China's New Digital Currency Initiative

Liz: Hi, Andrew.

Andrew Tilton: Hi, Liz.

Liz: You're the firm's chief Asia economist, and one of the themes you've been focused on recently is China's creation of a digital yuan. I want to talk about the implications of that. But first, what is this digital currency initiative?

Andrew Tilton: Sure. It's an effort to create digital cash, the digital form of the sovereign currency. And in China's case, it's going to be a so-called retail currency. That is, households and businesses can use it. It's not simply a mechanism for transferring funds from financial institutions to each other. It'll be distributed by banks in the same sense that physical currency is. So the intent is to keep banks very much a part of the financial system and playing their critical role, but to have this be a currency that's actually used at the retail level.

There will be a so-called centralized ledger of transactions, which means that it won't be anonymous, at least not outside the very smallest transactions. And I think the goal is also to, you know, cut down the costs of managing cash and accrue financial inclusion to some extent.

Liz: So how widespread is this initiative in China?

Andrew Tilton: China's efforts led by the People's Bank of China are really at the forefront globally of sovereign digital currency development. There already have been a number of pilot programs in individual cities where households received a small amount of digital cash and got to spend it with eligible businesses. We had one in Shenzhen a few months ago. Then one in Suzhou City. Now there's another one in Shenzhen with 100,000 households and several thousand businesses. So they're definitely scaling up. And it's been announced that there'll be a larger-scale trial at the 2022 Winter Olympics. However, we still don't have a firm date for the formal rollout of this digital currency.

Liz: What do you think is driving China's decision to digitize the yuan?

Andrew Tilton: I think the fundamental driver of this is a desire to maintain monetary sovereignty in the face of both domestic and external developments. Domestically, the very rapid growth of private payment providers and their central role in digital payments and making sure that banks continue to have a role in that. And externally, development of sovereign currencies elsewhere and discussions about potential currencies like Libra, now Diem, and concerns that maybe that could become a global standard or a standard that infringes on China's monetary sovereignty. So I think that motivation is the biggest driver of this. But there's certainly a number of other potential benefits, you know, cutting down the cost of printing and distributing paper cash, improving financial inclusion, having more information about what's going on in the financial system are all potential benefits of this digital currency development.

Liz: And how does China's digital currency differ from bitcoin or the other cryptocurrencies?

Andrew Tilton: I think the big difference between digital sovereign currencies and cryptocurrencies is the backing. So with a sovereign digital currency, it's equivalent to cash. The central bank is backing that. The sovereign is backing that, and it's a fixed value. With cryptocurrencies, there is no backing other than the scarcity of the coin itself. So in that sense, you know, people sometimes analogize them to gold or a digital form of something that's scarce in supply. So as a means of payment, digital currencies will have a big advantage of fixed value. Whereas cryptocurrencies clearly can fluctuate a lot and I think by many are seen more as a speculative investment, at least at this point.

Liz: And what about the risks involved in digital currencies?

Andrew Tilton: There are really two big things that we'd highlight based on the literature, the research into digital currencies. One is the poor cyber security. As with all things digital, there is a risk of hacking or potentially theft or compromising of digital currencies in theory.

The other is a little bit more subtle, and it's a risk that the banking sector becomes disintermediated. If households can get digital currency that is guaranteed by the sovereign then that's potentially preferable to bank deposits, which are guaranteed by the bank. And many countries also have deposit insurance. So there's a risk that the role of banks, at least in deposit gathering, becomes diminished. Generally, central banks are very focused on this and trying to make sure that doesn't happen. They're not planning to pay interest on sovereign digital currencies. They may even limit holdings or take other measures to make sure that banks, you know, continue to have a role in deposit gathering going forward.

Liz: And what about the broader macroeconomic implications?

Andrew Tilton: First and foremost, I think central banks and regulators are going to take this fairly slowly. So I think in the short term, those implications are pretty modest. But potentially they allow for better transmission of fiscal and monetary policy. You would potentially be able to target fiscal stimulus in a more narrow way. Digital currencies aren't required for that, but the infrastructure might aid in doing that.

You could potentially over time adjust interest rates on digital currency and transmit monetary policy more directly. Though that would also create some risks, as I mentioned, around banking sector disintermediation. You'd have a lot more information as a policymaker about what's potentially going on real time in the economy if you're capturing transaction information. This could be an enormous source of data on what's happening in the economy in real time. So there's quite a lot really that central banks see I think as benefits or potential advantages of a digital currency.

Liz: So finally, Andrew, what does the emergence of sovereign digital currencies mean from an international perspective? For reserve currencies like the US dollar, for instance?

Andrew Tilton: Well, there's been a lot of interest and focus on that, and many central banks are looking into developing digital currencies partly because of concerns about being too far behind in this. I think there are a couple of things we can say at this point. Most of the effort right now is focused on domestic usage of digital currencies to improve the efficiency and quality of the payment system and increase financial inclusion.

There are some potential benefits for international transactions. For example, for international remittances, individual points of transfer money from one country to another, this could potentially lower the cost of doing so. It could potentially turn out that sovereign digital currencies from a large country with a very stable currency could be favored over local currency in a place, you know, maybe an emerging market where we have a really volatile currency or a lot of inflation. But I wouldn't expect to see large-scale implications for, you know, the dollar as a reserve currency or really, you know, exchange rates or anything of that sort over the next several years.

Liz: Thanks, Andrew.