

– FACT SHEET –

Cryptocurrencies: The Next Big Thing or the Next Goldrush?

March 9, 2022

Introduction

Over the last few years, cryptocurrencies—or digital currencies—have moved from being an obscure, skeptically-viewed theoretical side project to an asset pitched to Main Street households, capturing headlines, public dialogue, and the interest of major tech corporations. Facebook tried to launch its own digital currency. The House Financial Services Committee has held several hearings on cryptocurrencies. Ads during the Super Bowl included several for cryptocurrency-related businesses including large exchanges that have sprung up and publicly listed. And many celebrities and sports stars including Kim Kardashian, Tom Brady, and Larry David have signed on as part of the massive promotional campaign to increase the investment in and usage of cryptocurrencies.

Why all the attention? Is this something real or just a modern-day gold rush that will end in crushed dreams and lost money? Proponents of these digital assets argue that they offer a reasonable alternative to the “traditional” financial system, one that is not bogged down by middlemen and instead is controlled by its users rather than faceless corporations. In their idealized version of a digital financial ecosystem, there is universal access to financial products and services at low costs to consumers accompanied by a ruthlessly effective “self-policing” system of consumer protection. Critics argue that this idealized system is far from the reality and that—broadly speaking—cryptocurrencies provide little to no additional benefit compared to the traditional financial system while raising all the same risks and introducing new risks.

It is too early in the industry’s lifecycle to assess whether indeed there are additional benefits that can be gained beyond those of the traditional financial system. However, it is certain that cryptocurrencies—and the financial products and services associated with them—pose the same or similar risks and raise the same or similar consumer protection issues as those of the traditional financial system. The U.S. financial regulatory agencies have recognized these facts and have accordingly begun to consider how cryptocurrencies can and should be regulated.

However, as an initial matter, the claimed but unclear benefits, if any, must be balanced against the very clear risks. In addition to regulators using existing traditional authorities to police securities and commodities offerings, regulators and policymakers must undertake a rigorous and independent financial and economic analysis to ensure that there are benefits and that those benefits decidedly outweigh the risks.

This Fact Sheet reviews the key issues with cryptocurrencies.

What is a cryptocurrency?

A cryptocurrency is a digital asset that is ostensibly designed to have some or all the properties of a traditional currency, including especially its security, reliability, and confirmability in conducting financial transactions. This aspect of assuring confidence in the process as secure and verifiable is claimed to be achieved through the technology that underlies cryptocurrencies—the so-called distributed ledger technology, typically in the form of blockchain design.

Essentially, this technology is designed to digitally record all aspects of an event, including of the items and factors involved, in a manner that is supposed to be free of manipulation or modification. For example, a unit of a cryptocurrency can be created and its ownership transferred or partially transferred multiple times, and all information of the creation and ownership transfers would be reliably recorded.

This technology provides a potential means for the secure and verifiable execution of all types of transactions, but, as with all technologies, it can be [subject to exploitation and manipulation](#). Its potential is the primary argument for the creation and usage of a decentralized financial system, or DeFi. That is, if an algorithm can be relied upon to provide a financial product or service securely and verifiably, then there is no need for the infrastructure and personnel of the traditional financial system to provide intermediation, is the claim. Instead, individual providers of financial products or services can interact directly with individual consumers. For example, stocks could be bought and sold without the presence of a broker-dealer, or a loan could be made without a bank or even a dedicated peer-to-peer lending platform. But the validity of this potential must be tested and established over time before such widespread adoption occurs.

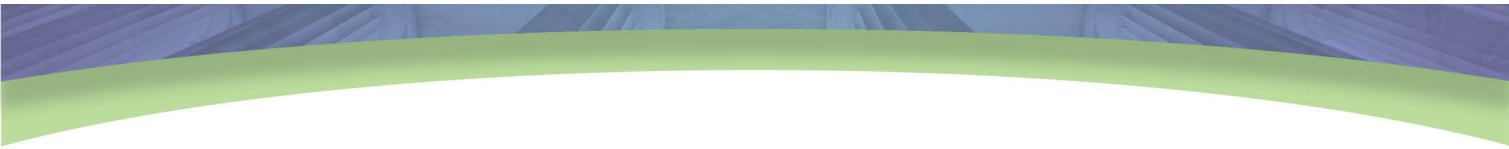
Wait, if cryptocurrencies are supposed to be like regular currencies, then what exactly is a currency?

