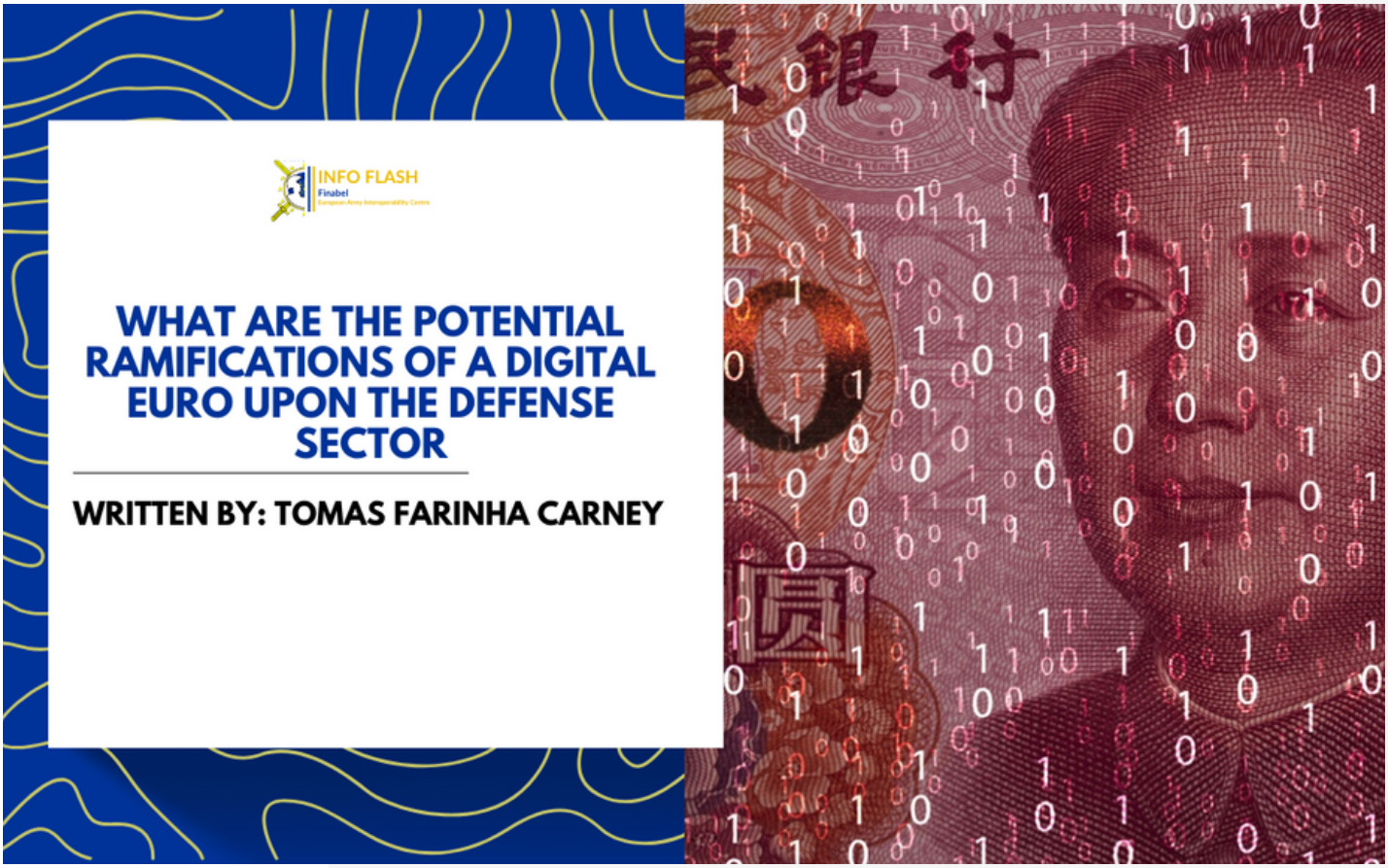
INFO FLASH
Finabel
European Army Interoperability Centre

FINABEL - THE EUROPEAN ARMY INTEROPERABILITY CENTRE

FEBRUARY 2023

# WHAT ARE THE POTENTIAL RAMIFICATIONS OF A DIGITAL EURO UPON THE DEFENSE SECTOR




**WRITTEN BY**
TOMAS FARINHA CARNEY

**EDITED BY**
JAMES EDWARD COLOMBO

**Abstract**

With China's introduction of the digital Yuan in 2021, the question of if the United States and the EU would respond with their own digital currencies has increasingly shifted to when (Areddy, 2021; Yates, 2023). Both the EU and US are already designing, debating and experimenting with their own versions of a central bank digital currency (CBDC), and could potentially launch these new currencies in the coming years (Federal Reserve Board, 2022; European Central Bank, 2022). Though the benefits and costs have been widely discussed and debated on a consumer and industry level, few discussions exist concerning the potential impacts on national defence industries within Europe. This paper will attempt to analyse and hypothesise what potential consequences and benefits the adoption of a digital euro could bring to the defence sector.

