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MARKETS | FINANCE

Bitcoin Is Failing Its First Inflation Test as Selloff Deepens

Original cryptocurrency has lost about half of its value since mid-April



Many investors agree that speculation still appears to be the main driver of bitcoin's price.

PHOTO: TOYA SARNO JORDAN/REUTERS

By [Paul Vigna](#)

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Bitcoin's steep selloff is undercutting the argument made by the digital currency's proponents that it's an inflation hedge.

The original cryptocurrency has lost about half of its value since mid-April, fizzling after a spectacular rally that saw it surge above \$60,000 from around \$7,000 at the start of 2020. It traded Wednesday afternoon at \$31,864, and got a small boost after Tesla Inc. boss Elon Musk said he has personal holdings of the cryptocurrency, as does his space company SpaceX.

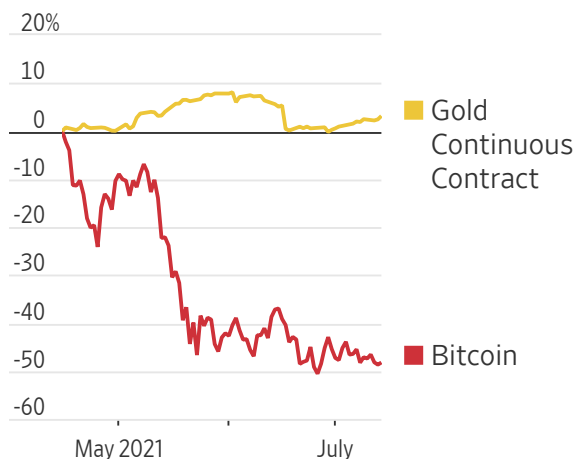
The timing is ironic.

Bitcoin's supporters for years have touted it as an inflation hedge like gold, mainly because the bitcoin network has a set limit on the number of units that can be created: 21 million. Their argument hadn't previously been tested, however,

Inflation Hedges

Bitcoin has fallen sharply as inflation has risen, while gold has gone up.

Percentage gain or loss



Sources: CoinDesk (crypto currencies); FactSet (futures)

because inflation has largely been under the Federal Reserve's 2% target since bitcoin's 2009 launch.

Now for the first time in years, shortages of semiconductors, lumber and workers are putting pressure on consumer prices, sparking worries about inflation. At the same time, governments and central banks have been forced to spend trillions to prop up their economies, potentially sapping the purchasing power of their currencies.

The consumer-price index rose to 5.4% in June, its fastest pace in 13 years. And inflation measures in 49 countries have

all been rising since the beginning of the year, according to the Center for Financial Stability, a New York-based nonprofit think tank.

Bitcoin is going in the other direction. The digital currency has fallen in five of the past seven days and is down 7.9% in July, extending its monthslong selloff. It is now up 10% in 2021.

"Bitcoin's price swings seem to be largely disconnected from macroeconomic fundamentals, including inflation," said Eswar Prasad, a professor of trade policy at Cornell University who has written extensively about currencies. "At the moment it is hard to see people buying bitcoin as an inflation hedge."

Other markets are also bucking traditional patterns during inflationary periods. Gold is down 4.8% this year and 12% from August's record. Government-bond yields have declined in recent weeks as well, suggesting investors are more concerned about slowing economic growth prospects than a surge in inflation.

Many investors have largely dismissed the gains in inflation, seeing them as skewed by short-term supply disruptions related to the reopening of the economy. Federal Reserve Chairman Jerome Powell and other policy makers have also maintained that they expect such gains to be transitory.

In bitcoin's case, scarcity itself isn't a stable source of value, Mr. Prasad said.

Bitcoin's going down...

Bitcoin's price is almost back to where it was at the start of the year.

Bitcoin priced in U.S. dollars

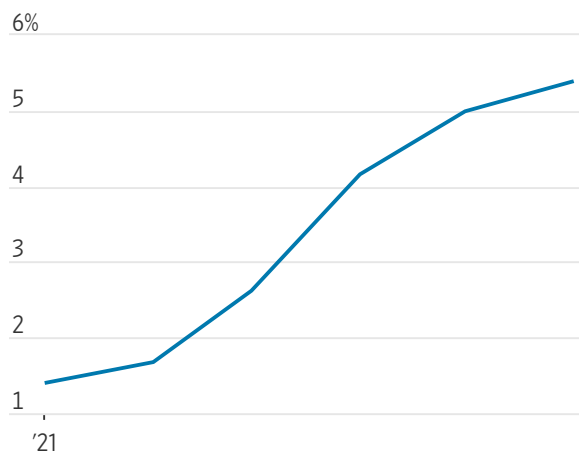


Source: CoinDesk

...While inflation's going up

Consumer prices in June rose at their fastest pace since 2008.

Consumer Price Index, percentage change from a year ago



Source: Labor Department via St. Louis Fed

Bitcoin, in fact, is more sensitive to regulatory changes and tweets from influential users than it is from inflation, he said.

“It’s a good asset if gotten at the right time as with any speculative boom,” Mr. Prasad said.

Many investors agree that speculation still appears to be the main driver of bitcoin’s price—people buy cryptocurrency because they believe they can sell it at a higher price in dollars later.

“It’s just like buying a lottery ticket,” said Leonard Kostovetsky, an assistant professor of economics at Boston College Carroll School of Management, of bitcoin. “Inflation is probably there for some people, but it’s way down the list” of reasons to buy.

The speculative drive can be seen in the volume of derivatives trading, in which traders aren’t taking physical possession of the underlying asset but are instead just betting on price. The volume of trading in the crypto derivatives market is anywhere from five to 20 times higher than the volume of spot trading on a given day, a study from Carnegie Mellon University’s CyLab research group said.

The volumes are so large that the moves in the derivatives market to a large extent have driven the overall price action, the study concluded.

“It’s very, very significant,” Kyle Soska, a postdoctoral researcher and the lead

writer on the CyLab report, said of the derivatives market. The liquidation of derivatives contracts alone can determine the price, he said, as happened in April when \$10 billion of liquidations in a single day accelerated bitcoin's selloff.

To be sure, the recent moves of both bitcoin and inflation are too brief to draw any conclusions, Mr. Kostovetsky said.

“It may be an inflation hedge some day, but not right now,” he said.

Write to Paul Vigna at paul.vigna@wsj.com

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