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Opinion Cryptocurrencies

The great crypto crisis is upon us

Any regulation needs to look at what tangible economic benefits the industry actually offers

HYUN SONG SHIN

FTX founder Sam Bankman-Fried. The collapse of FTX, and other falling dominoes in the sector, has led to much soul-searching among crypto promoters © Dante Carrer/Reuters

Hyun Song Shin DECEMBER 16 2022

The writer is economic adviser and head of research at the Bank for International Settlements

There is a bitter irony in the turmoil currently gripping the crypto universe. Crypto was born in the depths of the great financial crisis of 2008 as a backlash against the failings of the conventional financial system, with its overleveraged shadow banks and daisy chain of leverage and maturity mismatch. The original Bitcoin white paper published that same year sold a vision in which money was refashioned as a self-sustaining system of peer-to-peer transfer without the need for intermediaries. However, today's upheaval bears all the hallmarks of precisely the failings that the industry's early proponents railed against. As firms collapse and coin prices crash, the unravelling of this new daisy chain of over-leveraged shadow crypto banks is now in full flow.

While we survey the wreckage and plot a course for the policy response to rein in the sector, we need to keep in mind some key facts. Crypto operates under the banner of decentralisation, but it is highly centralised in two crucial respects.

First, many supposedly decentralised protocols turn out to be highly concentrated in terms of who actually governs and controls things. Often, it is the founder and a small number of venture capital backers that are in charge — as evidenced by the implosion of the Terra stablecoin in May. In most instances, crypto is decentralised in name only.

Second, centralised intermediaries, such as Sam Bankman-Fried's FTX, play a pivotal role as the gateway into the crypto world from the conventional financial system. They channel the flow of new investors, which is the oxygen that keeps these speculative dynamics alive. BIS research in this area has highlighted how crypto only really works when this is happening. To the extent that recruiting new investors is key to the survival of crypto, centralised intermediaries are crucial to propping up the edifice.

The current collapse of FTX, and other falling dominoes in the sector, has led to much soul-searching among crypto promoters. Predictably, we are hearing calls for the industry "to go back to its roots" and be reborn in a purer form. The vision is to turn back the clock to the days when crypto was the preserve of a small group of enthusiasts rather than something marketed as a mainstream financial product. In this vision, it would be more like a niche hobby among a small minority of followers, rather than entering our living rooms through television advertising in an effort to draw in retail investors.

This pure form of crypto, which imagines getting rid of centralised intermediaries, would have only a very small footprint. But crypto would not have grown to its current size without these entities channelling funds into the sector. Rather than standing in opposition, centralised intermediaries and crypto feed off each other. For this reason, any policy intervention now taken to mitigate crypto's impact will need to take account of this mutual dependence, as well as the role that stablecoins play as the gateway from the conventional financial system.

Some say "just let crypto burn", but the idea that it will disappear of its own accord may be wishful thinking. When financial conditions change, even a much diminished sector that is the preserve of purists could still provide the embers for the renewed entry of centralised intermediaries.

Any intervention would need to overcome one key challenge: if policy allows crypto to intertwine itself with the mainstream financial system, it will usher in something that has been avoided so far. In particular, if stablecoins are brought into the regulatory perimeter, their role as the entry point to the rest of the crypto ecosystem will need to be addressed. Policy should guard against letting them become the "cuckoo in the nest". The new standards issued by the Basel Committee on Banking Supervision on banking sector activities in crypto are a significant step in the right direction.

More generally, the approach to regulation will need to distinguish the underlying economic function of crypto from what it looks like on the surface. Even during the worst excesses of the subprime mortgage boom, the daisy chain of leverage ultimately led to real world activity — most obviously buying a house with money. Crypto, on the other hand, is largely self-referential; its activities deal with trading other types of crypto and have little reference to tangible economic activity.

Ultimately, any public policy response needs to start with a realistic assessment of the economic value that flows from blockchain technology. Blockchain's returns have been remarkably meagre considering the early hype. One after the other, projects that have explored its potential benefits have come up empty-handed.

A more promising approach is through central bank digital currencies that operate within the broader digital monetary system. This is an approach that builds on the trust embedded in central bank money, and could serve public interest in a future monetary system. The technology benefits flow to real world economic activities rather than just other types of crypto. The economic benefits of decentralisation should also be scrutinised more effectively. We are now seeing what happens when an industry rests simply on an article of faith.

Letters in response to this article:

Please let's not mix up crypto and blockchain / *From Olivier Morelle, Frankfurt, Germany*

Look beyond the domain of exchanges for crypto's real promise / *From Daniel Aronoff, Research Scientist, MIT, Cambridge, MA, US*

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