## Around the Corner, Digital Currencies

In an increasingly digital world in which technology has come to affect almost every aspect of society, it should not be surprising that central banks have become interested in digitalising their national currencies. In its most basic form, a CBDC is a digital version of a paper currency that is already issued by every central bank, with the major difference being the form of the currency and accompanying distribution ledger which identifies the currency (Birch, 2022). In many ways, this transition is already underway, with people all over the world increasingly moving away from cash towards paying through bank-issued cards or alternative digital payment platforms (England, 2022). While at first glance CBDCs may appear similar to crypto currencies, the fact that CBDCs are backed by the central banks and can be used to pay taxes, alongside the non-requirement of blockchain technology make the two currencies fundamentally different (Seth, 2022).

While it is unlikely that society will fully become cashless, the creation of CBDCs will undoubtedly help accelerate this transition by allowing safer and quicker digital payments (Georgieva, 2022). However, many questions remain concerning the form and model with which these CBDCs should be implemented, with there being various benefits and disadvantages associated with the level of involvement and control central banks would take on with these new CBDCs (Federal Reserve, 2022). This paper will not focus on this wider on-going economic and political debate but will instead focus on certain elements of the debate and the potential consequences these elements may have on the defence sector.

A crucial issue under scrutiny is the level of control that central banks would have over digital currencies in comparison to traditional forms of fiat currency. These controls range from having digital currencies with expiration dates, direct interest payments on digital currencies and even having limitations on what these digital currencies can be spent on (Hoenig & Knight, 2022). All of these new changes would represent a radical departure from the current currency regime and could hold serious implications for the defence sector, ranging from strengthening sanctions to undermining the dominance of the US dollar. However, these controls are in large part hypothetical, as outside of China all digital currencies are currently in the design and consultation phases of the legislation process (European Central Bank, 2022). Therefore, the specific level of control each central bank will hold will not be known until these proposals are finalised and passed into law. Furthermore, it's important to note that, in most preliminary discussions on digital currencies, the consensus is to keep the digital currency as close to the paper currency as possible; yet it can be argued that it is inevitable that the status quo will evolve and change (Catalini & Massari, 2021).

This can already be seen in the rollout of the digital yuan, which the Chinese central bank helped encourage the adoption of by giving temporary free digital currency to early adopters (Campbell, 2021). While an expiring currency could be a useful tool for central banks during an economic downturn, the successful implementation of this feature is living proof that currency is changing. This is especially true given the influence and size of the Chinese economy which is now rapidly and successfully adopting the digital yuan (Zhu, 2012).

What began as a small number of provinces has now spread throughout the entire country within a short period of time (Feng, 2022). Though it can be argued that the ground was already set within China due to the dominance of electronic payment providers WeChat and Alipay, the sheer speed of adoption is likely replicable, now that there is a successful existing model (Evans, 2017).

In contrast to the yuan, the digital euro and dollar are still in the proposal and consultation stages, with the digital euro being slightly closer to being implemented than the digital dollar. Unfortunately, there is limited public information on the specificities of both proposed currencies, however, from public comments, it is clear that both proposed digital currencies will be similar to the digital yuan in that they are designed to act as a digital version of their currencies(Federal Reserve, 2022). Currently, the digital euro is nearing the end of its design and consultation phase and by October 2023, the decision to launch the realisation phase will be made (European Central Bank, 2022). Meanwhile, the board of governors of the Federal Reserve have concluded their public comment stage on the preliminary discussions on the potential adoption of a digital dollar (Federal Reserve, 2022). Though it will still take some years to create and adopt these two digital currencies, the pace of these discussions arguably reflects a strong willingness on the part of central banks to create these currencies.

**The Weaponization of CBDCs**

With much of the debate surrounding CBDCs being focused on the economic implications of their adoption, it is only natural that the potential defence implications have been left by the wayside. However, given the potentially far-reaching effects of CBDCs and their likely quick adoption, it is important that military leaders begin considering the effects CBDCs have on their industry. Especially as CBDCs could both empower and weaken the current sanctions regime due to the disruption to the dollar domination and the weaponization of currency.

