

Crypto mania, financial contagion, and the ‘Goldilocks zone’

Beware falling for the ‘first-version trap’ – but also take care to avoid the dangers of unbridled speculation. **BY TOBIAS SEBASTIAN LIM**

FROM the gold fever of the 1840s and 1850s and the bicycle bubbles of the 1890s, to the bowling manias of the 1960s and the dot-com boom of the 1990s and early 2000s, our animal spirits are forever in search of greener pastures.

In recent times, the financial herd has stampeded into the field of cryptocurrency. In a Statista Global Consumer Survey early last year, 6 per cent of US respondents said they had purchased or traded cryptocurrencies in the previous 12 months. Respondents in Peru, Turkey, the Philippines and Vietnam entered the crypto market at much higher rates, from 16-21 per cent.

In Central America, El Salvador has made bitcoin legal tender and plans to develop “Bitcoin City” at the base of the Conchagua volcano. The International Monetary Fund has warned El Salvador against this course.

Digital currency has achieved remarkable legitimacy in the minds of the masses, the media and the markets. But not everyone buys the “techno-babble”, as Paul Krugman calls it. “Cryptocurrencies play almost no role in normal economic activity,” he writes. And investors

like Charlie Munger have been rather evocative in their criticism.

A key element of behavioural finance that we need to appreciate, however, is that perceived value is contagious. I may not believe in the aesthetic appeal of diamonds, for example, but I cannot ignore its psychological value in the imagination of others.

True, crypto ostensibly does have some economic value. The promise of blockchain technology – security, transparency, efficiency, traceability and automation – has been discussed at length.

For this reason, crypto non-believers should be wary of what former Intel chief executive Andy Grove calls the “trap of the first version”.

Think, for instance, of Apple’s handheld Newton devices in the early 1990s. There were legions of naysayers, and it became something of a boondoggle. But it was not the end of the digital handheld device. Sometimes, it can take generations for technology to realise its early promise and transform the landscape.

The crypto faithfuls, on the other hand, must beware the siren song of speculation. Irrational exuberance, natural Ponzi processes

and fear of missing out (Fomo) can generate a lot of recklessness. Just as it may take generations for a truly transformative technology to achieve critical mass, poor investments and outright scams can survive for decades before the bottom falls out; just look at Bernie Madoff.

What’s more, bad behaviour tends to fester where capital is most unfettered. One study found that around 1 in 4 bitcoin users and 46 per cent of bitcoin transactions are associated with illegal activity. This adds up to US\$76 billion in shady transactions.

Just as salient are the risks of financial contagion. Before the global financial crisis, in 2006, US sub-prime originations totalled US\$600 billion, or less than a quarter of the US mortgage market. Few imagined that that failure was possible, or that such failure would threaten the entire financial order.

As Ben S Bernanke, Timothy M Geithner, and Henry M Paulson, Jr, write in *Firefighting: The Financial Crisis and Its Lessons*, experts underestimated the dangers of an interconnected, overleveraged system, and of the potential for an E coli effect: the financial equivalent of a case of food poisoning at a local burger joint leading to a nationwide aversion to fast food.

The crisis of confidence was so visceral that even well-capitalised titans such as Berkshire Hathaway, in Warren Buffett’s words, stared “into the abyss”.



New instruments such as bitcoin bonds and crypto exchange-traded funds are making the rounds. And if the dot-com and sub-prime bubbles are any guide, we can expect opaque, complex and leveraged innovations and financial engineering to follow. PHOTO: REUTERS

Similar risks may apply today in the crypto world. As at this writing, the global market capitalisation of cryptocurrencies is north of US\$1.7 trillion. Gold’s market capitalisation, by comparison, is around US\$12.5 trillion.

Crypto’s market capitalisation is not an insignificant sum. A cocktail of housing debt, speculative assets, extended economic shock and a contagious panic could generate the perfect storm. We should not think about speculative markets reactively and in isolation from the real economy.

These tail risks, however, will not stop the music. Today, many

households are entrusting their hard-earned savings to digital coins. JPMorgan Chase, for example, is increasing its clients’ access to crypto funds, even as the firm’s chief executive Jamie Dimon describes bitcoin as “worthless”.

New instruments such as bitcoin bonds and crypto exchange-traded funds are making the rounds. And if the dot-com and sub-prime bubbles are any guide, we can expect opaque, complex and leveraged innovations and financial engineering to follow. Animal spirits set the stage for both rational speculation and swarming incompetence.

Similarly, George Soros describes how fallibility, reflexivity and positive feedback loops can push valuations into far-from-equilibrium territory. Narratives, expectations and prices will adjust, of course, as confirming and disconfirming evidence comes to light. Crypto will face this test too. At some point in time, it will have to prove its economic worth.

Until then, there seems to be a ‘Goldilocks zone’ of confidence and expectations. We do not want to fall for the first-version trap and reject every worthwhile risk that comes about. But we also have to avoid the dangers of unbridled speculation. We forget that even temporary failures in bloated markets can spread and endanger the broader system.

Of course, governments and institutions will play some role in stability and temperature control. But financial history tells us – whether due to bureaucracy, inertia, libertarian ideals, or some combination thereof – they will probably be late to the dance.

Either way, crypto will make for a fascinating case study in the annals of financial history, whether it ends up being the 21st-century equivalent of tulip mania, or a truly future-defining and lucrative innovation.

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