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The case against aggressive government action on crypto

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*The financial regulators have recently taken an active interest in cryptocurrencies, more than a decade after their law enforcement counterparts did. So why are they doing this now, and what will the consequences be? **Jón Danielsson** writes that regulators feel compelled to respond due to political pressures and their actions may backfire.*

After bitcoin, the first and still dominant cryptocurrency, emerged in 2009, it did not take long for it to be used for illegal transactions, with the attraction of anonymity beyond the government's control. It didn't quite work out that way for the criminal elements, as law enforcement wasted no time and has been closely monitoring transactions on the bitcoin blockchain ever since.

The criminals' mistake is that bitcoin does not promise anonymity, as made clear by Satoshi Nakamoto, the author of the original bitcoin paper. Instead, his objective was secure financial transactions outside government oversight and an algorithmic, instead of political, control of money creation. That political mission is what drives crypto success.

It is quite straightforward to observe transactions on the bitcoin blockchain. Not only is the chain publicly visible, but also, since blockchain addresses have a unique ID associated with them, so coins are easily tracked as they move between addresses. All that is left is to map that ID to a particular person, which is usually easy because any movement in and out of a fiat currency via crypto wallets happens via the regulated financial system, aided by crypto exchanges being compelled to comply with law enforcement demands.

This means that transactions with bitcoin and other cryptocurrencies tend to be much more visible than old school banking transactions because no national bank privacy rules protect the holders of bitcoins.

Unsurprisingly, law enforcement authorities have successfully identified criminals aiming to use bitcoin to disguise their money flow. However, the authorities might not always be able to apprehend those criminals because they might be agents of hostile nation powers, such as North Korea, or reside in countries like Russia that are relaxed about or even encourage ransomware attacks.

Outside of law enforcement, it took much longer for the financial authorities to, at least publicly, acknowledge cryptocurrencies. We can only surmise why they were so slow. Overworked regulators might have had their priorities elsewhere, the political mission of cryptocurrencies sat uneasily with the objectives of regulations, and crypto might not have been seen as much of a threat.

That has now changed, and the financial policymakers have reacted in two stages.

First, a few years ago, most crypto exchanges were compelled to comply with rules such as know your customer (KYC), anti-money laundering (AML), and sanctions. The aspect of financial policy with the strongest law enforcement overtones focussed on implementing other government objectives, like preventing terrorist financing. All reputable crypto exchanges now cooperate with the authorities.

Neither the macro nor micro prudential regulators have paid much attention to crypto until quite recently.

The macro regulators focus on the system and preventing disastrous financial crises, while the micro prudential regulators concern themselves with safeguarding the users of the financial system. That means protecting users from abuse and ensuring we can go about our financial business safely, knowing that the government is protecting us.

Neither the macro nor micro regulators are worried about us taking risk, even very high risk, and making large bets on very negative net present value investments, so long as the risk is disclosed and the entity selling the service is regulated. The absence of micro regulations targeting crypto has therefore been an anomaly, one the authorities have recently begun to rectify, especially those in the United States. The European authorities remain more sanguine towards crypto use, and when they act, they work to prevent crypto encroachment of the payment system and protect the incumbents, not typical micro concerns.

Why only act now?

The size of crypto assets is approximately the same today as half a decade ago. While the price of crypto has fluctuated quite a bit since then, there is no reason to believe that crypto poses any more micro concerns today than in 2017. If anything, the micro concerns were stronger in 2017 since the price of bitcoin had gone up 15 times that year, and prospective crypto investors were then more likely to be raptured by the rapid price rise than they are now. Meanwhile, the crypto market is minuscule compared to the overall financial system and very transparent, so it does not meet the test for being a macro concern.

The recent attention from the regulators does not seem to be due to concerns for their mission since, if it were, they would have reacted long before. Instead, the primary motivation appears political. The regulators feel compelled to respond as the press and politicians have increasingly expressed concerns about crypto.

Perhaps the regulators asked themselves, “should our financial stability report have a section on crypto?” spurned on by the heads of the agencies wanting regulatory reaction to crypto. That might explain the ongoing discussion on how stablecoins pose a risk to the system, however tenuous such a claim is.

When issuing a warning and taking action over crypto, the authority is covered if things go wrong. Why then not warn against everything? I do not recall hearing a senior regulator say in public they are not concerned about the risk of something. And since warnings tend not to come with confidence bounds, even if that should be standard practice, it is not possible to ascertain their accuracy, ex-post, and the warning is always justified.

I think the recent flurry of regulatory actions is a mistake for two reasons.

The case against aggressive government action

First, as I argued recently, crypto is embarking on its third and what I think is its terminal phase. My reasoning is that as crypto joins the mainstream financial system, the justification for it, at its core ideological, is eroded. If I am correct, there is no reason to act against crypto, as it is a small and declining concern.

Second, as the authorities act against crypto, the narrative changes. Instead of crypto collapsing under its own internal contradictions, as I think would have happened and would have been preferable, the government will now be blamed for crypto misfortune.

In other words, aggressive government action, one that is focused on the immediate political imperative and disregarding longer term consequences, may shift the responsibility from the crypto advocates to the government.

And interestingly, the very fact that the government is acting in such a heavy handed manner could well be what protects crypto. Just like Ruby Ridge in the US fired up anti government activists, today's regulatory response could fuel the activists so fundamental to cryptocurrencies.

This is a common problem with regulatory action. Suppose the regulators are only concerned with first order partial equilibrium impacts because that is where the politics are. They then ignore the general equilibrium consequences, often dominating the first order impact.

Suppose I am wrong and crypto is not in a terminal phase. Its success can then only be thanks to government fiat money, and financial regulations not meeting the demands of society. In other words, monetary policy and regulation failures would drive crypto success. The recent regulatory actions then only lend further support to crypto, further exposing the policy weakness that gave crypto its necessary breathing room in the first place. The solution to the crypto problem is then to address the policy failures that give it the oxygen to grow—instead of trying to contain it by regulations.

The anti crypto actions seem set to achieve precisely the opposite of what I suspect the government wants: to bring crypto under the government tent, curtail crypto use, and ultimately cause its demise.

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Notes:

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