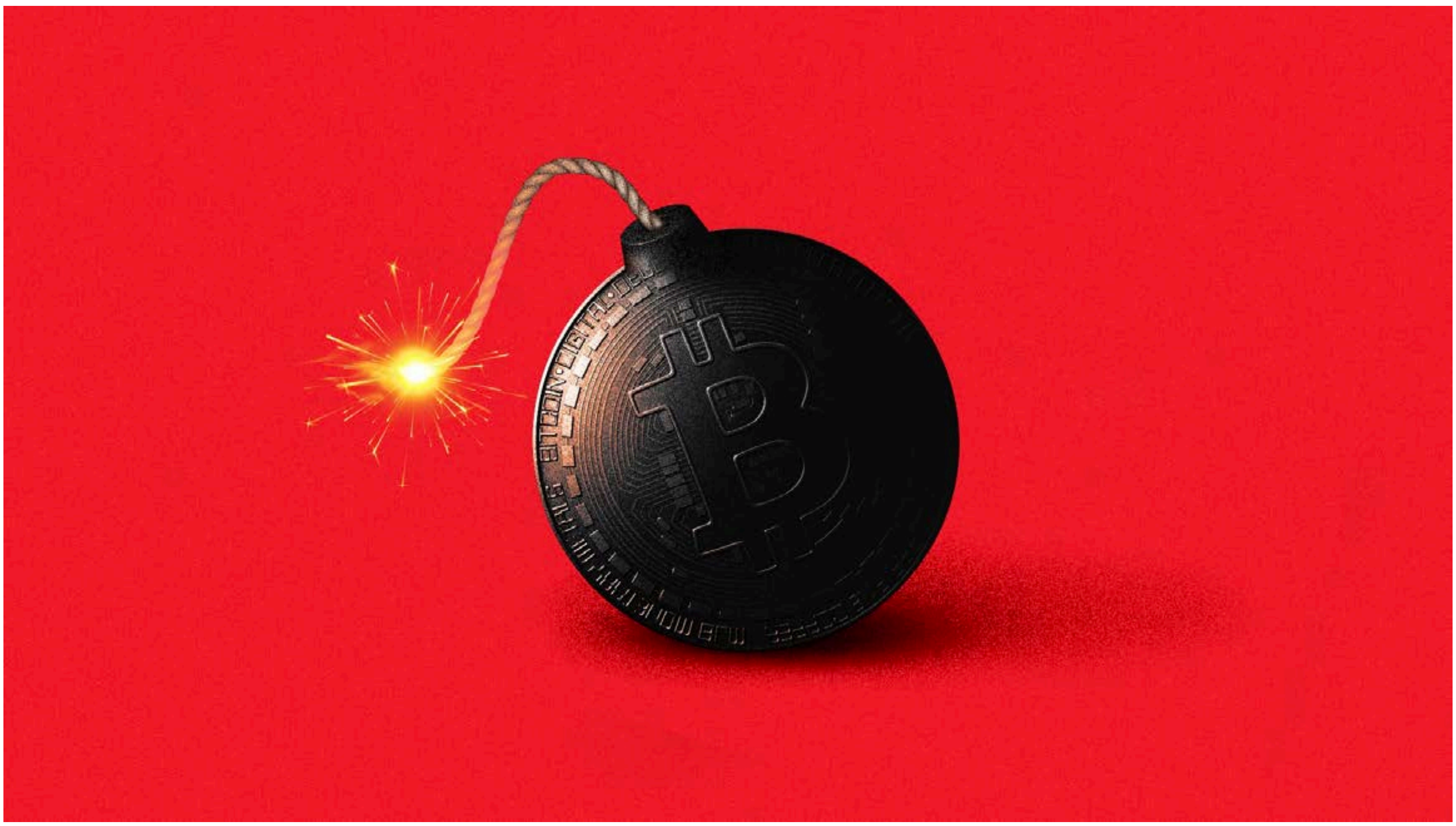
IDEAS

The Great Crypto Crash

Trump will usher in a speculative frenzy.

By Annie Lowrey



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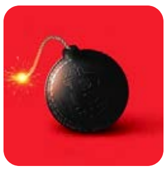

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“The countdown clock on the next catastrophic crash has already started,” Dennis Kelleher, the president of the nonprofit Better Markets, told me.

