GEOECONOMICS AND INDO-PACIFIC ENTERPRISE INITIATIVE
DIGITAL ASSETS FORUM

# Reimagining the power of money through digital currencies

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The international economy is beginning to fracture around the emergence of new digital assets, increased interest in a financial system less dependent on the US dollar, and the human values that these changes represent. Currencies are at the heart of the global economy as they represent a shared medium of exchange that acts as an enabler or disabler of economic relationships. Ultimately, they have the power to shape the global economy and, in turn, geopolitics. With Russia's invasion of Ukraine, unilateral U.S. sanctions, and China's ambitions to develop alternative frameworks for the global financial system, a post-SWIFT era is emerging. While the volume of international trade remains high despite recent disruptions, the rallying cry for a basket of currencies approach to dealing with debt instruments, trade, cross-border settlement, and the global economy is also increasing. Over the past century the dollar has been the center of the globalized economy, yet US allies and adversaries alike have been stepping up efforts to circumvent an American-centric system that is capable of putting holds on cross-border money transfers[1] in times of crisis.

## Challenges to the U.S. dollar's prominence

The current economic landscape is evolving rapidly with the emergence of various fiat currencies, central bank digital currencies (CBDCs), and cryptocurrencies, each of which representing a set of goals or priorities set forth by the issuing body. For instance, the U.S. dollar is seen as a symbol of globalization, while Bitcoin represents hyper-globalization with a focus on decentralization and a sprinkle of revolution. China's digital yuan, meanwhile, represents an attempt to track purchases, collect data on consumers, and disconnect a sizable portion of the global economy from the greenback. Recent developments including the global pandemic, increased discomfort with a US-centric global economy, and implementation of economic sanctions have ignited isolationist sentiment across the world, leading to the fracturing of interests, values, and leadership. If unchecked, this trend could create an economy that is based on a basket of currencies rather than one that hinges primarily on the performance of the U.S. dollar and is ultimately led by

1 **https://time.com/6153951/swift-sanctions-russia/**

Washington. At the same time, the growing pains of crypto have not deterred decentralized finance and creator economy from pursuing a privacy-based system that sometimes operates outside of the purview of governments, which explains in part the rise of Monero, Horizen, Railgun, Dash, ZCash, and other so-called privacy coins.

Most significant in the realm of CBDCs is China's continued push to implement their digital yuan that logged over $8 billion in transactions in the second half of 2021 and continued to grow throughout 2022. These advancements have still not been met with serious pushback from the international community. The digital yuan was used to log over $315,000[2] in transactions/day during the 2022 Beijing Winter Olympics, is now available to use on WeChat[3], and has a non-existent degree of anonymity since 'all phone numbers must be tied to an ID number.' Their project has also recently gained more credibility following a six week test[4], 'which ended late last month, (and was) part of m-Bridge—a project that pilots cross-border payments in digital currencies issued by central banks of China, Hong Kong, Thailand and United Arab Emirates. China's digital currency, or e-CNY, was the most issued, and actively transacted token in the $22 million pilot that used CBDCs to settle cross-border trades, a Bank of International Settlement (BIS) report showed.' This is yet another step in the Chinese effort to internationalize the Chinese digital yuan.

## The outlook for stablecoins

Stablecoins are meant to be exactly that: stable. A stablecoin is designed to maintain a fixed value over time and it is pegged to a specific government-issued currency—often the U.S. dollar. Stablecoins are used to keep assets invested in digital financial systems without converting into fiat currency, benefitting from some aspects of the market while reducing volatility. They are also a way for crypto-forward companies to complete transactions with one another without having to wait for the settlement of wire or ACH payments.

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2 **https://www.reuters.com/technology/around-300-mln-digital-yuan-used-every-day-olympics-pboc-official-says-2022-02-15/**

3 **https://www.china-briefing.com/news/china-launches-digital-yuan-app-what-you-need-to-know/**

4 **https://www.asiafinancial.com/chinese-banks-test-digital-yuan-for-cross-border-settlements**

With this expectation of stability, the crash of stablecoin Terra/Luna in early 2022 and the recent collapse of FTX have sent shockwaves across the industry, eroding credibility and decreasing overall trust in decentralized institutions and projects—$1.6 billion and up to $2 billion in losses, respectively. What made Terra's case unique was its algorithmic-calibrated peg.[5] In theory, Terra's value was supposed to be maintained via programmed smart contracts that would automatically sell or buy a "sister" coin called Luna. While Terra's approach proved vulnerable to a death spiral, it is worth noting that other stablecoins, such as USDC and Paxos, are in fact, backed by hard assets on a 1:1 basis. As noted by MoonPay, a crypto money service business, "USDC is often described as a safer stablecoin since Centre makes a greater effort to comply with audits and governmental regulation, and has more transparent, fully-backed reserves." Terra's crash will bring about further regulatory scrutiny, but stablecoins are expected to continue playing a significant role in the world of currency.

Even though it is not directly related to the viability of stablecoins writ large, it is also necessary to mention the recent fall of the FTX exchange, as well as its sister hedge fund, Alameda Research. While there is much reporting coming out now on the situation and the full details are still coming to light, FTX's collapse is a major setback for cryptocurrencies, including stablecoins. When a traumatic event like this occurs and many people lose money, trust and confidence is also lost in the underlying systems. While the concept and utility of stablecoins differs from that of a cryptocurrency like BNB token (Binance), stablecoins still require liquidity outlets that exchanges like FTX provide. The fallout from FTX's demise has been dramatic and years of trust building will be required before confidence and growth in stablecoins and crypto can return.

## The fracturing in currency markets

The network infrastructure being built in the world of cryptocurrency is more than just "magic internet money" (not to be confused with ticker MIM, Magic Internet Money). Rather, cryptocurrencies have durable value and their native

5 **https://decrypt.co/resources/what-is-terra-algorithmic-stablecoin-protocol-explained**

tokens will find a permanent place among other currencies of the world. The basket of currencies resulting from evolutions in fiat currency, stablecoins, CBDCs, popular Layer 1 networks, and some Layer 2 networks, will bring diversification to the U.S. dollar-centric world economy. While G7 economies (and other trade partners) will need to figure out how to innovate the SWIFT payments system to incorporate CBDCs[6] and increase interoperability of blockchains for cross-border transactions, their forays into the space mean that they are already exploring the benefits of this new financial technology.

As diversification in currencies occurs, the U.S. dollar will face increasing competition especially in the face of some of the recent developments in China's CBDC. This pressure is compounded with the reduction of dollar reserves in partner nations and the wavering trust in a US-centric financial system.

Authoritarian countries like China, Russia, and Iran will continue to seek ways to evade an international trade system that transacts in the U.S. dollar, which will lead to a fracturing of the current global system along ethical and value-based lines. In this new world there may be a decline in heavy trading with China amongst rules-based industrialized countries, and instead the move to a more limited and targeted collaboration with East Asia. Meanwhile, following Russian sanctions, India, the European Union, and others are conducting dollar stress tests to ensure the U.S. cannot put them in the crosshairs of strategic competition as it has done with Russia. U.S. policymakers are learning that the use of financial war has consequences and in a world with financial alternatives, even centuries-old partners may be incentivized to make a shift.

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6 **https://www.finextra.com/blogposting/23195/swift-and-cbdc-projects-successful-experiments**

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