Digital RMB: Assessing the benefits—and challenges—of China's new currency

Throughout last year, China reported substantial progress on its digital renminbi (RMB) and electronic payment system (DC/EP), and is now testing it in a growing number of cities. And as these new capabilities are introduced and evolve, CFOs at multinational companies (MNCs) have a leading role to play in understanding how to help capture value from them.

First, combined with the government's recent moves to regulate the country's dominant e-payment processors, the DC/EP could help MNCs make inroads into the country's large and growing e-payment market. In addition, the initiative could potentially reduce MNCs' business risks caused by the complexity and costs of both domestic and cross-border settlement.

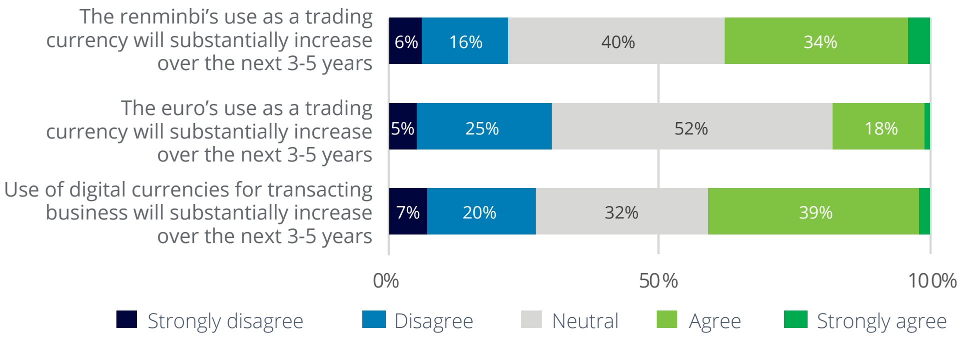
The possibilities are not lost on CFOs. In fact, in Q4 2020 *CFO Signals* report, almost 40% of respondents expect the RMB's use as a trading currency to increase, and 41% expect digital currencies for business transactions overall to rise (see Figure 1). And in this issue of *CFO Insights*, we'll discuss both the introduction and evolution of electronic payments in China, as well as the implications for MNCs going forward.

Timeline: Diversification of electronic payments

While a great deal of attention has been devoted to China's digital RMB—which will be an electronic form of money (cash in circulation) that official reports claim will eventually replace paper currency—an important implication of DC/EP for MNCs concerns changes to China's electronic payment capabilities and usage. Chief among those is greatly enhancing the ability of the People's Bank of China's (PBOC) to monitor payments and clearing data, which will strengthen its ability to fight fraud, illegal foreign exchange transactions, tax evasion, and capital flight.

China's ruling party has long focused on direct control over financial services as a major lever for economic management, with just a couple of dominant e-payment systems receiving regulatory approval and accommodating banking licenses as far back as 2011. Mobile transactions reached $49 trillion in 2019, accounting for four of every

Figure 1: How CFOs view the use of digital currencies going forward



Source: *CFO Signals*, Q4 2020, CFO Program, Deloitte LLP

five payments in China. Those licensed companies have leveraged their e-payment platforms to also become major and highly profitable providers of a broad range of financial services, most of which are linked to electronic payment systems.

Since 2017, however, rules bearing on the electronic payment systems' cash management have tightened considerably. Regulations now require financial services firms to place 100% of their money under management, including wealth management products, digital wallets, and retail float, in escrow in state-owned enterprise (SOE) banks. Moreover, in June 2018, the PBOC mandated that all third-party payments be cleared through China's NetsUnion Clearing Corporation (NUCC)—which the PBOC supervises—pulling back under state control a profitable slice of the electronic payment process and providing a new window for the government to oversee electronic payments at a highly granular level. Centralizing third-party payment settlement through NUCC took that role away from the SOE banks and their previous payment clients. The moves could mean more streamlined and transparent settlement terms and processes for all parties.