Perhaps the first means by which CBDCs will affect the defence sector is by increasing the weaponization of currency. It is as such also logical to assume that due to bankers already employing existing monetary tools to place serious sanctions on Russia, such measures might also be extended to digital currencies once implemented (Consilium, n.d.). Depending on the level of control that the digital currency is designed with, central banks could restrict their currencies in sanctioned countries in both specific and broad ways. For example, central banks could apply specific sanctions on targeted individuals and companies, stopping their digital currency from being spent on accounts linked to these individuals (Anthony & Michel, 2023). While on a broader scale, central banks could potentially freeze their currencies within sanctioned nations which could both prevent the utilisation of their currency by a sanctioned nation, but also limit the exchange of their currency with sanctioned currency (Rappeport, 2022).

Already, the EU and the US have targeted sanctions on Russian individuals and companies, as well as the Russian monetary system over their collective role in the invasion of Ukraine, causing the depreciation of the Russian rouble in 2022 and an economic recession that is still ongoing and that could last as long as the sanctions stay in place (BBC, 2022). With the advent of CBDCs for both of these currencies, the effects of future sanctions will likely be more impactful and severe than the current sanction regime.

Yet in many ways, the advent of digital currencies could also weaken the contemporary sanction regime (Wass, 2022). With a digital euro likely to be created before a digital dollar, the potential exists that by being the first digital hard currency, the digital euro could undermine the dominance of the dollar and the US sanction regime (Jones, 2020). While this effect would arguably be small, it would undoubtedly be compounded by the creation of other digital currencies which could allow sanctioned and illegal bodies to circumvent already existing limitations.

In many ways, digital currencies represent a double-edged sword for the present sanction regime. Whereas digital currencies would allow for better monitoring and tracing of the finances of rogue states, terrorist groups and criminal enterprises, these benefits would quickly be outweighed by the employment of other less stringent CBDCs (McLellan, 2022).

Though this trend is already occurring with sanctions groups employing crypto currencies to bypass sanctions, alternative CBDCs would remove the complexity and risks associated with cryptocurrency transactions (Reinsch & Palazzi, 2022). Additionally, as more states adopt CBDCs, the dominance of the dollar would likely decrease and allow for sanctioned groups to easily access funding through other digital currencies (McLellan, 2022). Especially as disagreements already exist between the United States and some EU member states on what groups should be classified as terrorist groups and what level of sanctions they should receive (The Economist, 2022). Already, the US has conducted war games in which North Korea used the digital yuan to build and test nuclear missiles, showcasing that the potential implications of digital currencies are far-reaching within the defence sector (De, 2019). It is therefore immensely important that the defence sector begins to prepare countermeasures for this scenario, given that it may come sooner than many expect.

Though much of this discussion is hypothetical, given that both the digital euro and dollar are in their design and consultation stage, it is important that the defence sector studies the potential effects of CBDCs and raise these concerns with their respective central bank. Though the defence sector can do little to impact the dominance of the dollar, plans should be in place to limit the damage of a weakened dollar, given that the world is increasingly multipolar. Especially as CBDCs are likely to contribute to complicate the international financial system. To be precise CBDCs will allow for greater and more effective sanctions, however, this benefit is also mitigated and hurt if sanctioned groups and countries can employ alternative CBDCs to bypass both new and old sanctions. It is for all these reasons that the defence sector should be proactive so as to limit the damage CBDCs could have, while also fully harvesting their benefits.

## References


Anthony, N., & Michel, N. (2023, January 10). Central Bank Digital Currency . Cato Institute. https://www.cato.org/briefing-paper/central-bank-digital-currency#conclusion

Areddy, J. T. (2021, April 4). China Creates Its Own Digital Currency, a First for Major Economy. Wall Street Journal. https://www.wsj.com/articles/china-creates-its-own-digital-currency-a-first-for-major-economy-11617634118

BBC. (2022, August 30). What are the sanctions on Russia and are they hurting its economy? BBC News. https://www.bbc.com/news/world-europe-60125659

Birch, D. G. W. (2022, August 3). When The CBDC Revolution Comes, It Won't Be On The Blockchain. Forbes. https://www.forbes.com/sites/davidbirch/2022/08/03/when-the-cbdc-revolution-comes-it-wont-be-on-the-blockchain/?sh=6181f71083af

