



Task Force 8
Multilateralism and Global Governance

Policy brief

CRYPTOCURRENCIES AND STATE POWER: HARNESSING THE BENEFITS OF DLT THROUGH MULTILATERALISM

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ABSTRACT

The challenges induced by COVID-19 highlight the need for a multilateral approach towards recovery. These challenges have combined with anti-establishment sentiment towards systems of governance. Concurrently, cryptocurrencies have provided an attractive location of activity for actors who feel disenfranchised by state-led systems of governance. This paper examines the impact of this, by comparing two reactions to cryptocurrencies: the USA and how it regulates cryptocurrencies through FinCEN, and China's central bank plan to integrate cryptocurrency functions through DCEP. In a departure from other G20 PBs, this study focuses on the broader mechanisms of state governance, and its proposals focus on providing a solution to the trifecta of the pandemic, political sentiment and cryptocurrency-related challenges.



CHALLENGE

COVID-19 has exacerbated socio-economic tensions and challenges for governance. These tensions are a product of the post-Second World War Liberal International Order (LIO), where over 200 sovereign territories intersect with – but do not merge into – a transnational system. This LIO architecture captures the flow of people, money, goods and diseases, while acting as a source of tension between and within states. This sentiment is well documented in a number of scholarly works that explain how the LIO created a need to recognise “the socially spatio-temporally differentiated and geopolitically mediated trajectories of territorial state formations” (Teschke and Lacher, 2007, p. 569). Moving one step further, the notion that leading states join or sponsor developing transnational networks with strategies to ensure those networks favour their national interests (Ikenberry 2009, p. 72), is explained as a way of “controlling movement” to allow states to “construct networks to one’s own advantage across political boundaries” (Flint 2017, p. 179). It is precisely these conditions that have driven a set of anti-state and anti-central-authority sentiments that have been brought to the surface by COVID-19. These sentiments, which have taken hold against the backdrop of mixed success of state responses to the pandemic, have neatly aligned with the forces behind cryptocurrencies.

The White Paper that launched the first cryptocurrency, Bitcoin, references the need to replace the poor way in which states maintained economic stability in the wake of the Global Recession (Nakamoto 2008, p. 1). The cryptocurrency-founded solution was established through its blockchain or decentralised distributed ledger technology (DLT) infrastructure. This DLT system is designed to execute and verify transactions through “cryptographic proof”, thereby eliminating the need for mediators, such as central banks, along with their guarantees and anti-fraud measures (Nakamoto 2008, p. 1). Conceptually, therefore, cryptocurrencies have become an attractive “location” for financial activity – beyond the grasp of most states and of particular interest to people who feel politically and economically disenfranchised from and distrustful of existing state-based systems of governance that are “maintained” by central banks, financial authorities, international standards, etc. The fact that cryptocurrencies have come to life in an ambiguous context (exemplified by the ‘Satoshi Nakamoto’ alias who authored the Bitcoin White Paper) has not diminished this attraction. Indeed, James makes the point that other currencies, including some fiat currencies, came into being in an equally ambiguous context (James 2018, p. 19). Consequently, cryptocurrencies have begun to thrive both in terms of popularity and prominence. Their existence and the subsequent relocation of finance onto the DLT, however, has led to a shrinking state purview over transactions and the associated remittances. The result is a weakening of national capabilities and governance mechanisms that some states have recognised and reacted to through regulation and the adoption of DLT.