Taken together, these developments show PBOC support for private sector innovation in providing enhanced financial services to the public. According to official reports, NUCC will operate only the clearing platform, leaving electronic payment services to nonstate retailers.

Implications for MNCs: Expanded e-payment market opportunity

Centralizing and strengthening the PBOC's oversight of electronic transactions has opened the door for more MNC market participation in e-payment and related financial services. In the last year, international payment processors and card issuers made major progress tapping into China's enormous domestic e-payments market, either through PBOC-approved acquisitions of domestic payments companies or direct arrangements with the NUCC itself. CFOs and executives with treasury responsibilities should consider how this enhanced role for international payment providers might serve their growth interests in China.

In order to participate in China's growing e-payment marketplace, regulations require MNCs to use operational platforms that are separate from those they use outside China. They will also need to address four pressure points:

1. Low-cost payment services offered by existing providers mean MNCs will require efficiencies in order to compete. The two major domestic digital currency providers dominate the marketplace and have huge networks of brick-and-mortar retail and industrial outlets, as well as a dominant presence in online transaction sites.
2. Building market share will require creativity, effort, and local organizational capability.
3. To support operations, MNCs will need to make major system adjustments to comply with China's cybersecurity laws, while protecting their global intellectual property and networks from compromise or intrusion.
4. External developments are contributing considerable uncertainty. China is tightening its mainland eco-system of cybersecurity- and other internet-related regulations, while global infrastructure providers intensify competition and potentially establish 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. For example, the State Department's Clean Network project is rolling out wide-ranging constraints on digital connectivity, targeting China. Current hybrid arrangements for cross-border payments could see improvements and benefits from these new initiatives.

Potential savings; future possibilities

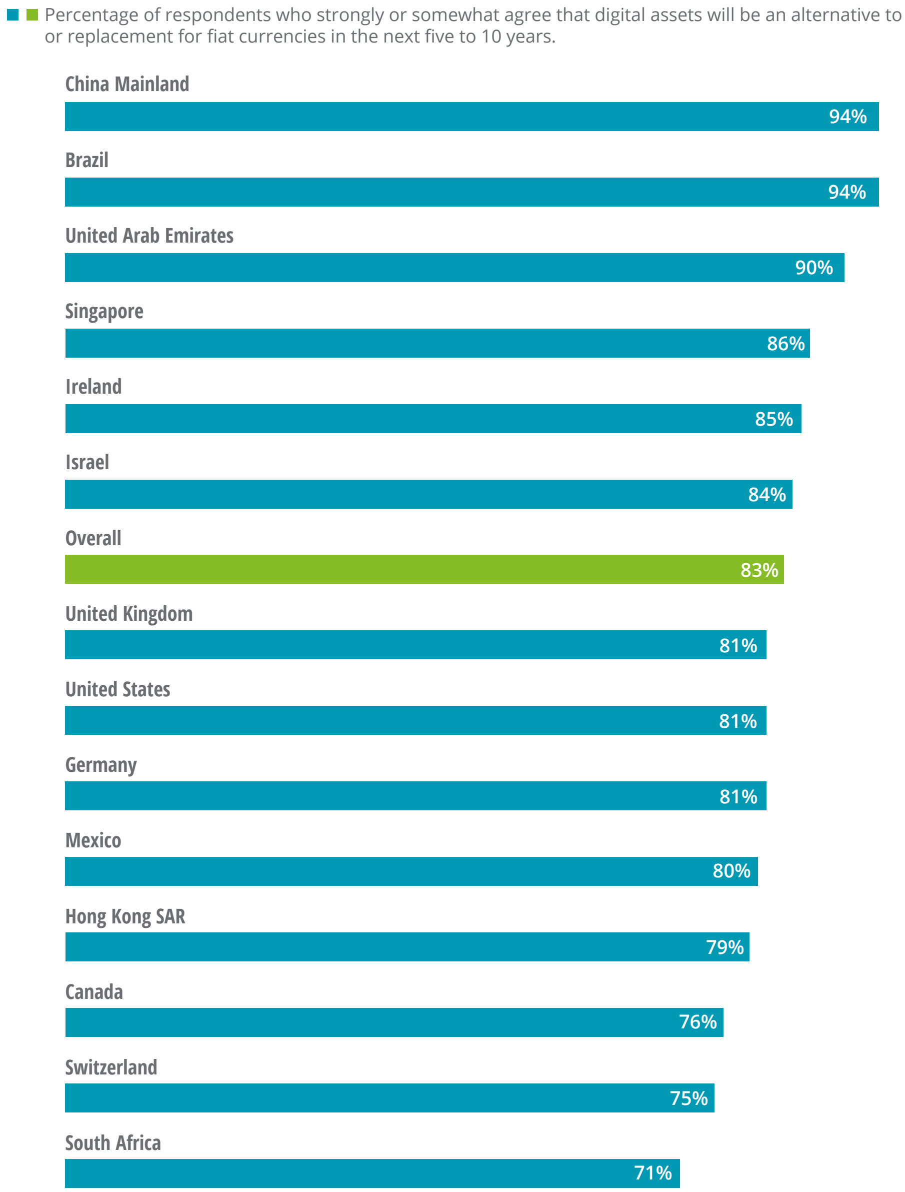
Electronic payments, potentially supported by China's extensive blockchain investments, will likely take costs out of current transfer systems. Diversification of payment options and services innovations could benefit a wide range of MNCs engaged with China, including retailers, consumer product companies, financial service companies, and even MNCs sourcing in China. Along with lower costs, expected benefits could include improved counterparty risk and payment transparency, which have traditionally created challenges for MNCs operating in China, as well as efficient transaction processing.