In the past few weeks, I have heard that sentiment or similar from economists, traders, Hill staffers, and government officials. The incoming Trump administration has promised to pass crypto-friendly regulations, and is likely to loosen strictures on Wall Street institutions as well.

This will bring an unheralded era of American prosperity, it argues, maintaining the country’s position as the head of the global capital markets and the heart of the global investment ecosystem. “My vision is for an America that dominates the future,” Donald Trump told a bitcoin conference in July. “I’m laying out my plan to ensure that the United States will be the crypto capital of the planet and the bitcoin superpower of the world.”

Annie Lowrey: The three pillars of the bro-economy

Financial experts expect something different. First, a boom. A big boom, maybe, with the price of bitcoin, ether, and other cryptocurrencies climbing; financial firms raking in profits; and American investors awash in newfound wealth. Second, a bust. A big bust, maybe, with firms collapsing, the government being called in to steady the markets, and plenty of Americans suffering from foreclosures and bankruptcies.

Having written about bitcoin for more than a decade—and having covered the last financial crisis and its long hangover—I have some sense of what might cause that boom and bust. Crypto assets tend to be exceedingly volatile, much more so than real estate, commodities, stocks, and bonds. Egged on by Washington, more Americans will invest in crypto. Prices will go up as cash floods in. Individuals and institutions will get wiped out when prices drop, as they inevitably will.

The experts I spoke with did not counter that narrative. But if that's all that happens, they told me, the United States and the world should count themselves lucky. The danger is not just that crypto-friendly regulation will expose millions of Americans to scams and volatility. The danger is that it will lead to an increase in leverage across the whole of the financial system. It will foster opacity, making it harder for investors to determine the riskiness of and assign prices to financial products. And it will do so at the same time as the Trump administration cuts regulations and regulators.

Crypto will become more widespread. And the conventional financial markets will come to look more like the crypto markets—wilder, less transparent, and more unpredictable, with trillion-dollar consequences extending years into the future.

"I have this worry that the next three or four years will look pretty good," Eswar Prasad, an economist at Cornell and a former International Monetary Fund official, told me. "It's what comes after, when we have to pick up the pieces from all the speculative frenzies that are going to be generated because of this administration's actions."

FOR YEARS, Washington has "waged a war on crypto and bitcoin like nobody's ever seen," Trump told crypto entrepreneurs this summer. "They target your banks. They choke off your financial services … They block ordinary

Americans from transferring money to your exchanges. They slander you as criminals." He added: "That happened to me too, because I said the election was rigged."

Trump is not wrong that crypto exists in its own parallel financial universe. Many crypto companies cannot or choose not to comply with American financial regulations, making it hard for kitchen-table investors to use their services. (The world's biggest crypto exchange, Binance, declines even to name which jurisdiction it is based in; it directs American customers to a smallish U.S. offshoot.) Companies such as Morgan Stanley and Wells Fargo tend to offer few, if any, crypto products, and tend to make minimal, if any, investments in crypto and crypto-related businesses. It's not so much that banks haven't wanted to get in on the fun. It's that regulations have prevented them from doing so, and regulators have warned them not to.

This situation has throttled the amount of money flowing into crypto. But the approach has been a wise one: It has prevented firm failures and crazy price swings from destabilizing the traditional financial system. Crypto lost $2 trillion of its $3 trillion in market capitalization in 2022, Kelleher noted. "If you had that big of a financial crash with any other asset, there would have been contagion. But there wasn't, because you had parallel systems with almost no interconnection."

Forthcoming regulation will knit the systems together. Granted, nobody knows exactly what laws Congress will pass and Trump will sign. But the Financial Innovation and Technology for the 21st Century Act, or FIT21, which passed the House before dying in the Senate last year, is a good guide. The law was the subject of intense lobbying by crypto advocates with billions on the line and cash to spend, including $170 million on the 2024 election. It amounts to an industry wish list.

FIT21 makes the Commodity Futures Trading Commission, rather than the Securities and Exchange Commission, the regulator of most crypto assets and firms and requires that the CFTC collect far less information from companies on the structure and trading of crypto products than securities firms give the SEC.