Currency is a [form of money](#) and is an asset that has three functions:

- Medium of exchange for other assets (including other currencies), goods, or services that is accepted more broadly by others
- Store of wealth
- Unit of account, or a standardized means to price assets, goods, or services

The U.S. Dollar, for example, has proven to perform all three functions very well over a long period of time. In fact, it is used to [serve these functions globally](#), being used as the basis for over 70% of export invoices in countries outside of Europe and the U.S. and making up around 60% of foreign currency deposits and loans. This is in large part due to its stability that results from the stability and growth of the U.S. economy, a history creditworthiness of the U.S. government, and the strength of and faith in its legal and financial systems, among other factors. This type of support is something cryptocurrencies lack, as discussed below.

The importance of the three factors shown above in the usefulness of a currency can be illustrated through a very topical issue—inflation. Over the last year inflation has been increasing in the U.S. and many other developed countries globally. Inflation primarily affects a currency's ability to act as a store of wealth and unit of account. If inflation is high, then savings that are held in a currency essentially reduce because that static amount of currency will be able to purchase fewer assets, goods and services as prices rise. Also, under high inflation prices change more rapidly, making it more and more difficult for consumers to have



reasonable expectations of what those prices will be in the near future. In fact, in cases of extremely high inflation, or hyperinflation, businesses adjusted their prices frequently and currencies lost their usefulness. In such cases, businesses and consumers instead relied on the value of more stable currencies [such as U.S. Dollars](#).

So then really what is a cryptocurrency?

A cryptocurrency is—in a theoretical way—a truly digital currency. That is, theoretically it can serve the three basic functions listed above that many traditional or official currencies serve. However, no cryptocurrency currently is performing any of the three functions in a meaningful way and it is uncertain any ever will. Therefore, they largely are simply digital assets that are used as an alternative investment. That is in significant part due to the fundamental design and structure of cryptocurrencies, discussed below.

Types of Cryptocurrencies

Generally, cryptocurrencies exist in three forms:

1. More “pure” cryptocurrencies, such as Bitcoin, that are not tied directly to any product or service and do not have any means of stabilization;
2. “Usage-related” cryptocurrencies, or tokens, whose existence is tied to provision of some product or service, such as Ether; and
3. So-called stablecoins, such as USD Coin, whose value is supposed to be stable by design.

These three forms can and have been likened to existing assets. Pure cryptocurrencies could be thought of as commodities such as precious metals and stones, gold for example, because their supply is limited and their value is based almost entirely on the amount investors are willing to put into them (discussed more below). Usage-related cryptocurrencies could be thought of like stocks in a company, because the funds they raise are used to pay for the development and ongoing maintenance or production of the product or service with which they are associated. Finally, stablecoins could be thought of like shares in money market funds. That is, they essentially accept deposits and issue shares (the coins) that are supposed to be redeemable at any time 1:1 for the original amount deposited. These are the lines along which the regulatory agencies are generally looking to regulate these assets (also discussed more below).

Cryptocurrency usage as currency

Although some businesses have publicly announced they are accepting cryptocurrencies in exchange for their products and services, including a few larger companies such as Microsoft, very few businesses or individuals actually accept cryptocurrencies in exchange for goods and services. In fact, [estimates show](#) that only around 2,500 of the more than 32 million businesses in the U.S. accept cryptocurrencies. And even those that do accept cryptocurrencies conduct very few of their transactions in cryptocurrencies – in February of last year the online site Overstock [reported that](#) around 0.01% of its transactions were conducted in Bitcoin. And considering its extreme volatility, retailers are most likely immediately converting the cryptocurrency received from consumers back into dollars or some other official currency.

Volatility of Cryptocurrencies

The volatility of cryptocurrencies is many multiple times greater than traditional currencies and even other risky assets. For example, the volatility for Bitcoin, which accounts for around 80% of the cryptocurrency



market, has been shown to be [ten times higher](#) than major currency exchange rates. With value that fluctuates so severely, cryptocurrencies are very poor at being a stable store of value and unit of account. It is impossible to know what the value of cryptocurrency holdings will be from one day to the next. And if anything were priced in a cryptocurrency as a basis, its price would be changing constantly. For example, a baseline Tesla would have cost about 0.95 Bitcoins in April of last year, 1.5 Bitcoins in August, back down to 0.95 Bitcoins by November, and back up to around 1.5 Bitcoins today.