Campbell, C. (2021, August 11). How China's Digital Currency Could Challenge the Dollar . TIME. https://time.com/6084146/china-digital-rmb-currency/

Catalini, C., & Massari, J. (2021, August 10). Stablecoins and the Future of Money. Harvard Business Review. https://hbr.org/2021/08/stablecoins-and-the-future-of-money

Consilium. (n.d.). EU sanctions against Russia explained. Consilium. Retrieved 1 February 2023, from https://www.consilium.europa.eu/en/policies/sanctions/restrictive-measures-against-russia-over-ukraine/sanctions-against-russia-explained/

De, N. (2019, November 20). In Wargaming Exercise, a Digital Yuan Neuters US Sanctions and North Korea Buys Nukes . CoinDesk. https://www.coindesk.com/policy/2019/11/20/in-wargaming-exercise-a-digital-yuan-neuters-us-sanctions-and-north-korea-buys-nukes/

England, J. (2022, July 18). Fintech future: How soon will the world be cashless? . FinTech Magazine. https://fintechmagazine.com/digital-payments/fintech-future-how-soon-will-the-world-be-cashless

European Central Bank. (2022). Progress on the investigation phase of a digital euro. https://www.ecb.europa.eu/paym/digital_euro/investigation/governance/shared/files/ecb.degov221221_Progress.en.pdf?f91e0b8ff8cbd6654d7e6b071a8f7071

Evans, M. (2017, April 12). How China Won The Race To Be A Mobile-First Commerce Nation. Forbes. https://www.forbes.com/sites/michelleevans1/2017/04/12/how-china-won-the-race-to-being-considered-a-mobile-first-commerce-nation/?sh=3a9dfc2c1b49

Federal Reserve. (2022). Money and Payments: The U.S. Dollar in the Age of Digital Transformation (Issue January). https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf

Feng, C. (2022, October 13). China digital currency: transactions total 100 billion yuan at end of August as uptake marred by Covid-19 curbs, slowing economy . South China Morning Post. https://www.scmp.com/tech/policy/article/3195744/china-digital-currency-transactions-total-100-billion-yuan-end-august

Georgieva, K. (2022, February 9). The Future of Money: Gearing up for Central Bank Digital Currency. International Monetary Fund. https://www.imf.org/en/News/Articles/2022/02/09/sp020922-the-future-of-money-gearing-up-for-central-bank-digital-currency

Hoenig, T., & Knight, B. (2022, May 4). Benefits, Costs, and Design Considerations of a Central Bank Digital Currency . Mercatus Center. https://www.mercatus.org/research/public-interest-comments/benefits-costs-and-design-considerations-central-bank-digital

Jones, C. (2020, September 20). Does a digital euro challenge the dollar's global dominance? . Financial Times. https://www.ft.com/content/d492ac51-5016-4f7f-b2d6-29876fb57fd0

McLellan, L. (2022, March 2). CBDC networks could defang sanction threats . OMFIF. https://www.omfif.org/2022/03/cbdc-networks-could-defang-sanction-threats/

Rappeport, A. (2022, February 28). US Escalates Sanctions With a Freeze on Russian Central Bank Assets . The New York Times. https://www.nytimes.com/2022/02/28/us/politics/us-sanctions-russia-central-bank.html

Reinsch, W. A., & Palazzi, A. L. (2022, December 20). Cryptocurrencies and U.S. Sanctions Evasion: Implications for Russia. Center for Strategic & International Studies.

Seth, S. (2022, March 19). What Is a Central Bank Digital Currency (CBDC)? Investopedia. https://www.investopedia.com/terms/c/central-bank-digital-currency-cbdc.asp

The Economist. (2022, June 28). What is the PKK? . The Economist. https://www.economist.com/the-economist-explains/2022/06/28/what-is-the-pkk

Wass, S. (2022, March 9). Slow US, Europe progress in digital currencies leaves holes in sanctions . S&P Global Market Intelligence. https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/slow-us-europe-progress-in-digital-currencies-leaves-holes-in-sanctions-70045605

Yates, T. (2023, January 16). Why central banks should not push ahead with CBDCs . Financial Times. https://www.ft.com/content/44015dbd-e28a-4be9-b690-ff309b80b890

Zhu, X. (2012). Understanding China's Growth: Past, Present, and Future. Journal of Economic Perspectives, 26(4), 103–124. https://doi.org/10.1257/JEP.26.4.103