

Fintech Deep Study

Digital currency grand scheme, China and US

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The present determines the future, position makes attitude. We are now at the historical crossroad of evolving from the traditional international monetary system to the new digital currency era. Although there are many forms of existing digital currencies, their ultimate direction is not clueless. China and the United States are now in different stages regarding their currency status, development and market sentiment, which affects their approach to the digital currency reform. As a challenger to the old system, China chose to completely ban private stablecoins and took the lead in self-developed and self-built digital yuan to adapt to the advent of the digital economy. Meanwhile the United States, as a defender, is still in flux, but tends to bring private stablecoins under the existing regulatory framework, and tries to leverage the popularization of digital currency to extend the US dollar hegemony. Given their different choice of digital currency, China and the United States will chart different course in the digital economy development: China focuses on the division of labor and functionality between the public and private sectors, gives clear-cut guidance on innovation, and makes sure that the public sector takes the lead in the orderly management of the next-generation Internet infrastructure, which makes for a benign environment for the private sector to focus on technological application innovation and creation; the United States focuses on public-private "competitive coordination", believes competition nurtures innovation, and makes no strict division between public and private sectors' involvement in basic science development and technological application innovation.

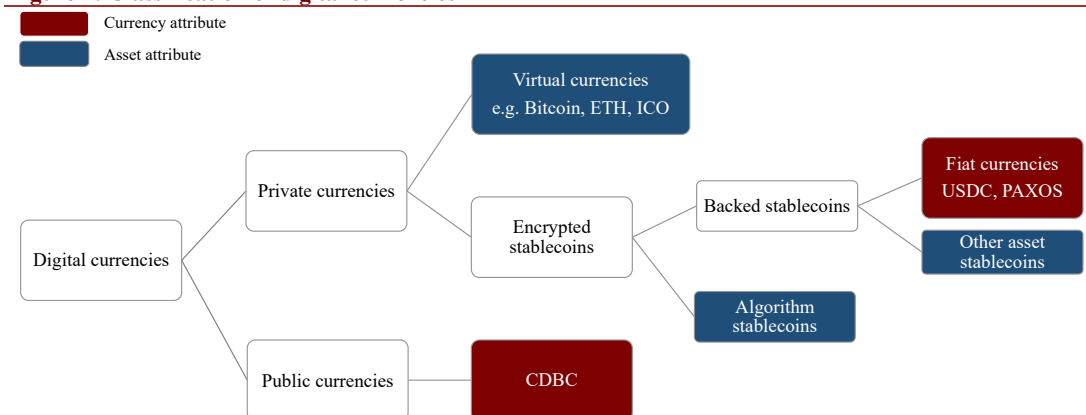
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There are two important issues in the regulation of digital currency. The first is how to regulate digital currency as an asset. Second, should digital currency as a currency be public or private, or public and private concurrently? If we want to answer these two questions, we first need to clarify the classification of digital currencies and understand which digital currencies have assets or currencies as their main attributes. As shown in Figure 1, among the various existing digital currency forms, virtual currencies, other asset-backed stable currencies and algorithmic stable currencies are more like an asset, while stable currencies backed by fiat currencies and CBDC are more like a currency. It is worth noting that, with the exception of the CBDC initiated by the central bank, other digital currencies are issued by private institutions. Virtual currencies are represented by the well-known Bitcoin and Ethereum. They create value with their own unique mechanism. The currency value fluctuates sharply, which makes it a risky speculative investment. There are three main types of stablecoins: 1) stablecoins backed by fiat currencies such as USDT, USDC and Diem pegged with the U.S. dollar at 1:1, but there are also subtle differences between them. USDT is now the US dollar stablecoin with the highest global market share. It is issued by Tether and is not regulated. Judging from the underlying asset report disclosed by it, short-term debt securities such as commercial paper accounted for nearly 50% of total asset, similar in nature to currency funds. Regulated USD stable currencies such as USDC and PAXOS mainly comprise cash equivalents in their reserve assets, thus they are more like currencies in the traditional sense; 2) stablecoins backed by other assets, including deposits and loans, bonds, stocks, commodities, and encrypted assets; and 3) algorithmic stablecoins which are more innovative and do not take any assets as collateral. It adjusts supply and demand relationship, through additional issuance, deflation, bonds, dividends and other algorithmic tools, to achieve currency stability, but at present, the core function of "value stabilization" has not been fully achieved. It can be seen that the fiat currency backed stablecoins have stronger currency attributes, while the stablecoins backed by other assets and algorithmic stablecoins have stronger asset attributes. The CBDC initiated by the central bank is a pure currency, which is exchanged 1:1 with deposit reserves or cash,

and has legal effect.

