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GUEST ESSAY

Don't Get Fooled Again by Crypto

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Crypto appears to be on the verge of mainstream acceptance. The price of Bitcoin, the original (and still most prominent) cryptocurrency, hit an all-time high recently, while the Securities and Exchange Commission has loosened rules that make it much easier to invest in crypto. Donald Trump is vowing to make the United States "the crypto capital of the planet," and a new Republican-sponsored Senate bill demands that the Fed invest billions in bitcoin. Even Kamala Harris is reportedly more open than President Biden to crypto's potential.

All of this might suggest that the crypto world is finally putting its scandals and unsavory reputation as the playground of crooks and financial charlatans behind it. Perhaps it will finally sweep aside stodgy banks and put power back in the hands of users, delivering benefits such as easier access to basic financial products and services, more competition and improved resilience.

Or perhaps not. Politicians' newfound love of crypto probably has more to do with a cynical bid for young voter support and Silicon Valley cash than a maturing of a financially perilous set of assets. If anything, crypto today presents even greater risks to its investors and to our financial institutions than it did before. The fact that the Republican Party is publicly celebrating crypto to American voters could only make matters worse.

I am not a perennial crypto naysayer. Having written a book about digital currencies, I can tell you that Bitcoin has remarkable creative concepts and innovative technology behind it. Bitcoin and other such cryptocurrencies are in principle decentralized — which means they are not issued or managed by any institution or agency. Because the digital transactions of records are maintained on a worldwide network of computers, cryptocurrencies are in principle secure, invulnerable to manipulation by a small group and resilient to failure. As such, they should theoretically displace the need for trusted intermediaries such as commercial banks, which often use their power to limit competition and restrict broad access to financial products and services.

Unfortunately, some of these benefits have fallen by the wayside as cryptocurrencies gained in popularity and speculative forces in search of quick profits took hold. One major paradox of crypto is that there is now enormous centralization in this unregulated ecosystem. Apparently unwilling to put their full faith in a trustless technology, most users rely on cryptocurrency exchanges to hold their crypto assets and to trade them. The fraud perpetrated by Sam Bankman-Fried's FTX, in which its executives treated investor funds like a personal piggy bank, highlights this vulnerability. And the government's charges that Binance, the world's largest cryptocurrency exchange, engaged in money laundering and other forms of malfeasance show how the problems of concentrated market power can pervert the noble aims of crypto visionaries.

Despite the problems illustrated by FTX and Binance, regulation is scant and centralization remains pervasive. The process by which transactions are validated and recorded on the Bitcoin digital ledgers is controlled by a handful of major consortiums that deploy their computing power to enable this process and reap the rewards. And in other parts of the crypto world, true democracy goes only so far.

Large stakeholders have been accused of trying to manipulate rules, which are based on majority voting power, in ways that favor their interests over those of smaller players.

Moreover, it has become clear that risks could spill over from decentralized finance to traditional finance, as well as the other way around. Consider stablecoins, a highly popular type of cryptocurrency whose value is tied to the U.S. dollar, making them far more useful for payments than other, more volatile, digital currencies. Stablecoins are usually backed up by easily tradable securities such as U.S. Treasury bonds. A huge volume of redemption requests could lead a stablecoin issuer to liquidate a sizable volume of such securities, causing problems in those markets. On the flip side, the failure of Silicon Valley Bank last year caused problems for a major stablecoin issuer that had deposits in that bank.

Bitcoin, in particular, has essentially become a purely speculative financial asset, whose value seems to hinge solely on its scarcity rather than any useful purpose it serves. Its volatile value, which is evident in its wild price swings in the last few days, high transaction fees and slow processing times have rendered it ineffective as a means of payment, which was its original purpose .

But thanks to a loosening of restrictions by the Securities and Exchange Commission, retail investors, even nonprofessionals with modest savings, can now easily incorporate crypto into their portfolios via products that are offered by mainstream investment management firms. Endorsement by politicians further legitimizes crypto as an asset class. This only exposes such investors to risks they may not fully understand and that could hurt them financially.

That is not to deny progress. Other cryptocurrencies like Ethereum, which are far more energy efficient than Bitcoin and enable the processing of a large volume of transactions quickly and cheaply, are becoming more popular. And the blockchain technology at the heart of crypto is already being deployed via smart contracts, which facilitate a broad range of transactions without intermediaries and just use computer code.

Ironically, some of the greatest benefits of the blockchain technology are being reaped by the traditional banks and financial institutions that crypto was intended to replace. Among such institutions, the technology is gaining acceptance for reducing costs and making it easier to offer basic banking products and services through digital channels even to low-income households that previously were deemed too unprofitable to service. Various consortia of banks are using the technology to settle payments between their members more quickly and efficiently. Even some central banks are incorporating the technology in experiments to issue digital versions of their currencies and also to improve the efficiency and reduce the cost of cross-border payments.

At a minimum, the emergence of decentralized finance has highlighted glaring inefficiencies in traditional finance and shown how technology can help get around some of them. But crypto itself is in danger of becoming mainly an arena for speculation, financial engineering and outright fraud.

While there should be room for such innovations, we need to find a better balance of risks and benefits, with a clear regulatory framework to mitigate the risks to consumers and investors and limit spillovers to traditional financial markets.

For all its ostensible benefits, decentralized finance built around cryptocurrencies has essentially imported the fragilities of traditional finance, but with much less regulation and with many new risks. While being open to innovations that improve access to and efficiency in financial markets, users, investors and regulators ought to beware of false promises and hype. Especially if that hype comes from politicians.

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