Annie Lowrey: The Black investors who were burned by Bitcoin

Beyond loose rules, financial experts anticipate loose enforcement. The CFTC predominantly oversees financial products used as hedges by businesses and traded among traders, not ones hawked to individual investors. It has roughly one-fifth the budget of the SEC, and one-seventh the staff. And in general, Washington is expected to loosen the strictures preventing traditional banks from keeping crypto on their books and preventing crypto companies from accessing the country's financial infrastructure.

According to Prasad, this regime would be a "dream" for crypto.

TRUMP AND HIS FAMILY are personally invested in crypto, and the president-elect has floated the idea of establishing a "strategic" bitcoin reserve, to preempt Chinese influence. (In reality, this would mean deploying billions of dollars of taxpayer money to soak up speculative assets with no strategic benefit to the United States.) How many Republicans will invest in crypto because Trump does? How many young people will pour money into bitcoin because his son Eric says its price is zooming toward $1 million, or because the secretary of commerce says it is the future?

Nothing being considered by Congress or the White House will reduce the inherent risks. Crypto investors will remain vulnerable to hacking, ransomware, and theft. The research group Chainalysis tallied $24.2 billion in illicit transactions in 2023 alone. And if the U.S. government invests in crypto, the incentive for countries such as Iran and North Korea to interfere in the markets would go up exponentially. Imagine China engaging in a 51 percent attack on the bitcoin blockchain, taking it over and controlling each and every transaction. The situation is a security nightmare.

Americans will be exposed to more prosaic scams and rip-offs too. The SEC has brought enforcement actions against dozens of Ponzi schemers, charlatans, and cheats, encompassing both the $32 billion sham-exchange FTX and ticky-tacky coin firms. Nobody expects the CFTC to have the muscle to do the same. And FIT21 leaves loopholes open for all kinds of scuzzy profiteering. A crypto firm might be able to run an exchange, buy and sell assets on its own behalf, and execute orders for clients—legally, at the same time, despite the conflicts of interest.

Simple volatility is the biggest risk for retail investors. Crypto coins, tokens, and currencies are "purely speculative," Prasad emphasized. "The only thing anchoring the value is investor sentiment." At least gold has industrial uses. Or, if you're betting on the price of tulip bulbs, at least you might end up with a flower.

With crypto, you might end up with nothing, or less. A large share of crypto traders borrow money to make bets. When leveraged traders lose money on their investments, their lenders—generally the exchange on which the traders are trading—require them to put up collateral. To do that, investors might have to cash out their 401(k)s. They might have to dump their bitcoin, even in a down market. If they cannot come up with the cash, the firm holding their account might liquidate or seize their assets.

A report released last month by the Office of Financial Research, a government think tank, makes clear just how dangerous this could be: Some low-income households are "using crypto gains to take out new mortgages." When crypto prices go down, those families' homes are going to be at risk.

Many individual investors do not seem to understand these perils. The Federal Deposit Insurance Corporation has had to warn the public that it does not protect crypto assets. The Financial Stability Oversight Council has raised the concern that people do not realize that crypto firms are not subject to the same oversight as banks. But if Trump is invested, how bad could it be?

Regulators and economists are not worried primarily about the damage that this new era will do to individual households, however. They are worried about chaos in the crypto markets disrupting the traditional financial system—leading to a collapse in lending and the need for the government to step in, as it did in 2008.

Where Wall Street once saw fool's gold, it now sees a gold mine. Ray Dalio of Bridgewater called crypto a "bubble" a decade ago; now he thinks it is "one hell of an invention." Larry Fink of BlackRock previously referred to bitcoin as an "index of money laundering"; today he sees it as a "legitimate financial instrument"—one his firm has already begun offering to clients, if indirectly.

Early in 2024, the SEC began allowing fund managers to sell certain crypto investments. BlackRock launched a bitcoin exchange-traded fund in November; one public retirement fund has already staked its pensioners' hard-earned cash. Barclays, Citigroup, JPMorgan, and Goldman Sachs are doing crypto deals too. Billions of traditional-finance money is flowing into the decentralized-finance markets, and billions more will as regulators allow.

Charlie Warzel: Crypto's legacy is finally clear

What could go wrong? Nothing, provided that Wall Street firms are properly accounting for the risk of these risky assets. Everything, if they are not.

