

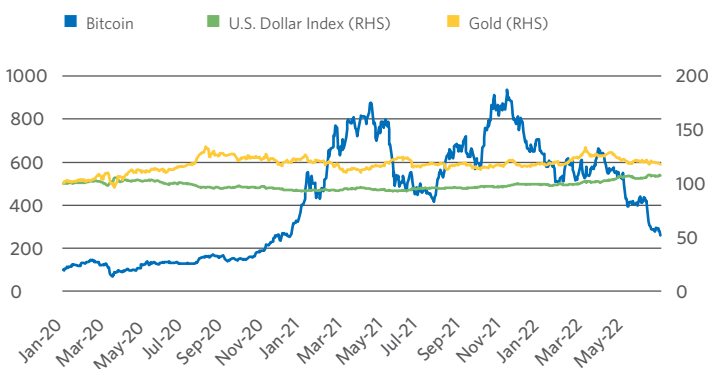
Crypto – Innovation Catalyst?

Crypto markets are in turmoil. Cryptocurrencies have crashed, some losing as much as 90%. Bitcoin, a prominent cryptocurrency, has fallen over 70% relative to the U.S. dollar since its peak in November 2021, a period in which both the dollar and gold have enjoyed steady gains (Exhibit 1). Terra, a stablecoin designed to be pegged to the U.S. dollar and its sister coin Luna have fallen to essentially zero, destroying \$60 billion in value. Celsius, a prominent crypto lender, and Voyager, a large crypto brokerage, have frozen user accounts and filed for bankruptcy. And crypto hedge fund Three Arrows Capital has defaulted on its obligations, spreading instability throughout a deeply interconnected and opaque market. This Investment Brief considers whether new technologies capable of revolutionizing financial markets might emerge from the crucible of the present tumult.

EXHIBIT 1:

Bitcoin's Steep Decline Roils Crypto Markets

Source: Bloomberg. Index January 1, 2020 = 100.



Nascent Innovations of Crypto Markets

Decentralized finance is a fledgling alternative financial market that operates using crypto assets based on distributed ledger technology that records transactions in a way that is transparent, secure, and available to all market participants. The main building blocks of decentralized finance include stablecoins, cryptocurrencies pegged to a fiat currency, and smart contracts, software programs that execute transactions automatically once certain conditions are met.

Innovations based on these technologies have the potential to allow the bundling of multiple transactions through tokenization, speed the execution of transactions through instantaneous (“atomic”) settlement, streamline the recording of trades, and eliminate the need for the intervention of financial intermediaries. Assets, including stocks, bonds, or even real assets, could be bundled in tokens, and transferred by exchanging tokens rather than traditional book entry records. The successful tokenization of real estate transactions would,

for example, eliminate the cumbersome process of transferring deeds and title to record changes in ownership. The innovations of crypto markets could also streamline back-office functions, provide more efficient structures for securitized products, and allow seamless and instantaneous international transfers. Besides obviating the need for intermediaries, conditional atomic settlement using smart contracts would virtually eliminate settlement risk and the need for collateral.

Structural Weaknesses of Crypto Markets

Money is the ultimate network. The more people who trust and use a particular form of money, the greater its value to society as a means of exchange, a store of value and unit of account. Efficient market-based resource allocation and price discovery depend on a single unit of account to permit the easy comparison of the prices of different goods and services.

Cryptocurrencies, in their present form, have negative network effects because of their decentralized, consensus-based process to validate the legitimacy of trades. As transaction volume increases, so do their costs and the time needed for execution. Congestion in turn leads to fragmentation, a process which partly accounts for the proliferation of cryptocurrencies, which now number over 19,000. In addition, crypto markets are lightly and unevenly regulated. There are few investor protections, no regulatory capital requirements, uneven auditing requirements, and no tradition of evolving best risk practices. Past financial crises have amply demonstrated the perils of banking with no regulatory reserve requirements, no lender of last resort, and no deposit insurance.

Central Bank Vision of Future of Finance

The central bank vision of how best to harness the promising innovations of crypto markets is diametrically opposed to the original libertarian vision of a financial world without central intermediation. Global central banks are developing central bank digital currencies – the equivalent of digital cash – that would be used as the basis for national financial systems. Using CBDCs, central banks would manage wholesale settlements and permit trusted intermediaries to manage retail fast payment systems as well as platforms designed to facilitate the interoperability of systems used to provide financial services. Building the financial system on the foundation of a CBDC would solve the problem of negative network effects and fragmentation now evident in crypto markets, while allowing experimentation by the private sector to apply the tools of crypto markets to develop new and more efficient financial services and payment systems. The present ferment in crypto markets could well be the catalyst for a revolution in the stodgy world of central banking and traditional finance.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.