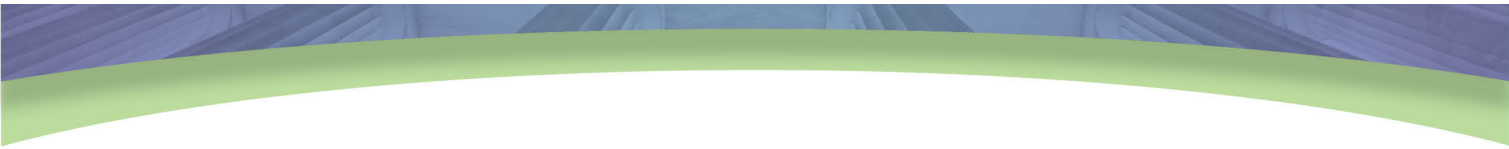
To address this volatility, many stablecoins have been created. Generally, these are claimed to be backed by stable assets, such as official currencies like the U.S. Dollar or relatively stable securities like U.S. Treasury securities. The intention is for these cryptocurrencies to maintain a stable value, such as keeping a 1:1 value with the U.S. Dollar. However, there are no regulations that currently apply to these stablecoins, and so there is no requirement for any stablecoin issuer to disclose the assets supposedly backing them or to choose assets that indeed are in fact of stable value. It is entirely up to the discretion of the issuers to decide what to “back” the stablecoins with, which can lead to negative outcomes. For example, the stablecoin Tether, which was supposed to be backed by stable assets, was investigated by the New York Attorney General and [was shown](#) to be backed by many assets with high volatility, such as commercial paper.

Outside of stablecoins, the extreme volatility of cryptocurrencies is the result of two major factors. First, there is almost nothing truly underlying the value of cryptocurrencies other than the amount investors are willing to invest, similar to certain precious metals and stones. The value of official currencies are broadly tied to the robustness and stability of their underlying economy as well as other factors; the value of stocks are tied to the future earnings of their associated companies; and the value of debt securities are tied to the future cash flows of the securities as well as the creditworthiness of the issuer. None of these underlying value factors apply to cryptocurrencies.

Second, unlike these more standard assets - official currencies, stocks, and debt securities—cryptocurrencies are divisible by substantial multiples. For example, Ethereum can be purchased in increments of 0.000000000000000001 of a coin, whereas 0.01 is the smallest increment of the U.S. Dollar as well as most offerings of fractional shares. That means the supply of cryptocurrencies effectively is both limited and unlimited at the same time. This makes them easily purchased by anyone from the largest institutional investors to the smallest of retail investors. Combined with the general absence of anything supporting their value, capital can and does flow very easily into and out of cryptocurrencies regardless of their whole-unit price. Over the last year, the daily trading volume of Bitcoin averaged around 4.5% of its total market value as compared to around 0.5% for Apple stock.

What are the potential benefits?

Cryptocurrencies, and the DeFi ecosystem associated with them, potentially can offer a means for greater financial inclusion and the provision of faster, easier, and cheaper financial products and services. However, it is really the technology underlying the currencies – the distributed ledger or blockchain technology—that allows for this potential, and so this technology could be utilized within existing processes without the need for cryptocurrencies. For example, the purchase and sale of stocks could be executed and recorded without the need for a broker-dealer but could be paid for with U.S. Dollars instead of cryptocurrencies.



The most cited example of a financial service that ostensibly has been made faster, more accessible, and cheaper is the peer-to-peer transfer of funds, particularly internationally. While on the surface this may seem logically self-evident, there is still a long way to go on making this process reach its purported potential. The fees associated with moving funds are very dependent on the volume of transactions being processed at any time. Recently, Coindesk estimated that the [average Bitcoin transaction cost](#) is \$23. This is about twice as much as the [most recent global average](#) to send \$200 internationally, as reported by the World Bank, and three times greater than the average for a “savvy consumer,” such as those that would be sending money with cryptocurrencies.

There are also hurdles to moving the funds, including converting between the local currency and cryptocurrency on both ends and ensuring the funds are accessible once received. Additionally, instant payment services have been or are being developed that will be able to transfer funds peer-to-peer instantaneously, most notably The Clearing House’s [Real Time Payment network](#), or RTP, and the Federal Reserve’s [FedNow service](#) that is expected to come online in 2023.

