

## Could China's Digital Yuan Challenge U.S. Dollar Dominance?

By Drew Bernstein

Some China watchers have recently sounded the alarm that the digital yuan, a central bank digital currency, is poised to challenge the U.S. dollar's dominance in the global financial system.

Could China's new digital currency soon displace the dollar as the favored means of pricing commodities, powering global commerce, and banking foreign currency reserves? Might Americans someday soon have wallets full of digital yuan loaded on their smartphones?

While the promise of CBDCs is real, the U.S. dollar is unlikely to be toppled from its position as the global reserve currency anytime soon. The greatest threat to the dollar's pre-eminence would be self-defeating policies that undermine the world's confidence in America's commitment to an open financial architecture and sustainable fiscal policies.

### **What Is The Digital Yuan?**

The digital yuan, also known as the e-yuan, is a digital currency issued by the People's Bank of China. It is a digital equivalent of physical cash, enabling digital cash withdrawals, electronic transactions, and peer-to-peer transfers. As compared to existing electronic payment systems, it can create a government digital trail that follows the CBDCs wherever they go.

The Chinese government has been vigorously promoting the digital yuan within China, where it's now available in 17 provinces and 26 cities, and has amassed over 260 million users. To drive adoption, local governments and state-owned enterprises have begun paying salaries in digital yuan and even giving away small amounts of currency around holidays to spur consumers to try it out.

Digital yuan transactions leaped from 100 billion yuan in the first eight months of 2022 to 1.8 trillion yuan (about \$250 billion) in the first six months of 2023, according to the governor of China's central bank. While still a tiny fraction of China's \$3.6 trillion digital payments market, this suggests the currency may be gaining traction with domestic consumers.

The most significant competitor for wallet share is not physical cash or credit cards but China's well-entrenched digital payment duopoly, Alipay and WeChat Pay, which

collectively control 90% of digital payments. As of 2021, Alipay racked up 1.3 billion users, while WeChat Pay had 900 million. These payment platforms are embedded with the apps Chinese consumers use to navigate nearly every aspect of their daily lives.

But competing against China's central bank may pose stiff headwinds. China's government plans to introduce a universal QR code, smart contracts, and other features to tilt the playing field toward the digital yuan. Having already banned the use of cryptocurrencies, China seems poised to forcefully assert its sovereignty over the money supply.

### **Currency As The Ultimate Soft Power**

A recent research report from Deutsche Bank posited that "Geopolitics have prompted a re-evaluation of the current international financial system, and some countries may position CBDCs as a soft power tool – potentially upsetting the dominance of the US dollar and SWIFT."

China's success with the digital yuan has caught the attention of other nations seeking to modernize their financial infrastructure and position themselves as players in the digital economy. Twenty-four central banks are expected to launch some form of digital currency by 2030, according to the Bank for International Settlements. The European Central Bank and Swiss National Bank, along with India and Brazil, are all planning for pilot programs in the next few years.

In October 2022, China held a small-scale pilot of a cross-border payment platform called m-Bridge, along with the UAE Central Bank, the Hong Kong Monetary Authority, and the Bank of Thailand. According to media reports, a working version of m-Bridge may be ready for release by the end of this year, which could offer a viable alternative to SWIFT and correspondent banks.

CBDCs offer several potential advantages over physical cash, including reducing transaction costs for merchants and consumers, increasing security, preventing counterfeiting, and improving financial inclusion for those with limited access to bank accounts. But it is the potential of CBDCs to replace the dollar as the backbone of global trade that has caused concern in Washington.

The United States, as the global reserve currency, has enjoyed supplying its currency to the world. The U.S. dollar was used in 88% of foreign exchange trades in 2022, even though the country only accounts for 11% of global trade. And it makes up 60% of global foreign exchange reserves. All those dollars and dollar-denominated securities

have enabled America to finance its government debts and run a persistent trade deficit without igniting runaway inflation. The dollar's dominance provides the U.S. with a unique ability to enforce sanctions and police money laundering based on its reach over correspondent banks that power the SWIFT transfer system.

Challenging the dollar's status as a global reserve currency would require that China embrace financial liberalization, including removing capital controls, enabling full convertibility of the yuan, and reporting more transparent economic data. Despite China's large share of global trade, it seems unlikely Beijing will take the necessary steps to make its digital yuan a functional global reserve currency.

The Federal Reserve issued a white paper last year and launched a research project with the MIT Digital Currency Initiative. But Chairman Jerome Powell has clarified that launching a U.S. Digital Dollar would require congressional authorization. The issue has already become a lightning rod among those concerned about government overreach, with presidential candidates including Ron DeSantis and Robert Kennedy Jr. vowing to prohibit a digital dollar if elected.

The U.S. government would be well advised to continue exploring the potential of a CBDC to bring greater efficiency to cross-border currency transactions and global trade. The current, creaky SWIFT messaging system dates to the 1970s and can require days for transactions to clear. The new FedNOW system increases the speed of transactions but lacks some of the key features of a CBDC. If other large economies gain traction with digital currencies that can clear in seconds —either the m-Bridge or another system — the dollar's status could be at risk.

For now, the dollar's role in the global economy remains irreplaceable, based on the depth of America's capital markets, trust in its government securities and its commitment to open financial architecture. However, overly frequent use of financial sanctions as a policy tool or repeated budget brinkmanship as to whether America will honor its debts could erode that position of trust.

The greatest threat to the almighty dollar is not China's digital yuan but taking for granted the sources of the U.S. currency's strength.