Examining what happened to crypto

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Credit: Oliver Burston

Recent high-profile financial meltdowns at Bitcoin, Celsius, and Terraform Labs, which together wiped out hundreds of billions in market value, helped trigger a flight from the cryptocurrency market, driving its value from $2.9 trillion last fall to less than $900 billion today. This "crypto crash" has reinforced the perception of critics that markets for the digital currency—used primarily as an investment vehicle as it is not widely accepted as payment for goods and services—are little more than global casinos operating with virtually no rules or accountability.

Scott Duke Kominers is the M.B.A. Class of 1960 Associate Professor of Business Administration at Harvard Business School and a faculty affiliate of Harvard's Department of Economics and the Harvard Center of Mathematical Sciences and Applications. Kominers spoke to the Gazette about why the crypto market has plunged in value recent months and how a tide of upcoming international regulation could affect the market. The interview has been edited for clarity and length.

What set off the cryptocurrency slide?

Kominers: For the past six months, we've been tilting into a state of overall financial uncertainty. Crypto assets are very volatile, in part because there's so much uncertainty about which crypto technologies are likely to be the most useful in the long run—for example, which ones the market may coordinate on for mediums of exchange, and a lot of the applications are technological in nature and novel (or at least unproven). And so, there's a lot of uncertainty and a lot of the value of return is downstream, just like with tech companies.

Note there's been a broader pullback for tech companies. A lot of tech firms make big investments in growth upfront, and then the payoff is long-term in the future. In our current macroeconomic climate, it's harder for them to find money for those sorts of investments, and so that type of business can get more difficult to operate.

Crypto can have that same dynamic. On top of that, it's more uncertain which technologies are going to be long-run successful. And then, on top of that, there's the speculation attached to new asset classes and similar. And so, there's a lot of uncertainty around crypto; and in times of overall financial market uncertainty, people pull away from riskier assets.

At the same time, a lot of the basic technology investment and entrepreneurship in crypto is still going on. We saw this with previous crypto cycles as well. In late 2017-2018, there was a significant downturn, and many of today's top crypto companies emerged out of that. So, I think from an entrepreneurship perspective, there's a lot of teams still building, and there's an opportunity here when things are a little bit less crazed, when there's less attention and especially energy around speculation and trading—this gives an entrepreneur more time to focus and actually develop their product carefully without constantly having to face the market.

In November, the global crypto market capitalization was $2.9 trillion. Today, it's $870 billion, according to CoinMarketCap. Bitcoin, the oldest, most established cryptocurrency, has fallen over 70 percent in value during that period. What changed?

Kominers: There was still uncertainty. We were just in much more of a financial boom and a crypto boom, specifically. Even in that period, the market prices of various cryptocurrencies were moving up and down—massive swings—30 percent swings within a week, sometimes. I advise a bunch of entrepreneurs and the feeling of many at the time was that it was very difficult to be building in that environment because things were changing so rapidly, and there was so much attention and pressure from the boom cycle. When all of that slows down, it washes out a lot of the projects that in one way or another weren't sustainable. That means there has been lost value—there have been losses for the entrepreneurs; there are losses for the investors. And that percolates back to retail investors, as well.

But at the same time, the entrepreneurs who are still out there swinging are getting a lot done and creating a lot of value. And remember: not all crypto products are purely financial. For example, many are more consumer-facing products like systems for coordinating group decisions or managing event tickets. The long-run view is that there is real fundamental technological value here, and so what really matters for the market is whether we can realize that value through entrepreneurship and supporting regulation. And I think the current environment is one in which we have a lot of potential to do that.

We still don't know what the long-run, successful business models and infrastructure solutions are going to look like. We don't know if they're the things we have right now, in some variation, or whether there'll be completely new platforms and crypto products. In the early days of the internet, a lot of the platforms and business models didn't survive. What I'm really interested to see is which crypto projects come out of this "bear" market phase much stronger.

The flurry of bad news involving high-profile firms like Bitcoin, Terra, and Celsius has renewed calls for

regulators to protect consumers from fly-by-night currency operators, scammers, and theft. How vulnerable are crypto investors, particularly the retail-level amateur investors?

Kominers: I definitely think there's a need for more consumer protection in this space across the board. There needs to be more transparency and not just transparency at the abstract level, but the technology needs to be made transparent for consumers in ways that they can understand. This is a problem across crypto, and it's one that companies are starting to try and solve. It's very hard for a consumer to be managing their own position in the central crypto market with current tools. As a result, if you're a retail consumer, you often end up on one of these intermediated platforms where the lack of transparency means you may not understand what's going on. As we've seen, people may choose to enter into these platforms during a boom, and it's very exciting. But if you don't understand the risk you're taking on, that can be really harmful as soon as the state of the market changes.

There needs to be much more transparency and better messaging and clearer definitions of the different asset classes. Everything from taxation—it's still really difficult to figure out how to pay taxes on your crypto assets even if you understand precisely what they are—to information that would help people make assessments about which markets they want to be in and how much risk they're taking on. Highlight it in the same way that we provide information about other asset classes and products. There aren't unified disclosure standards for crypto platforms; there aren't standardized disclosure rules or formats. And it's two layers of non-transparency: You both don't necessarily have a clear sense of what platforms may be doing, and then on top of that, a consumer might not understand the aggregate volatility in the crypto market and so they can't make an overall risk assessment.

This week, a panel of banking regulators and treasury officials from the G20 countries said it will put forward "robust" new regulations in October in response to the "intrinsic volatility and structural vulnerabilities in crypto currencies." Earlier this month, the U.S. Treasury Department presented to President Biden what it called a "framework" for overseeing digital financial assets across the government and internationally, while the European Union and European Parliament agreed to sweeping new crypto rules that include a licensing requirement that's expected to go into effect next year. How is this wave of regulation going to affect the market?

Kominers: Some regulation is probably good for the industry because in order for crypto to reach mainstream adoption and use, it needs to be in a market and technology context where the consumer can gain access and do so in a way that is valuable and much lower risk than today. Frameworks, when they're developed well and respond directly to the types of problems the market is seeing, can make a market more efficient and more valuable for everyone to participate in. So, some degree of improved structure and framework-building is good. The challenge, of course, is that these crypto currencies and other crypto assets are often simultaneously financial assets and tech platforms—which means that you have to think about two different categories of regulation working in concert with each other.

On the one hand, licensure and vetting of an asset to be able to trade it in some centralized system—that sounds like a really good thing from a stability and oversight perspective. But at the same time, that could very much limit competition. If it's hard to introduce new types of tokens, then you may block innovation, and you reduce the possibility of new platforms emerging, which means you don't necessarily get to the most efficient technology. These are hard tradeoffs. One of the big challenges we've faced in regulating crypto to this point, and we'll face going forward, is balancing the need to achieve platform stability with the need to maintain platform competition and interoperability.

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