Even the sturdiest-seeming instruments are dangerous. Stablecoins, for example, are crypto assets pegged to the dollar: One stablecoin is worth one dollar, making them useful as a medium of exchange, unlike bitcoin and ether. Stablecoin companies generally maintain their peg by holding one dollar's worth of super-safe assets, such as cash and Treasury bills, for every stablecoin issued.

Supposedly. In the spring of 2022, the widely used stablecoin TerraUSD collapsed, its price falling to just 23 cents. The company had been using an algorithm to keep TerraUSD's price moored; all it took was enough people pulling their money out for the stablecoin to break the buck. Tether, the world's most-traded crypto asset, claims to be fully backed by safe deposits. The U.S. government found that it was not, as of 2021; moreover, the Treasury Department is contemplating sanctioning the company behind tether for its role as a cash funnel for the "North Korean nuclear-weapons program, Mexican drug cartels, Russian arms companies, Middle Eastern terrorist groups and Chinese manufacturers of chemicals used to make fentanyl," *The Wall Street Journal* has reported. ("To suggest that Tether is somehow involved in aiding criminal actors or sidestepping sanctions is outrageous," the company responded.)

Were tether or another big stablecoin to falter, financial chaos could instantly spread beyond the crypto markets. Worried investors would dump the stablecoin, instigating "a self-fulfilling panic run," in the words of three academics who modeled this eventuality. The stablecoin issuer would dump Treasury bills and other safe assets to provide redemptions; the falling price of safe assets would affect thousands of non-crypto firms. The economists put the risk of a run on tether at 2.5 percent as of late 2021—not so stable!

Other catastrophes are easy to imagine: bank failures, exchange collapses, giant Ponzi schemes faltering. Still, the biggest risk with crypto has little to do with crypto at all.

If Congress passes FIT21 or a similar bill, it would invent a novel asset class called "digital commodities"—in essence, any financial asset managed on a decentralized blockchain. Digital commodities would be exempted from SEC oversight, as would "decentralized finance" firms. In the FIT21 bill, any firm or person can self-certify a financial product as a digital commodity, and the SEC would have only 60 days to object.

This is a loophole big enough to fit an investment bank through.

Already, Wall Street is talking up "tokenization," meaning putting assets on a programmable digital ledger. The putative justification is capital efficiency: Tokenization could make it easier to move money around. Another justification is regulatory arbitrage: Investments on a blockchain would move out of the SEC's purview, and likely be subject to fewer disclosure, reporting, accounting, tax, consumer-protection, anti-money-laundering, and capital requirements. Risk would build up in the system; the government would have fewer ways to rein firms in.

Crypto regulation could end up undermining the "broader $100 trillion capital markets," Gary Gensler, the soon-to-be-former head of the SEC and the crypto industry's enemy No. 1, has argued. "It could encourage noncompliant entities to try to choose what regulatory regimes they wish to be subjected to."

Annie Lowrey: When the Bitcoin scammers came for me

We have seen this movie before, not long ago. In 2000, shortly before leaving office, Bill Clinton signed the Commodity Futures Modernization Act. The law put strictures on derivatives traded on an exchange, but left over-the-counter derivatives unregulated. So Wall Street ginned up trillions of dollars of financial products, many backed by the income streams from home loans, and traded them over the counter. It packaged subprime loans with prime loans, obscuring a given financial instrument's real risk. Then consumers strained under rising interest rates, crummy wage growth, and climbing unemployment. The mortgage-default rate went up. Home prices fell, first in the Sun Belt and then nationwide. Investors panicked. Nobody even knew what was *in* all of those credit-default swaps and mortgage-backed securities. Nobody was sure what anything was worth. Uncertainty, opacity, leverage, and mispricing spurred the global financial crisis that caused the Great Recession.

The crypto market today is primed to become the derivatives market of the future. Were Congress and the Trump administration to do nothing—to leave the SEC as crypto's primary regulator, to require crypto companies to play by the existing rules—the chaos would remain walled off. There's no sensible justification for digital assets to be treated differently than securities, anyway. By the simple test the government has used for a century, nearly all crypto assets *are* securities. But Washington is creating loopholes, not laws.

As the crypto boosters like to say, hold on for dear life. "A lot of bankers, they're dancing in the street," Jamie Dimon of JPMorgan Chase said at a conference in Peru last year. Maybe they should be. The bankers are never the ones left holding the bag.

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Annie Lowrey is a staff writer at *The Atlantic*.

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