Paradise lost? How crypto failed to deliver on its promises and what to do about it

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Shifting crypto narratives

• Crypto has relied on **constantly creating new narratives:**
  - from digital cash or digital gold to allowing finance to operate without trusted intermediaries
• But cryptos have **failed to provide an efficient, scalable means of payment or a reliable store of value**
• And they are **increasingly relying on centralised solutions and market structures**
• The bursting of the crypto bubble does not necessarily spell the end of cryptos, as they offer a **way to gamble**
Technical limitations

• Transacting cryptos on blockchains can be inefficient, slow and expensive

• **Blockchain trilemma**: security, scalability and decentralisation cannot be achieved at the same time

• Risks of public blockchains: lack of an accountable central governance body, potential for code errors

• Challenges in handling crypto-assets
  - Blockchains do not permit transaction reversal
  - Risk of theft or loss of personal keys
Cryptos exhibit instability and high volatility

Chart 1
Prices of bitcoin and selected altcoins

(USD thousands)

Source: CryptoCompare.

Chart 2
Price volatility of cryptos compared with other assets

(a) Gold, oil and equity index

(b) Bitcoin and selected altcoins

Sources: CryptoCompare, Bloomberg, Refinitiv and ECB calculations.
Cryptos do not perform any socially or economically useful function

- They are not used for payments
- They do not fund consumption or investment
- They often generate enormous damage to the environment
- They do not improve our capacity to hedge against inflation (chart 3)

Chart 3

Returns correlations of bitcoin vis-à-vis selected financial assets

(yearly rolling correlation)

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<td>Gold</td>
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<td>EUR non-financial high yield index</td>
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Sources: Bloomberg, S&P Global IBoxx, CryptoCompare and ECB calculations.
Cryptos as a means of gambling and circumvention

- Instability of unbacked cryptos makes them appealing as a means of gambling
  - Facilitated by the establishment of a centralised market structure and integration into the financial system to support their broader use
- Cryptos are also being used as a means to circumvent taxes, regulations and sanctions
  - Bitcoin used to evade restrictions on international capital flows and foreign exchange transactions
Risks arising from the growing centralisation of the crypto ecosystem

• Dependence on often unregulated third-party intermediaries increases the risk of **failures** and **contagion**:
  - Concentration risks from the role of stablecoins and large crypto exchanges
  - Interconnectedness and opacity of crypto markets

• Attempts by the crypto industry to strengthen **ties with actors in the financial system** (including banks, big techs and public sector)
  - Risks for banks associated with raising deposits from the crypto sector
  - Contradiction: crypto touts itself as an alternative to the financial sector, yet seeks shelter within that very sector to address its inherent risks
The public response: backing, regulating or innovating?

Resist the temptation to offer public backing to cryptos

- Would **socialise crypto risk**
- If the stablecoin issuer were able to invest its reserve assets in the form of risk-free deposits at the central bank, this would effectively **outsource the provision of central bank money**, endangering monetary sovereignty and financial stability

Establish a comprehensive framework regulating crypto activities

- Avoid legitimising unsound crypto models in a bid to attract crypto activities
- Regulate all activities related to the crypto industry and **enhance transparency**
- Importance of **global regulatory cooperation**

Innovate by developing reliable digital settlement assets

- **Central bank digital currencies** would offer a digital, risk-free standard and uphold the singleness of money
- For both **retail** and **wholesale** transactions
Thank you