China's digital currency program may eventually impact currency and payments processing involving cross-border payment systems and could potentially replace the SWIFT banking payment system as a new global standard. If implementation regulations allow RMB wallets for overseas users outside of China, for example, that would enable a range of direct transfers. Overseas branches of Chinese state-owned banks are increasing services to MNCs in countries such as Cambodia, presently using SWIFT. Those developing client relationships could be easily augmented with new payment systems as they become available, giving the Chinese banks a competitive edge. (See Figure 2 for comparative data on where other countries are in digital currency investment.)

Of course, there are still hurdles along the way, many related to current capital controls and the RMB's current minor role outside China. Given the PBOC's regulatory role, however, its DC/EP initiatives could set the pace for the ongoing evolution of domestic and international payment systems that would affect or complement services of private providers, other central banks, and incumbent transfers systems. The first phase of pilots began last spring in four mainland Chinese cities and has since been expanded to nine more cities, while the cross-border rules and regulations are yet to be determined. In parallel, China's State Administration of Foreign Exchange is piloting processes for simplified foreign exchange transactions.

Figure 2: Where are digital assets being embraced?

In Deloitte's 2020 Global Blockchain Survey, China and Brazil lead the countries and regions that consider digital assets a promising alternative to or replacement for fiat currencies.



Note: N=1,488.

Source: Deloitte's 2020 Global Blockchain Survey

At the same time, there is room for caution. Direct and indirect transaction costs and contracting costs for Chinese subsidiaries are concerns for MNCs, especially for cross-border transactions. Commercial banks are using digital tools, including AI and the distributed ledger capability of blockchain, to reduce transaction and contracting costs and enter into new alliances with major MNCs to deploy the cost-reducing digital tools. With many questions remaining about how these digital technologies, central bank-backed digital currencies, and non-sovereign cryptocurrencies will interact, these moves merit careful attention on the part of executives tasked to explore emerging financial management options to manage costs in an increasingly competitive global marketplace.

China's economy: What's the view from here?

How do CFOs and economists view China going into 2021?

In his "Weekly global economic update" for January 4, 2021, Ira Kalish, Chief Global Economist of Deloitte Touche Tohmatsu Ltd., wrote: "China's economic growth continues at a healthy pace.* Consumer spending has been boosted by confidence that the virus is under control. Fixed asset investment has been helped by substantial funding for state-owned enterprises, as well as regional governments. And exports have performed well, in part owing to China's global competitiveness in technologies for which demand has accelerated during the pandemic. This includes personal protective equipment (PPE) and technologies used for remote interaction.

