How to Build a Great Power of Digital Finance[1]

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Abstract: *In October 2023, the Central Financial Work Conference clearly stated that "building a strong financial nation" requires significant efforts in five major areas, which includes digital finance. The development of digital finance can change the financial system in three aspects: access, efficiency, and risk control, thus contributing to the development of a strong financial nation. China has a first-mover advantage in the field of digital finance, and the development of digital finance in Singapore offers significant lessons for China to maintain its lead and build a great power of digital finance: firstly, promoting innovation to improve financial services and solve pain points; secondly, managing risks to construct a regulatory model that balances innovation incentives and risk prevention; thirdly, promoting openness and encouraging domestic digital finance enterprises to expand globally.*

To construct a normalized digital finance regulatory framework suitable for a great power of digital finance, six specific recommendations are proposed: first, establish a stable and transparent regulatory framework; second, carry out more responsive regulation; third, take the new features of digital technology into full consideration when formulating digital financial regulatory policies; fourth, create favorable hardware and software infrastructure and environment for digital finance innovation and development; fifth, promote the two-way openness of the digital finance industry; and sixth, consider establishing digital finance innovation pilot zones.

I. Building a great power of digital finance is an important part for the development of a strong financial nation

Digital finance refers to an innovative financial model that uses digital technologies like blockchain, the Internet, big data, cloud computing, and artificial intelligence to improve financial products, processes, and models. The inception of digital finance in China dated back to the end of 2004; it then entered a rapid development phase in 2013, and has developed over nearly 20 years. Looking back at its development, it's clear that many achievements have been made, but there have also been many problems left. Overall, China's digital financial innovation is at the forefront globally, being a remarkable achievement.

Recently, China's financial industry has undergone many changes, both in terms of market business and national policies. The Central Financial Work Conference clearly stated that "building a strong financial nation" requires significant efforts in five major areas which includes digital finance. The specific role of digital finance in building a strong financial nation varies from different perspectives. In my opinion, digital finance can play a role in four aspects: comprehensively strengthening regulation, improving the financial

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system, enhancing financial services, and preventing and resolving risks.

Applying digital technology to the financial sector can change financial business and services to a certain extent, but it does not change the essence of finance. The essence of finance is the integration of funds, which is achieved through the transformation of terms, scale, and risk to share profits and distribute risks. Regardless of how technology is applied, the essence of finance will not change. What technology can change are the operational characteristics of finance. For example, in traditional financial business, there is the 80/20 rule, where the top 20% of customers occupy 80% of the market share, and the remaining 80% of customers only hold 20% of the market. This makes it difficult and costly to extend financial benefits to the remaining 80% of customers, making inclusive finance challenging to advance in most countries. However, the rational application of digital technology may change this 80/20 rule, even if the difficulties in promoting inclusive finance still exist, it can significantly reduce the difficulty.

Specifically, digital technology can change the financial system in three aspects: access, efficiency, and risk control. First, the use of digital technology can help traditional financial institutions more easily reach customers. Second, the application of digital technology can improve the efficiency of financial business. Third, risk control, digital technology can help realize risk control that was difficult to achieve in the old days. Therefore, digital technology should be an important part of building a strong financial nation in China.

II. Building a Great Power of Digital Finance: Lessons from Singapore

In November 2023, our research team visited Singapore to attend a Fintech Festival and conduct research. In fact, about five or six years ago, a team of the Institute of Digital Finance at Peking University visited Singapore and other Southeast Asian countries. At that time, Singapore claimed its ambition to become an international fintech center, which some of our colleagues doubted. The two important conditions for digital finance are technology and market scale, with scale merit being a key feature of the digital economy. Considering Singapore's lack of technology and market scale, along with a population of just 4 million, it is easy to see the difficulties in excelling in digital finance. However, this research visit revealed that Singapore's fintech development has been remarkably successful. The Fintech Festival attracted 80,000 people globally, with representatives from various companies and hot discussions at the event, which was truly admirable. After attending this Fintech Festival and engaging in extensive exchanges, we gained two profound insights.

First, the most important reason why a country like Singapore, originally lacking in fintech development conditions, could become an international fintech center in just a few years, is its favorable policy environment. Singapore compensated for its disadvantages in technology and market size with a good policy environment, attracting dynamic enterprises worldwide and incubating many local businesses.

Second, Chinese digital finance companies are very popular and active in Singapore and Southeast Asia. Their business models, tested in the domestic market, are at the forefront in the international market. Of course, there have been some problems, with several risk events occurring in certain areas.

Looking back, whether digital finance business is good or bad hinges on two key factors: whether it can solve the pain points in the economy, and whether it can control risks. Both need to be met simultaneously; failing either condition leads to unsustainable business development. This raises a crucial question: how should our financial regulation be conducted?

China has shifted from special rectification to normalized regulation of platform finance. What this normalized regulation should look like for digital finance and platform finance is a matter worth pondering. If placed in the context of building a strong

financial nation, good financial regulation should achieve three things: solve pain point issues, resolve risk problems, and form a highly open financial system. Only a highly open system can be called a strong nation; otherwise, it's just a large country with decent business levels.

Therefore, the construction of a great power of digital finance relies on three key concepts.