The challenge for the G20 (and beyond) is to address the sentiments represented by cryptocurrencies in state-based governance mechanisms. While this may be an oxymoron for



actors dedicated to the cryptocurrency cause (or indeed the state cause), failure to do so may lead to even more finance flowing out of state coffers. To draw out policy proposals of how to address this challenge, the following sections examine two contrasting case studies of how states have reacted to cryptocurrencies: the USA and China. This lays the groundwork for how the political and economic weight of the G20 represents a powerful forum in which to identify and implement policies that make the most out of cryptocurrency (i.e. DLT) benefits on a multilateral level. These are directly linked to multilateral institution reforms, including stakeholder perspectives, improving prospects for trade, service and investment, engaging with civil society and setting transparency targets. To do so, the burden lies with policymakers to ensure lawful DLT-induced, trust-based financial activity. This could take the form of a G20/multilateral consensus – including developing countries and non-G20 members – based on DLT that cannot be altered by a central authority. This lies somewhere between the USA's and China's reactions to cryptocurrencies, as examined in the next section. It includes options for policymakers to grapple with how trust and finance can be maintained in the COVID-19 context, to ensure a speedy and sustainable recovery.



PROPOSAL

The G20 is uniquely placed to implement policies that leverage the benefits of cryptocurrencies, in particular, the DLT's faster and more efficient transaction process. This section presents an analysis of the USA and China's responses to cryptocurrencies, to demonstrate the benefits and drawbacks of addressing the forces driving capital into the digital currency arena. There are of course other examples of policy responses both inside and outside the G20 membership. These range from Saudi Arabia's ban on cryptocurrencies for financial transactions, but increased adoption of blockchain infrastructure, including a joint venture with the UAE to launch a common digital currency project (Saudi Central Bank 2019), to Georgia's decision to encourage mining – the energy intensive activity that validates and distributes new cryptocurrencies (Rozen 2019), German legislation that does not tax cryptocurrencies when used as a form of payment, and Nigeria's ban on cryptocurrency trading through regulated financial institutions (Odunsi 2021). While we leave an analysis of these other policy responses to others, it is worth noting that they also have benefits and drawbacks from a G20 perspective. Some of these lessons are linked to how the USA and China have reacted to cryptocurrencies. In addition, Washington, DC and Beijing's practices have influenced the activity of other states in the past and are likely to do so in the future – particularly for developing states that have looked to these two centres of power for leadership and support. As such, a closer look at both the USA and China helps identify some of the characteristics that will likely make up a future international regime on cryptocurrencies. The following two sections set out these lessons and potential avenues for the future, in the context of these two G20 heavyweights.

POLICY OPTIONS 1: LESSONS FROM THE USA'S FINCEN

The USA has introduced various layers of regulation for the cryptocurrency market, which include Internal Revenue Service (IRS) tax rules, US Congress oversight over securities and the Financial Crimes Enforcement Network (FinCEN) to combat money laundering and crime financing. While the IRS and Congressional stipulations have implications for the rationale behind people who support and use cryptocurrencies, here we focus on FinCEN, as it provides a useful example for examining two particular issues relating to the digital currency arena: money laundering and crime. This analysis raises some useful points that prompt reflection on the broader impact that cryptocurrencies have on the state's ability to mitigate security threats such as organised crime, the financing of terrorist activities and the verification of sources of money.

For the USA, control over monetary instruments has been the cornerstone of Washington, DC's ability to maintain financial supremacy through its national currency. This is evidenced by the fact that the US dollar makes up just over 60% of the world's official foreign exchange reserves (IMF 2020), close to 90% of foreign exchange transactions (BIS 2019) and 40% of corporate debt (IMF 2019, p. 31). DLT therefore has the potential to shift funds away



from the dollar, thereby undermining its global financial supremacy, escaping Washington, DC's purview, and ultimately disrupting US primacy in international affairs. This is specifically recognised by the Federal Bureau of Investigation (FBI) as an acute problem in the state-led fight against fraud, crime and money laundering – as reflected in their warning against cryptocurrency scams in the wake of COVID-19 (FBI 2020).