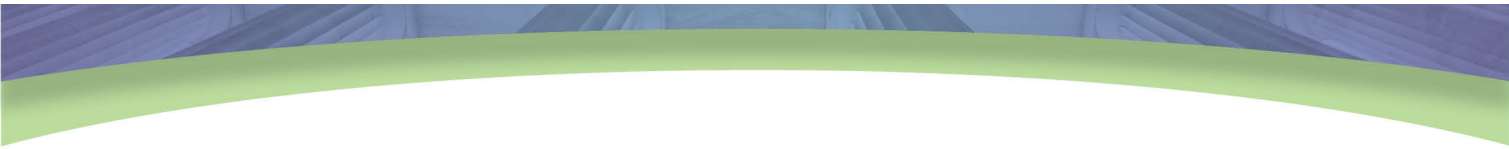
Promises of increased financial inclusion face the same issues as more traditional financial products and services, such as assessing a borrower’s credit risk, and it is unclear what benefits the association with cryptocurrencies and the “decentralized” nature of DeFi might bring. Nonbanks and financial technology companies are already improving financial inclusion, providing [proportionally more loans to borrowers of color](#) and deposit-like services to people that are unbanked. And “decentralized” seems to be a euphemism for “out of the government’s reach” and “unregulated,” both of which are negatives when it comes to consumer protections and mitigating risks to the financial system.

What are the risks?

Just as with all poorly and inconsistently regulated industries, the most obvious risks raised by cryptocurrencies are around fraud and consumer protections. Reports of cryptocurrencies being used in fraudulent transactions abound, with the Federal Trade Commission reporting that cryptocurrencies were by far [the most used means of investment-related fraud and theft](#) online, making up the majority of all online investment-related fraud. The platforms provide scammers with anonymity and transactions that are irreversible and without recourse, the perfect mix to execute scams. Additionally, the code underlying many DeFi applications are being exploited for theft, resulting in cryptocurrency being stolen from digital wallets and even [over \\$4 billion](#) from one major cryptocurrency exchange.

Additionally, as usage of cryptocurrencies grows, so do its potential risks to the financial system. One particular concern is around the usage of stablecoins. Because these are marketed basically as being very similar to money market funds, albeit ones that hold uninsured deposits, they face the same run risk that money market funds have experienced. Those risks materialized in both [the 2008 Global Financial Crisis](#) and during the 2020 pandemic-related market stress. Runs on money market funds were a significant contributor to exacerbating market stress during both events as the funds had to sell the underlying assets to redeem deposits, further depressing asset prices and increasing funding costs. With greater market size and usage (and if left unregulated), stablecoins could have a similarly negative effect.

If cryptocurrencies were to gain more widespread adoption, other more systemic risks could arise. First, and most obviously, if these actually were to be utilized as currencies, the issues associated with the existence of multiple currencies within an economy that were [experienced previously in our history](#) and that were



addressed with the establishment of central banks and single currencies would materialize. Some may be solved by technology, but certainly not all, including especially run risk as well as the need to create and deploy large pools of capital, which would be complicated by the usage of numerous currencies. Second, the cost of funding in U.S. Dollars could rise if there are significant capital flows into the cryptocurrency ecosystem and away from the productive economy. Third, the execution of monetary policy would be frustrated by the existence and usage of currencies that are beyond the control of the central bank.

What regulations are being considered?

The regulatory agencies and the U.S. Congress are considering how cryptocurrencies should be regulated. Without additional legislation from Congress, the agencies have been proceeding under their current authorities, which are ample. So far, pure cryptocurrencies that are commodities are being regulated accordingly by the Commodity Futures Trading Commission. Usage-related cryptocurrencies and stablecoins that are deemed to be securities are being regulated accordingly by the Securities and Exchange Commission. The SEC has also taken enforcement actions against some companies that engage in cryptocurrency activities with cryptocurrencies deemed to be securities. The U.S. Treasury Department [released a report](#) specifically on stablecoins recommending that Congress pass legislation to classify them as bank deposits, which would make them subject to prudential supervision and regulation by the banking regulatory agencies, but it is unclear if this will happen.

Whatever the future of regulation is for cryptocurrencies, it is clear that they must be comprehensively regulated to protect the American consumer, financial system, and economy. As with any investments or financial product and service, transparency and accountability are paramount not only to protect consumers but also to ensure these investments are being assigned the value they deserve in fact and not the value promoters claim they deserve. This is necessary if cryptocurrencies are ever to be determined to have value and, if so, to fulfill the promises touted by their advocates.

By Phillip Basil and Jason Grimes



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