**Central Bank Digital Currency (CBDC) and illicit financial flows**

**Cenfri** with support from **GIZ** and in collaboration with **On Think Tanks**, is hosting a series of digital dialogues to explore issues at the intersection of digital governance, digital financial services (DFS) and the Sustainable Development Goals (SDGs) across emerging economies. The first dialogues will cover:

- Responsible deployment of AI in financial services
- Financial sector and data innovation and cybersecurity risks
- DFS for transparent supply chains
- CBDC and illicit financial flows

This note puts the spotlight on the fourth topic, namely **Central Bank Digital Currency (CBDC) and illicit financial flows**.

The last couple of years have seen cryptocurrencies and other digital currencies rise in prominence. Generally, there are two types of digital currencies: cryptocurrencies that are decentralised (with Bitcoin as the most well-known example), and private or stable cryptocurrencies that are centralised and backed by an organisation (e.g. Facebook’s Libra).

Governments are taking divergent responses to the rise in cryptocurrencies. El Salvador recently became the first country to make Bitcoin legal tender, with government accepting payment in it. Many countries are more cautious, however, with some, like Zambia and China, prohibiting any and all use of cryptocurrencies.

The reasons for caution include the fact that decentralised cryptocurrencies have limited trackability. Thus, they lend themselves to be used in illicit financial flows. Illicit financial flows are a fiscal drain on economies that extends beyond the use of cryptocurrencies. In Africa alone, it is estimated that as much as **US $1.3 trillion (1980-2018) has been lost as a result of tax evasion and illicit financial flows** enabled by slow or poor tracking of funds across different financial service providers.

CBDC poses an official, regulated alternative to cryptocurrencies that would counter the risk of illicit financial flows. It is a form of digital currency that is centralised and backed by the local central bank, making it universally accepted and fully interoperable. It is legal tender in the same way that cash would be.

**Is CBDC the right solution for the illicit financial flow risks created by cryptocurrencies and how can CBDC be implemented in emerging markets?**
In 2020, China became the first major economy to announce that it would start testing its own CBDC. A recent BIS survey found that 86% of central banks, globally, are now actively engaging in some type of CBDC work. Significantly, emerging markets represent seven out of the eight countries that are in advanced stages of CBDC work. Increasingly, CBDC is seen as inevitable for forward-looking countries rethinking the future of legal tender in a cashless world.

There are many factors for policymakers and regulators to take into account in answering these questions, including:

The real danger
What are the illicit financial flow risks from cryptocurrencies? To what extent are cryptocurrencies already used for money laundering, tax evasion and other illicit activities? How is money laundered using cryptocurrencies? Are cryptos a threat to monetary policy or sovereign status?

The upside
What are the opportunities created by CBDC? Can it enhance the value and convenience of mobile money and digital payments? How does the inherent encryption of transactions promote data privacy for consumers? How can CBDC help to reduce the danger and cost of cash, plus to recover national funds that would otherwise be lost to illicit financial flows?

The prerequisites
What basic infrastructure needs to be in place to implement CBDC? Is there a minimum level of digital payment engagement needed before the adoption of CBDC will gain traction among the population at large? What are the requirements for a digital identity system to support the implementation of CBDC? Does the legal framework offer sufficient support for data protection and cybersecurity?

The challenges
What are the challenges to implementing CBDC in emerging markets? What is the resource ask, over what time period, to investigate the scope and get the prerequisites in place?

Pursuing CBDC is a long-term game, not a quick fix. The answers to these and other questions will determine the path towards the adoption of CBDC in emerging markets, but they are by no means clear-cut. The New Nexus convening on CBDC and illicit financial flows will be bringing together researchers, development partners and regulatory and policy experts to discuss these questions, looking specifically at the scope of CBDC to counter illicit financial flows. If you are interested in exploring the topic, please contact karenk@cenfr.org.

The convening is hosted in collaboration with the Digital Frontiers Institute. Through online executive education courses and targeted research, DFI builds capabilities to prepare tomorrow’s leaders for the challenges and opportunities they will encounter in a fast-changing world. DFI will be hosting a webinar on CBDC in Africa on August 3rd. For more information, visit www.digitalfrontiersinstitute.org.