What explains the cryptocurrency crash?

July 8 2022, by Phil Ciciora

Cryptocurrencies have real-world use cases and will remain a viable investment because of the functionality blockchain technology provides as a public ledger for transactions, says Robert Brunner, the associate dean for innovation and chief disruption officer at the Gies College of Business at the University of Illinois Urbana-Champaign. Credit: Fred Zwicky

Robert Brunner is the associate dean for innovation and chief disruption officer at the Gies College of Business at the University of Illinois Urbana-Champaign, where he helped spearhead efforts to create iBlock, the first blockchain created by a business school. Brunner spoke with News Bureau business and law editor Phil Ciciora about turbulence in the cryptocurrency market.

Cryptocurrencies have taken a beating lately—both in the markets and in reputation. What explains the current dynamics of the cryptocurrency market, which has experienced a boom-bust cycle over the past two years?

The last few years provided an unprecedented macroeconomic environment where money was cheap and readily available. Central banks held interest rates near zero and governments were supporting people during the pandemic with cash to prevent demand destruction. As a result, investors inevitably chased high yields, leading to increased risk taking on their investments, whether it be tech stocks, cryptocurrencies or any other risky asset such as meme stocks.

Now, with inflation spiraling, we're seeing the inverse of that. The Federal Reserve has tightened its monetary policy so that money is no longer cheap. Interest rates are rising and investors have pulled back from risky assets, including cryptocurrencies. However, we're also seeing massive drawdowns in tech stocks that mirror the decline in the cryptocurrency market.

I don't think it's right to say that the cryptocurrency bubble has popped and everything else is fine. All risky assets are declining, sometimes dramatically, at the same time. Investors aren't sure what's going to happen with the economy—are we tipping into a recession, and will it be long-lasting or will we pull out of it quickly? There's a lot of uncertainty, so people have naturally pulled back from the riskier bets.

Are cryptocurrencies still a viable technology, or is this a replay of the early-2000s dot-com stock bubble?

Will cryptocurrencies go away like many of the early dot-com-era companies? This is very unlikely. Anyone thinking about this asset class needs to remember its historic volatility. In the case of bitcoin, it's been cycling up and down since its inception. I believe we are just experiencing the decline of the latest cycle.

Cryptocurrencies such as bitcoin have real use cases and are, therefore, here to stay. For example, bitcoin allows one to transfer large amounts of money anywhere in the world, and to have both sides agree it's been done without a third party, in basically an hour or less. And the only reason it takes an hour is the speed at which the bitcoin blockchain validates transactions. If you use a different blockchain, the transaction could go even faster. This is in stark contrast to traditional financial transactions, which take days to reliably transfer large amounts of money and require a trusted, third-party intermediary. Cryptocurrencies support a fundamentally different way of doing finance, which also allows people who may be unbanked or underbanked to participate in the benefits of a global monetary system that's not controlled by any one party. There is real value in this approach.

In the bigger picture, the reason cryptocurrencies will remain a viable investment is the functionality blockchains provide as a public ledger for transactions. This is why bitcoin was created in the first place after the 2008 market crash, which itself was due to a failure in the financial systems that we had trusted. Bitcoin was developed to operate in an essentially trustless manner.

Blockchain technology itself is just a database, pure and simple. But it's out there in the open; everybody can see what's on it. There's a lot of power in this approach, but it also scares a lot of people. The same thing happened a few decades ago with software. Microsoft had their proprietary code, and they wouldn't share it with anybody. And then along comes Linux, which is open-source software. People liked that openness. They liked to be able to see what the software was doing, to know where the bugs were and to be able to fix them, and to extend the software into new application areas. Blockchain technology is pushing that same idea of openness but with data.

In response to the rollercoaster nature of the cryptocurrency market, should the government develop better regulatory guardrails?

Currently, there's very little regulation in the cryptocurrency market. And because of that, people built overleveraged positions and created "stable coins" that purport to be pegged to the value of the U.S. dollar. But these risky activities can backfire when macroeconomic conditions change. We have seen that recently, as certain large parties haven't been nimble enough or have had insufficient foresight to realize how quickly the market conditions were shifting. They became overextended and were forced to liquidate assets, causing further price drops of cryptocurrencies.

These incidents send ripples through the cryptocurrency market, and of course the price of all cryptocurrencies, including bitcoin, drop. And as the price of these cryptocurrencies goes down, it triggers additional margin calls on people or firms who were overextended, extending the downward cycle. But again, what drove this initially was largely U.S. inflation data that panicked investors who then quickly began to move away from potentially risky assets.

Given the importance of this market and the economic benefits that innovation in this space can drive, I do think that regulation will be forthcoming. The Biden administration issued an executive order a few months ago that essentially said we need to figure this out. For example, there is discussion now about whether anything that is allowed to be called a stable coin in the U.S. market must be backed dollar-for-dollar by fiat money.

But one of the problems is nobody knows which federal agency should regulate cryptocurrencies. Is it the Treasury Department, the Securities and Exchange Commission or the Commodity Futures Trading Commission? There isn't agreement between the agencies over who should be overseeing cryptocurrencies. Hopefully, the executive order will soon bring needed clarity to many of these questions.

Provided by University of Illinois at Urbana-Champaign

Citation: What explains the cryptocurrency crash? (2022, July 8) retrieved 26 April 2024 from https://techxplore.com/news/2022-07-cryptocurrency.html