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Analysis of today
Assessment of tomorrow

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Are The Crypto Crises Coming?

Having adopted one major piece of digital-currency legislation (the GENIUS Act) and with more pending (the CLARITY Act has passed the House of Representatives), the United States is poised to become a major hub for cryptocurrency-related activities, or even – taking President Donald Trump literally – the "crypto capital of the world."

But those who support the new legislation should be careful what they wish for.

Unfortunately, the crypto industry has acquired so much political power – primarily through political donations – that the GENIUS Act and the CLARITY Act have been designed to prevent reasonable regulation. The result will most likely be a boom-bust cycle of epic proportions.

Historically, US financial markets' major advantage compared to other countries has been relatively greater transparency, which enables investors to gain a deeper understanding of risks and make better-informed decisions.

The US also has strict rules against conflicts of interest, requirements to treat investors fairly (including by protecting their assets in proper custody arrangements), and limits on how much risk many financial firms can take.

This framework is not an accident or something that emerged purely through market competition.

Rather, it is the result of sensible laws and regulations that were created during the 1930s (after a major disaster) and that have evolved in a reasonable fashion since then.

These rules are the major reason why it is so easy in the US to do business, to bring new ideas to market, and to raise capital to support innovation of all kinds.

Risks for the entire financial system

Any individual entrepreneur or even a potential new industry (such as crypto) may balk at these rules, claiming that they are different from anything the world has ever seen.

But financial innovation involves risks for the entire financial system, not just for individual investors. The point of regulation is to protect the whole.

Many major economies – including the US – learned this the hard way. Over the past 200 years, they have experienced severe financial disruptions and even systemic meltdowns.

One such collapse was a major contributor to the Great Depression, which began with a stock-market crash in 1929 and spilled over to bring down many banks (and other investments), destroying millions of Americans' wealth and dreams.

Avoiding a repeat of that experience has long been an important policy goal.

> We should expect significant demand, including from non-financial firms, seeking to bypass established payment systems

But the GENIUS Act does not advance this goal. The law creates a framework for stablecoins, an important emerging digital asset, issued by US and foreign firms, that purports to maintain a stable value against a particular currency or commodity, with the US dollar being the most popular anchor.

Stablecoins are useful to investors active in cryptocurrency trading, enabling them to move into and out of particular crypto assets without having to navigate the traditional (non-crypto) financial system.

We should expect significant demand, including from non-financial firms (such as Walmart and Amazon) seeking to bypass established payment systems.

A major source of vulnerability

The business model of stablecoin issuers is to capture the spread between what they pay on their currencies (which is zero interest under this legislation) and what they can receive when they invest their reserves, just like a bank.

All the incentives for stablecoin issuers are to invest at least some of their reserves in riskier assets to get higher returns.

This will be a major source of vulnerability, particularly when issuers are licensed by permissive state authorities.

When any stablecoin issuer – domestic or foreign – gets into trouble, who will step in

Indeed, from a systemic perspective, the GENIUS Act's main shortcoming is its failure to deal effectively with the inherent risk of stablecoin runs, because it prevents regulators from prescribing strong capital, liquidity, and other safeguards.

And when any stablecoin issuer – domestic or foreign – gets into trouble, who will step in, and with what authority, to prevent the problems from spreading to the real economy, like in the 1930s?

The real possibility of the return of financial panics

Simply applying the bankruptcy code to failed stablecoin issuers will inevitably impose severe costs on investors, including prolonged delays in receiving what's left of their money. It will almost certainly exacerbate runs on other stablecoin issuers.

Moreover, if the GENIUS Act's goals include preserving the US dollar as the world's reserve currency and boosting demand for Treasuries (as stated by its advocates), why does Section 15 of the law allow foreign issuers to invest their reserves in assets such as their own country's (risky) government debt, even if that debt is not denominated in dollars? We should expect foreign regulators to condone or even favor such arrangements.

The CLARITY Act would allow conflicts of interest and self-dealing on a scale not allowed since the 1920s

But then we will have "stablecoins" with fixed dollar obligations, backed in significant part by non-dollar assets – and one can easily imagine what a big appreciation in the value of the dollar will do to such arrangements (spoiler alert: immediate liquidity problems, insolvency fears, and destabilizing runs).

There is a lot more trouble to come, particularly if any version of the CLARITY Act passes the Senate. This legislation would allow conflicts of interest and self-dealing on a scale not allowed since the 1920s.

There are also major national security concerns, to the extent that both the GENIUS Act and the CLARITY bill allow or even facilitate the continued use of stablecoins (and crypto more broadly) in illicit financial transactions.

The US may well become the crypto capital of the world and, under its emerging legislative framework, a few rich people will surely get richer.

But in its eagerness to do the crypto industry's bidding, Congress has exposed Americans and the world to the real possibility of the return of financial panics and severe economic damage, implying massive job losses and wealth destruction.

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