Are Central Banks Whistling Past the Crypto Graveyard?

Bill Campbell | June 2021

Many have embraced cryptocurrencies in an attempt to escape debasement of the world's fiat currencies. Crypto champions, however, are missing the supreme irony: They themselves are printing money at a rate that dwarfs the speed of the legal-tender presses of the world's central banks. This explosion in crypto "money supply" could ultimately debase crypto coinage itself and threaten consumer, credit and securities markets. The U.S. Federal Reserve and the European Central Bank have recently begun to address these risks, but they are moving at a slow inertial pace that could cost them control of the money supply.

The cryptocurrency market is expanding at an eye-popping rate. The size of the market stood at $1.63 trillion as of May 31, 2021, after reaching a record $2.4 trillion in early May from a capitalization of $200 billion about a year ago, according to estimates by CoinMarketCap. This represents a year-over-year growth rate of 735%. By comparison, the U.S. money supply, denominated of course in dollars, grew by $3.1 trillion, an increase of 18%, over a similar period (April 2020 to April 2021). As the cryptocurrency market matures, its growth rate likely will moderate, but that outcome might not remove crypto's threat to the global money supply.

Beyond the problematic size of this new market is its complexity. The United Nations recognizes 180 distinct currencies. New cryptocurrencies are launched daily, and more than 10,000 were in existence as of May 25, 2021, according to CoinMarketCap. Given that this market is still in its infancy, rapid growth remains likely for at least the next few years.

Several threats arise from the explosion in cryptocurrency values. The first is that individuals might get hurt in the crypto markets. Cryptocurrencies have exhibited high volatility. Bitcoin, for example, generated daily annualized return volatility above 70% since 2017 while the S&P 500 Index generated a volatility of about 20% for the same period. Given such volatility, calling these contracts "currencies" amounts to a dangerously misleading misnomer.

This high volatility and risk of loss of so-called crypto*currencies* should make them off-limits as forms of payment for a good or service. Would you accept shares of a stock as payment for a car or a house? Unfortunately, the crypto's masquerading as a currency, and thus a store of value, masks its true nature: that of a securitization and credit market with quasi-venture-capital risk. The blockchain technology underlying cryptocurrency has many exciting new applications such as smart contracts that enable real-time information sharing while protecting individuals' privacy. This vibrant, VC-like market holds immense promise but also poses risk of severe capital losses.

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Beyond risks to participants in the crypto market is the threat to global financial stability: the danger of non-official entities flooding the aggregate money supplies in sovereign states. Cryptocurrencies' acceptance for the purchase of goods or services would remove control of the monetary base from central banks. If cryptocurrencies are accepted as a medium of exchange this amounts to the creation of new money in the system. This will act as a currency debasement in an economy as the central bank-issued currencies lose their monopoly on the legal tender. In the U.S., U.K. and European Union, no rules govern the creation of cryptocurrencies, let alone their use. Some cryptocurrencies follow protocols to limit the amount issued. However, in theory, nothing is in place to prevent a new currency from being developed and accepted as legal tender.

Stablecoins represent another branch of this threat to the money supply. Stablecoins are cryptocurrencies used for settlement of transactions, but their value is pegged to another asset, in most cases the U.S. dollar. To lock in this link, many stablecoins are backed by collateral. Some of this collateral, however, is invested outside of the U.S. dollar or U.S. Treasury bills, relatively safe assets, at least for dollar-domiciled participants. In some cases, stablecoins are collateralized by other cryptocurrencies!

Until now, the only form of legal tender have been the currencies issued by central banks. This monopoly gives the central banks and other monetary authorities an effective tool to help influence credit creation, economic growth and consumer and producer prices. If central banks lose control of the monetary base, inflation, asset bubbles and excess credit are all likely to build in the economy. El Salvador earlier this month became the first sovereign state to surrender its monetary monopoly: the Salvadoran congress voted to approve a bill submitted by President Nayib Bukele, recognizing bitcoin as legal tender. Notwithstanding the small size of this country of 6.5 million people, El Salvador's embrace of a cryptocurrency sets a dangerous precedent. At the other extreme, China has banned the acceptance of cryptocurrencies for any transaction within its jurisdiction.

An entire ecosystem of new currencies is being built on top of blockchain, a powerful technology that has created rapid innovations in the financial and healthcare fields. For investors, this new "market" holds alluring promise on par with the internet in the late 1990s. I oppose a blanket ban on this powerful and potentially transformative technology. Instead, I think serious participants in these markets, business leaders and financial authorities should set the rules of the road for its development and legitimate uses. Soon. Let's not wait for yet another catastrophe to happen in the wake of inattention and complacency and then over-regulate later. ■

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Mr. Campbell joined DoubleLine in 2013. He is a Portfolio Manager for the DoubleLine Global Bond Strategy and is a permanent member of the Fixed Income Asset Allocation Committee. He covers developed markets, Central and Eastern Europe, the Middle East and Africa (CEEMEA) and China. Prior to DoubleLine, Mr. Campbell worked for Peridiem Global Investors as a Global Fixed Income Research Analyst and Portfolio Manager. Prior to Peridiem, he spent over five years with Nuveen Investment Management Co., first as a Quantitative Analyst in its Risk Management and Portfolio Construction Group, then as a Vice President in its Taxable Fixed Income Group. Mr. Campbell also worked at John Hancock Financial as an Investment Analyst. He holds a B.S. in Business Economics and International Business, and a B.A. in English from Pennsylvania State University. Mr. Campbell holds an M.A. in Mathematics with a focus on Mathematical Finance from Boston University.

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