The gravity of this sentiment is accentuated by the fact that DLTs are in a cyber attackable location – something that can also be said for conventional banking systems. For cryptocurrencies, however, one of blockchain's benefits is that the longer the chain, the more difficult it is to hack. The reverse is also true, and both scenarios can be problematic from a financial crime perspective. For example, a cyber attacker who uses cryptocurrency-based ransomware can benefit from the cryptographic defences of the DLT (Massad 2019, p. 3). This makes cryptocurrencies an attractive medium for nefarious actors, by facilitating the perpetration of criminal acts. This is evidenced by the Department of Justice's (DoJ) seizure of the cryptocurrency accounts of Al Qassam Brigades, Al Qaeda and DAISH (DoJ 2020), and is the driving force behind FinCEN's aim to "protect national security, assist law enforcement, and increase transparency while minimizing impact on responsible innovation" (Mnuchin 2020).

The resultant draw to the cryptocurrency periphery and subsequent regulation-inducing cycle has strengthened the cause of those who support and drive increased digital currency adoption. This is precisely why the G20's reforms – and those of its peers – should focus on integrating the benefits of DLT into a multilateral governance mechanism. The FinCEN type of regulatory response, while prudent for sovereignty-strengthening purposes, does little to resolve the embedded and growing anti-central-authority sentiments that are flourishing in the wake of Covid-19. The incentive for a long-term resolution that captures the best of both worlds is therefore greater, not just for the G20, but also for the USA's premier position in the international system. This of course will not be possible unless other G20 and non-G20 states join such an initiative. The contrasting Beijing response to cryptocurrencies indicates a different way in which this issue is being addressed, while further re-enforcing the above point.

POLICY OPTIONS 2: THE POTENTIAL OF CHINA'S DCEP

Beijing's position on cryptocurrencies and DLT has evolved over time. This evolution has come in a manner that is not dissimilar to how China has adjusted to and interacts with the global economic system. Since the Paramount leader of the People's Republic of China, Deng Xiaoping's 1978 'Open Door' policy proposals took hold, the country has experienced several reforms. These carefully curated reforms have focused on integrating with other states in the global economy. This has meant that China has engaged with transnational flows of capital and global governance in a manner that protects its strategic and philosophical interests, as evidenced by the policy of maintaining control over national strategic technology industries, whether at home or abroad. A similar blueprint has emerged in the cryptocurrency space.



One of the world's largest exchanges, Binance, was founded in China prior to the government's 2017 decision to ban initial coin offerings (ICOs) and close cryptocurrency exchanges (PBC 2017). In July 2020, the Beijing Arbitration Commission (BAC) clarified its position on cryptocurrencies in a paper explaining that: "the state does not prohibit Bitcoin's activities as a virtual commodity, except for the activities that Bitcoin is engaged in as legal tender and the activities specified [please see the appendix for this specified list of activities]" (BAC 2020). This amounts to a situation where China effectively legislates against international DLT activity within its borders, while simultaneously encouraging state-level blockchain activity. All this points to China benefiting from the use of DLT.

These indications followed President Xi Jinping's comments during a Politburo session in 2019 to "make the blockchain a core technology for key breakthroughs in independent innovation" (Jinping 2019). This move paved the way for the world's first Central Bank Digital Currency (CBDC) in China, known as Digital Currency Electronic Payment (DCEP). While DCEP's launch date has yet to be confirmed, it has been revealed that it will be pegged 1:1 to the yuan and will be issued by central and commercial banks. Notably, it will *not* be decentralized, i.e. outside the control of Beijing – as the cryptocurrency founders intended. For China, this ensures that it can be controlled by the central bank (People's Bank of China, PBC), guards against speculation, and will perhaps most importantly operate outside of USA-based and international payment mechanisms, such as the Clearing House Interbank Payments System (CHIPS) and Society for Worldwide Interbank Financial Telecommunication (SWIFT), respectively. The launch of DCEP is also a way of improving China's position in the global economy and, of course, consolidating Beijing's growing position in the FinTech industry (Ehrlich 2020). The former head of PBC's Digital Currency Research, Yao Qian, described the digital yuan as a global route to advancing China's role in the international system, in the same way that robotics, big data and artificial intelligence have done previously. All this has also boosted the USA's desire to implement its own equivalent in the form of a digital dollar (Kempe 2021).

