

INSIGHTS FROM CFA SOCIETY SINGAPORE

The alchemist's paradox, central bank sovereignty and the fate of crypto



MARK J HIGGINS

CRYPTOCURRENCY exchange FTX filed for bankruptcy on Nov 11, as Sam Bankman-Fried's estimated net worth plummeted from US\$16 billion to roughly zero.

While I've always been a crypto sceptic, I tempered my opinion because I did not understand the technical underpinnings or fully grasp the broad-use cases. This led me to discount what was obvious: that the crypto craze had all the signs of a speculative bubble, and that cryptocurrencies fulfilled none of the critical requirements needed to replace major currencies or serve as "digital gold".

Whatever the value of the technical innovation that minted them, cryptocurrencies suffer from two major and insoluble problems that make it extremely doubtful they would ever supplant fiat currencies or be used as an underlying commodity to which the value of a

currency is pegged.

Problem 1: The alchemist's paradox

One of the keys to crypto's value proposition is the concept of supply constraint. According to their proponents, cryptocurrencies cannot be minted ad infinitum the way paper currencies ostensibly can.

Each cryptocurrency can supposedly be reined in by programmatic constraints that prevent arbitrary increase in supply and preserve a cryptocurrency's scarcity value.

This sounds great in theory, but it only applies to single cryptocurrencies. Because crypto technology is so easily replicated, nothing prevents entrepreneurs from launching new cryptocurrencies. Which is precisely why there are now roughly 12,000 varieties circulating in cyberspace.

This is the same problem ancient alchemists would have encountered had they discovered how to create gold out of lesser elements. Once the secret was out – and it would get out – gold would lose its scarcity value and no longer serve as a reliable store of value. The same rule applies to cryptocurrencies. The technology that gave

rise to Bitcoin was novel, but other cryptocurrencies have since emulated it. This distinct lack of supply constraint has made cryptocurrencies, in aggregate, a poor store of value.

Problem 2: Central bank sovereignty

The next hurdle to broad cryptocurrency adoption is the central banks. They must accept cryptocurrencies as a viable form of reserves.

For that to happen, they would first need to abandon the current system of fiat currencies that most employ and re-peg their currencies to some other commodity.

No major central bank is likely to do this willingly and, contrary to popular belief, for good reason. Doing so would significantly reduce their ability to adjust the money supply in response to financial crises.

It was precisely this constraint under the gold standard that prolonged the Great Depression in the 1930s and caused repeated panics and depressions throughout the 1800s and early 1900s. Central bankers will not voluntarily reintroduce this structural weakness into their financial systems.

Second, even if central banks retired fiat currencies, they would have to determine that a cryptocurrency, rather than gold, silver, or something else, was the best commodity to link their currency to. In what sort of scenario would any major central bank willingly harness its currency to something over which it could exercise no control of the supply? At least with gold, the supply is limited by formidable natural constraints.

The last time a major sovereign country relinquished control over its money supply to my knowledge was in early 18th century France, when the regent for Louis XV handed the money supply, tax collection system, and control of Mississippi Company shares to John Law.

The Mississippi Bubble that followed decimated the French economy and reverberated for the remainder of the century. Louis XV suffered a tremendous loss of wealth, and his successor, Louis XVI, lost his life. This is not something central bankers would dare repeat.

Relegation to the shadows of finance

Without broad-based central bank acceptance, cryptocurrencies will



Cryptocurrencies' supposed supply constraint is key to their value proposition. But crypto technology is so easily replicated; there are now around 12,000 varieties. PHOTO: PIXABAY

be permanently exiled to the fringes of the financial markets.

The black market, failed or failing nation states, and the 24-hour casinos run by FTX-like firms may find limited use cases.

But even if these are viable, we can only guess how large the potential market might be and which or how many cryptocurrencies will emerge as viable mediums – which makes buying and selling them no more than speculation.

What's worse, those who play this game will need to accept the risk of bank runs, bank robberies, and fraud without the protections of a well-regulated banking system.

For those who made their fortunes in this shadowy market, I bear no ill will. Every bubble has its share of winners.

But those looking to make crypto fortunes should be aware that there are more Bankman-Frieds lurking in the shadows.

Whether or when they divulge the real value of their assets – or steal yours – is anybody's guess.

The writer, CFA, CFP, is an author and financial historian. His work draws from his upcoming book, *Becoming an Enlightened Investor*, which will arrive in bookstores in autumn 2023.