First is innovation, improving financial services and solving pain points through innovation. Mobile payment is an excellent case of innovative solutions to economic problems. The Institute of Digital Technology at Peking University collaborated with the Brookings Institution to research on China's mobile payment, and concluded with one interesting point: China achieved great success in mobile payments, but the U.S. doesn't need it. Their argument is that payment service in the U.S. have been largely resolved, so even if mobile payment tools were introduced in the U.S., they wouldn't be as popular as in China. The reason mobile payments spread rapidly in China is that before their advent, over 90% of residents had no payment tools other than cash. That is, mobile payments addressed a pain point for Chinese residents, hence their widespread popularity. Therefore, digital finance must solve real problems through innovation and serve the real economy.

Second is regulation, managing risks through regulation and balancing the relationship between efficiency and stability. When P2P first emerged, many thought it was financial socialism because it allowed everyone to participate in the financial market. However, our research found that P2P wasn't very reliable due to the lack of effective risk management processes and means, which ultimately led to many problems. Therefore, it's essential to control risks. The current core issue is how to build a regulatory framework. Whether enterprises comply with rules and operate prudently first depends on the regulatory rules, which places high demands on regulation. The fundamental task of regulation is to seek a balance between efficiency and stability. If completely unregulated, problems arise easily; too strict, innovation may be stifled. Thus, finding this balance is a major challenge.

Third is openness, a crucial measure for a great power of digital finance. Objectively, some of China's digital finance enterprises have the potential and basis to exert international influence as they go global. Whether they can do better and exert greater influence is still worth discussion.

III. Build a normalized digital financial regulatory framework suitable for a great power of digital finance

To support the development of a great power of digital finance and contribute to China's high-quality economic development, the research group proposes the following policy recommendations based on the aforementioned considerations:

First, establish a stable and transparent regulatory framework. China's early regulatory framework was not robust enough, leading to regulatory gaps and chaos. Having digital finance included for regulation and treating them equally could help eliminate these gaps and chaos. The Central Financial Work Conference proposed five features of regulation, which is institutional, functional, behavioral, penetrating, and continuous regulation and explicitly assigned the National Financial Regulatory Administration the responsibility of comprehensive supervision, ensuring no blind spots. Additionally, the stability and transparency of regulatory rules are crucial, as unclear rules are detrimental to innovation.

Second, adopt more responsive regulation. Although regulatory policies should treat all equally, for some innovative activities, their efficiency and risks might not be clear initially, necessitating specific policy arrangements. Singapore's regulatory authorities implement a "regulatory sandbox," originally proposed by the UK, which has been effective. Our research in Singapore found that many businesses see the business environment there as favorable because they can always get a response when they want to

communicate new ideas with regulatory officials. Not just responses, but officials also discuss the pros and cons of these ideas with businesses and jointly design a “regulatory sandbox” scheme to help them advance. This arrangement is a key reason businesses are willing to incubate in Singapore. Compared with Singapore and Southeast Asian countries, China’s fintech innovation pilots could further improve in openness, flexibility, and interactivity, encouraging businesses to better implement new ideas.

Third, the formulation of digital financial regulatory policies should also fully consider the new characteristics of digital technology to address the operational changes brought by its application. For example, under digital finance conditions, traditional regulatory methods might not be sufficient to prevent risks. Previously, preventing banking risks involved reviewing reports, on-site inspections, etc., but now, with big data platforms, risks change rapidly, necessitating digital technology to assist in regulation and risk management. Additionally, under digital finance conditions, the judgment of monopolies is also somewhat controversial. The recent “Non-Bank Payment Institution Supervision and Management Regulations” draft proposed triggering warnings or presuming market dominance based on market share, which is a traditional economic mindset and unsuitable for digital age financial services. In platform and digital economies, scale merit is a key feature. If monopoly status is determined by market size, successful businesses will be penalized for becoming large, creating a paradox. Therefore, monopoly judgment must consider what businesses actually do and whether they engage in anti-market behavior.

In discussions of monopoly, the concept of competitive conditions is crucial. If a company’s market share reaches a monopolistic level, but market entry isn’t completely blocked, and other businesses or platforms can enter normally, it can’t be deemed a monopoly. For example, in 2013, an e-commerce platform held a 93% market share in China, but just a few years later, its share fell to barely sustainable levels, indicating there was no monopoly in 2013, or other e-commerce platforms couldn’t have developed.

Fourth, create a favorable infrastructure and environment for digital finance innovation and development. In the past, China’s internet development focused on consumer internet, but in the future, it may rely more on industrial internet and the Internet of Things, requiring efforts in data governance, standards, fluidity, and sharing.

Fifth, promote the two-way openness of the digital finance industry. Building a great power of digital finance involves both “bringing in” and “going out.” For digital finance, it’s particularly important to push Chinese businesses into the international market. Based on Southeast Asian experiences, Chinese digital finance companies’ domestic market experiences are valuable for international market development. Businesses that can survive in China also have the basic capacity to survive in Southeast Asia. Building on their influence in China, government departments could consider improving existing policy frameworks, promoting domestic and international policy alignment, extending and exporting digital finance services to Belt and Road countries, and even helping to formulate international digital finance regulations.

Sixth, consider designating the Shanghai Free Trade Zone, Lingang New Area, or Guangdong-Hong Kong-Macao Greater Bay Area as digital finance innovation pilot zones. If regulatory recognition can be promoted, it will be more convenient for domestic businesses to go global and foreign businesses to come in, and cross-border mobile payment development will be easier. In the pilot zones, if regulators can sign memorandums or cooperation agreements to promote mutual recognition of investment and financial services, future cooperation with other countries’ regulators will also become easier.