Yet, the strength of China's economy has come with a cost in terms of rising debt. Moreover, the government is evidently keen to avoid the kinds of financial pitfalls that often emerge when credit creation is excessive. For example, the government is allowing bad corporate debtors to default on loans and bonds rather than encouraging lenders to roll over loans. This suggests that the government wants to create a sounder financial base for the coming decade. Although a system of credit that punishes failure will eventually generate more productive investment and faster growth, in the short term, it will create disruption.

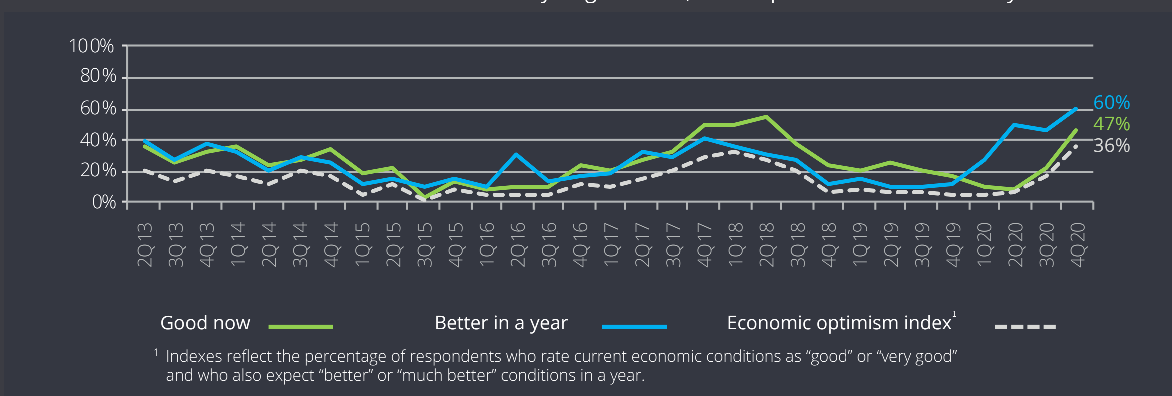
While the economic outlook for China in 2021 appears positive, one big unknown is the future of the relationship between China and the United States. With a new US administration, there is clearly potential for change. Yet the Biden team has downplayed the possibility of a swift change in US policy toward China. They prefer to first focus on domestic issues as well as solidifying political support before taking potentially unpopular actions with respect to China."

For their part, North American CFOs are more optimistic about China's economic outlook than their own. In the Q3 2020 *CFO Signals* report, for example, perceptions of China's economy exceeded those of North America for the first time, and the gap widened in Q4. In fact, in the latest survey, nearly half cite good conditions in China now, and 60% expect better conditions in a year, whereas only 18% view North American conditions as good, with 59% expecting improvement in a year (see Figure 3).

*The Chinese economy grew 2.3% last year, according the country's National Bureau of Statistics

Figure 3: How CFOs view the Chinese economy

Almost half of North American CFOs view the Chinese economy as good now; 60% expect it to be better in a year



Source: Source: *CFO Signals*, Q4 2020, CFO Program, Deloitte LLP

The combination of these new technology tools and more accommodating regulations are also likely to improve risk mitigation and capital flows. For example, automated processes are being deployed in finance to reduce transaction costs and improve key finance activities, including settlement of receivables and payables, reconciliation, forecasting, and monitoring.

The PBOC's attention to digital currencies and electronic transactions signals that the central bank itself is counting on these technology developments to expand the global relevance of the currencies under its management, as well as to enhance the appeal of its commercial global service offerings and those of China's huge, SOE banks. It will be essential for CFOs to stay on top of the many complex and fast-moving developments involving digital currencies, especially the services that major international commercial banks are developing with these new and important tools.

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