Figure 1: Classification of digital currencies



Source: ICBCI

On July 19, Yellen summoned US regulators to discuss stablecoin rules and called for the swift introduction of a stablecoin regulatory framework. In the White Paper on China's Digital Yuan Research and Development Progress recently, the People's Bank of China also highlighted many potential risks and challenges of stablecoins. It is worth noting that when it comes to regulatory supervision, China and the US target the stablecoins backed by fiat currency as defined above. Why are China and the US' regulatory bodies so concerned about stablecoins backed by fiat currencies now? We think it is mainly due to its uniqueness. Looking at the digital currencies issued by private institutions, only fiat currency-backed stablecoins have currency attributes. Compared with traditional fiat currencies, they can overcome the weakness in cross-border payments, or directly compete with public fiat currencies, which pose a series of threat to the stability of the original financial system. First, the public using stablecoins may lack proper protection. For example, USDT is often criticized for the low transparency of reserve assets. Even if it is issued to capacity, its asset composition is determined by the issuer. The reserve ratio requirements for traditional financial institutions are not applicable, which may trigger a run risk. Second, the anonymity of stablecoins creates barrier in fighting money laundering. Stablecoins allow transactions to be conducted on the basis of complete anonymity. Although it solves the data privacy problem, it will significantly increase the risk of money laundering crime. Third, stablecoins may also threaten the government's role in currency creation. Since issuers are not restricted and censored for issuing additional stablecoins, they may convert huge amount of non-cash assets into high-powered currencies, resulting in additional credit expansion.

Both China and the United States generally disapprove asset-backed digital currencies, but they are different in the regulatory strength and direction. On the one hand, they are different in the regulating the encrypted assets trading behaviour. The Prudential treatment of cryptoasset exposures issued by the Basel Committee[1] adopts the minimum standard principle, and countries can implement stricter supervision according to their own conditions. U.S. supervision meets the minimum standards of the agreement, and aims to incorporate private digital currencies into the existing financial regulatory framework. Although transactions are not excluded, they need to be reasonably supervised and included in the taxation system in accordance with the law. In January 2021, the OCC (Office of the Comptroller of the Currency) proposed to allow the National Bank of the United States and the Federal Reserve Association to use regulated public blockchains and stablecoins for settlement. Recently, the new infrastructure bill proposed by the U.S. Senate clearly requires enhanced tax enforcement on cryptocurrencies. Brokers (that is, any person who is responsible for and regularly providing any service that realizes the transfer of digital assets) are required to provide tax reports, specific to the level of the name and address of each customer, as well as detailed information about total revenue, are expected to

contribute USD 28 billion in tax revenue. Meanwhile, China adopts a more stringent regulatory approach. It completely bans domestic banking financial institutions from crypto-asset exposure to expunge the potential risks to domestic financial stability. In June 2021, the PBoC interviewed a number of banks and payment institutions on the issue of virtual currency speculative trading, and once again stressed the prohibition from providing products or services such as account opening, registration, trading, clearing, and settlement for related activities. On the other hand, China and the US are different in the crackdown on the energy-intensive crypto mining activities. Since March 2021, China's Inner Mongolia, Xinjiang, Sichuan, and Qinghai have successively proposed plans to suspend mining operations for rectification. According to Cambridge University data, China's share of global bitcoin mining activities decreased from 65% in April 2020 to 46% in April 2021. In the United States, in the new infrastructure bill, some senators proposed amendments to the definition of brokers, and tax waiver to miners and software developers.

For digital currencies with currency as the main attribute, both China and US' regulatory authorities believe that currency should be controlled by the public sector, but their public sector adopts different participation approach. In its July paper[2], the Federal Reserve mentioned that although the development of private stablecoins is unstoppable, it is not the first time in history that currencies issued by the private sector have appeared. Indeed, the current barbaric growth of stablecoins calls to mind the Free Banking Era in the United States in the 19th century. Since private currency cannot meet the public's need to pay full amount at any time, it has increased the social cost of verifying the value of the currency, and eventually vanished into history with the introduction of a series of money bills, and stablecoins will do the same. The paper also puts forward the key conclusions and comes up with two solutions to address the potential systemic risks caused by stablecoins. The first is to regulate the issuers of stablecoins and convert them into public currencies. The second is to launch a public-attributed CBDC on its own to completely replace stablecoins. At present, the digital yuan independently researched and developed by the People's Bank of China has entered the stage of public testing, which is undoubtedly the second solution. The Fed has not yet made a definitive choice, but we believe that the Fed does have reasons to adopt the first solution which promotes relatively modest improvement. As stated in the speech of the Vice Chairman of the Federal Reserve [3], the development of CBDC by the Federal Reserve is not necessarily better than the private sector, and it will also incur huge public system development costs. Currently, fiat currency stablecoins mainly peg with the US dollar. Therefore, the United States only needs to bring the US dollar stablecoins within the scope of supervision to actually control the so-called permission chain and continue the US dollar hegemony in the global economy. It is reported that in 2020, the addresses of USDC and USDT have been blocked at the request of law enforcement agencies. This shows to some extent that the United States can achieve similar effects to SWIFT financial sanctions through the regulatory supervision and control of US dollar stablecoins.