Through DCEP, China has the potential to expand the reach of its monetary power more efficiently and on a global scale (owing to DLT's ability to transfer funds much faster than most existing bank-based payment systems). In addition, China's first mover advantage could pave the way for this currency class, set standards and, above all, operate outside the purview of US-based governance systems. The G20 is ideally placed to ensure that members follow a multilateral approach to the use and eventual implementation of cryptocurrencies, regardless of whether member states decide to adopt their own (or indeed opt for basket cryptocurrencies). From here, the G20 can lead the way for other non-G20 states to follow suit. This includes a range of countries that have yet to recognise or incorporate cryptocurrency-based technology (such as Algeria, Bangladesh and Egypt), as well as countries such as Venezuela, that have embraced cryptocurrency activity to the point that it accounts for a large proportion of their economy (Business Fast 2021). The key point is that an early and pre-emptive endeavour to capture the benefits of DLT has the potential to assuage some of the distrust that drove uptake of cryptocurrencies in the first place.



CONCLUSION

Our overarching recommendation lies in a coordinated G20/multilateral approach to gaining a consensus on how to designate and implement cryptocurrencies, the most effective of which should include non-G20 member states. From here, multilateral institutions can reap the trust benefits of DLT, as well as the enhanced efficiency that is built into this type of transaction. This is further driven by the fact that states have reacted to cryptocurrencies in different ways, from regulation (USA FinCEN rules) to plans for adoption (China's DCEP). There are of course benefits and drawbacks to these Washington, DC and Beijing policy blueprint options, especially in terms of addressing the tensions felt by actors who are politically and economically disenfranchised by the way states govern. It would therefore be prudent for policymakers to strike a balance between ensuring that financial activity remains lawful and integrating the benefits of DLT. An example of this could take the form of a G20/multilateral consensus-based DLT that cannot be altered by a central authority. In other words, a digital infrastructure that carries out certain functions of the state in an efficient manner that ensures trust-based accountability and thus requires no further state intervention. This is a departure from previous Policy Briefs that suggest various ways of dealing with cryptocurrencies by means of regulation. The problem with this approach is that it has the potential to further exacerbate distrust in existing governance systems and increase the attractiveness of cryptocurrencies, thus further eroding state and state-based capabilities.

This can be avoided by dedicating a G20/multilateral working group to analysing cryptocurrency trends and issues, with a view to determining a basis for consensus, comparing in-depth analyses of US and Chinese approaches to cryptocurrencies (as well as those of other states not examined in this paper, representing the full spectrum of no, partial and increasing cryptocurrency activity), analysing the benefits of DLT in terms of trust and finance, by including stakeholder perspectives, and evaluating how the benefits of DLT can be implemented within a multilateral framework. Adopting a multilateral system that incorporates the logistical and governance benefits of DLT would represent a "third way" – of neither US nor Chinese origin – of engaging with cryptocurrencies. This third way would help earn the trust of the disenfranchised and ensure that financial activities are carried out in a manner and space that is conducive to a sustainable post-pandemic recovery.



APPENDIX

The Beijing Arbitration Commission's (BAC 2020) prohibited cryptocurrency activities:

Token financing trading platforms must not engage in the exchange business between legal currency and tokens, or “virtual currencies”, and must not buy or sell tokens or as a central counterparty. “Virtual currency” shall not provide services such as pricing or information intermediary for tokens or “virtual currency”. Financial institutions and non-bank payment institutions shall not directly or indirectly provide products or services such as account opening, registration, trading, clearing and settlement for the issuance and financing of tokens and “virtual currency”, and shall not provide underwriting related to tokens and “virtual currency”. The insurance business may include tokens and “virtual currency” into the scope of insurance liability.



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