and the evolution of the digital RMB could help.

Data collection at a granular, individual transaction level is an explicit and primary goal of PBoC's interest in electronic payments. Currently, the clearing functions of the state agents provide such information at an aggregate batch level, but a more granular view, what has been called "controllable anonymity," will balance privacy concerns with crime prevention. A more granular view would strengthen the PBoC's ability to fight fraud, illegal forex transactions, tax evasion, and capital flight. Leadership's interest in a more dominant role in electronic payments aligns well with China's Social Credit Scoring System.[2]

Diversification of electronic payments

China's ruling party has always focused on direct control of financial services as a major lever for economic management. In the early stages of reform, China had six commercial banks, each with a specialized set of sector interests: agriculture, construction, trade and foreign exchange, communication, investment, and industry and commerce. Those banks, as well as rural and credit co-ops, were all within the State's direct control. Influence over the financial services was an asset in top-tier political competition.[3]

China's two dominant incumbent payment systems are among a small number of platforms that were given regulatory approval to offer payment services in 2011, including foreign exchange transactions, internet payments, mobile payments, and debit card services.[4] Both received accommodating banking licenses in 2014, further expanding their service offerings.[5] Both have grown to a scale where they are major and highly profitable providers of a broad range of financial services, most linked to their ubiquitous electronic payment systems.

The major role of these dominant electronic payment systems in financial services has been enabled by the growth of China's shadow banking sector, which provided a range of short-term, high-return investment opportunities. In recent years, the Ministry of Finance has worked to get better information on shadow banking, which is a significant part of what is called Total Social Credit, and to institute regulatory control, in part to reduce risk of failures and fraud. This has led to tighter enforcement of rules constraining the investment and earning potential of large payment platforms.

Rules bearing on cash management have tightened considerably since spring 2017, when 20% of their money under management, including wealth management products, digital wallets, and retail float, was by regulation required to be put in escrow in SOE banks. Now regulations have raised that number to 100%, eliminating previous revenue earned by investing those funds outside the designated banks. In March 2017, China established the NetsUnion Clearing Corporation (NUCC), and in August, a PBoC notice mandated that by June 2018, all third-party payments would be cleared through NUCC. NUCC is under the direct supervision of PBoC and majority-owned by state-owned financial service providers. Two dominant electronic payment systems hold equity positions of 9.61%. NUCC's role is to process all nonbank third-party payment activity, essentially pulling back under state control a profitable slice of the electronic payment process and providing a new window to oversee electronic payments at the most granular level.[6]

Multinational companies' (MNCs) interests

There are several implications in these important developments. First, by centralizing third-party payment settlement through a dedicated and exclusive platform directly supervised by PBoC, that role is taken away from the SOE banks and their previous payment clients.[7] Secondly, from official reports, it is apparent that the development of the PBoC's digital currency and electronic payment project is not primarily about a cryptocurrency that would supplement or replace the physical RMB, but is focused on advancing China's electronic payment capabilities and usage.

Finally, the events reveal respect for the innovation the private sector has shown in providing enhanced financial services to the public. NUCC will not, according to official reports, provide competitive retail electronic payment services, but will only operate the clearing platform while the nonstate retailers continue their services and undertake future service developments.

The new opportunities this offers international payment processors and card issuers are already apparent. Previously confined to providing cross-border payment services in cooperation with China's banks and domestic payment servicers, MNCs have made major progress in the past 12 months in their long pursuit to tap into China's enormous domestic payments market. This has been done through acquisitions of domestic payments companies and winning PBoC approval or direct arrangements with NUCC itself. Centralizing and strengthening PBoC's oversight of electronic transactions has opened the door for more MNC participation.

Expanded business scope will also require MNCs to create operational platforms that are innovative, different from operations outside China. Among these pressures, four are key. Very low cost for payment services from existing providers will require efficiencies to compete. The two major domestic providers dominate the marketplace and have huge networks of brick-and-mortar retail and industrial outlets, as well as dominant presence in online transaction sites. Building market share will require creativity, effort, and local organizational capability. And to support operations, MNCs will also need major system adjustments to comply with China's cybersecurity law while protecting their global IP and networks from compromise or intrusion.

And finally, the external environment is contributing considerable uncertainty as China tightens Mainland ITC regulations, global infrastructure providers are intensifying competition and potentially establishing incompatible standards, both China and the United States are expanding the scope of national security concerns and pressing for localization and domestic ownership of key networks and platforms. The United States is rolling out wide-ranging constraints on digital connectivity in the State Department's Clean Network project with China as a target.[8]

The current hybrid arrangements for cross-border payments could see improvements and benefits from these new initiatives. China had already inaugurated in October 2015 its own alternative to SWIFT, the Cross-border Interbank Payment System (CIPS), to settle cross-border RMB transactions.

Electronic payments, potentially supported by China's extensive blockchain research, will likely take cost out of current transfer systems. Whether this will spur further use of the Chinese currency internationally, in a digital form of the off-Mainland CNH or some other fungible currency category, remains to be seen, because the direction of that initiative remains uncertain under a range of economic and political pressures influencing the CNH markets outside China. By one measure reported by the Hong Kong Monetary Authority, total RMB bank deposits in Hong Kong peaked in December 2014 and currently stand at less than 70% of that level.[9]

Diversification of options and innovation in services will potentially provide benefits for a range of MNCs engaged with China, including retailers, consumer product companies, financial service companies, and even MNCs sourcing in China. In tandem with improved credit information in the offing, we expect improvement in managing many forms of payment risk that have been challenging for MNCs in China since reforms began. We also expect some improved efficiency in many forms of financial transactions. Executives with treasury responsibilities should likely follow this enhanced role for international payment providers and think expansively about how this might serve their growth interest in China.

Also, the impact of DC/EP toward cross-border payment systems may prove to be very significant. Given the nature of digital currency, theoretically, it might replace the current SWIFT system (in the long run) and help RMB internationalization. If implementation regulations allow RMB wallets for overseas users outside of China, it would enable a range of direct transfers.

Of course, there are still a lot hurdles along the way, many related to current capital controls, the minor role of RMB outside of China, and the like. But given its regulatory role, PBoC's DC/EP initiatives might set the pace for a significant evolution of domestic and international payment systems that would affect or complement services of private providers, other central banks, and incumbent transfers systems.

Endnotes

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