Regarding the future development path of digital currency, both China and US' regulatory authorities have made rational choices under existing conditions. China and the United States are now in different stages regarding their currency status, development and market sentiment, which affects their approach to the digital currency reform. As a result, the policies introduced by China and US' regulatory authorities in the digital currency-related areas are not fragmented, reflecting the coherence of planning based on the actual situation. As a challenger to the old system, China has undergone more radical reforms and took the lead in launching CBDC to adapt to the changes in the digital economy. The United States, as a defender, relatively lags behind in launching the digital dollar. The main goal is to first bring the US dollar stablecoin issued by the private sector under the scope of supervision. As the proverb "big picture is the extension of small details" goes, China would focus more on the division of labor and functionality between public and private sectors in the future development of digital economy, calling for the public sector to lead the orderly management of the next generation of Internet finance and computing infrastructure,

thereby laying the groundwork for the private sector to focus on business innovation in the application field. In contrast, the United States will pay more attention to public-private competition and coordination, and will not strictly distinguish the public-private cooperation model between infrastructure and innovative applications. The above two development paths have their own merits. China's natural monopoly in the field of infrastructure can ensure efficiency to the greatest extent. With a single CBDC, the innovation path in both the capital market and the real economy is clearer. While the United States follows a more open development path, which may nurture innovation in the course of natural evolution, but there may be a waste of resources in competition in the public domain that would rather be suitable for natural monopoly.

Figure 2: China and US' digital currency policy overview

| | China | US |
|---------------------------|---|--|
| Virtual currencies | <p>Full ban on encrypted asset transaction: According to the "Notice on Preventing Bitcoin Risks" issued in 2014, banks and payment institutions must earnestly perform KYC duty, and must not provide products or services such as account opening, registration, trading, clearing and settlement for related activities; in June 2021, the People's Bank of China interviewed some banks and payment institutions on the issue of providing services for virtual currency speculative trading by banks and payment institutions.</p> <p>Full ban on ICO: On September 4, 2017, the People's Bank of China, the Central Cyberspace Administration of China, the Ministry of Industry and Information Technology, the State Administration for Industry and Commerce, the China Banking Regulatory Commission, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission jointly issued the "Announcement on Preventing Token Issuance Financing Risks", officially suspending ICO</p> <p>Crackdown on energy-intensive crypto mining activities: Since 2021, Inner Mongolia, Qinghai, Sichuan and other places have successively proposed mining cleanup and rectification plans</p> | <p>Information disclosure and taxation requirements for cryptocurrency transactions: the new infrastructure act requires enhanced tax enforcement for cryptocurrencies, in which brokers (that is, any person who is responsible for and regularly providing any service that realizes the transfer of digital assets) must provide tax reports, specific to the name and address of each customer, as well as detailed information about their total revenue. It is expected to contribute USD 28 billion in tax revenue.</p> <p>Bring ICO within supervision scope: In 2017, the SEC officially announced the division of tokens into security tokens and instrument tokens, insisting that if a token is a security token, it must operate within the scope of the current securities law.</p> <p>Stay neutral on crypto mining: Senator proposed amendments to the definition of brokers, holding the view that no taxes should be levied on miners and developers.</p> |
| stablecoins | <p>Full ban on virtual currency equivalent</p> | <p>Permitted payment activities: The Office of the Comptroller of the Currency (OCC) stated that the National Bank of the United States and the Federal Reserve Association can become operating nodes of blockchain stablecoins.</p> |
| CBDC | <p>Digital yuan has entered public testing stage</p> | <p>Issuance still under discussion</p> |

Source: ICBCI

Reference:

[1] BCBS. (2021). Prudential treatment of cryptoasset exposures

[2] Gorton, G. B., & Zhang, J. (2021). Taming Wildcat Stablecoins. *Available at SSRN 3888752*.

[3] Randal K. Quarles. (2021). Parachute Pants and Central Bank Money. At the 113th Annual Utah Bankers Association Convention, Sun Valley, Idaho

[4] Chair Gary Gensler. (2021). Remarks Before the Aspen Security Forum. SEC

[5] White Paper on the R&D Progress of China's Digital Yuan, Digital Yuan R&D Working Group of the People's Bank of China, July 2021

This is a translation of our Chinese report. For details, please refer to the Chinese version.

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