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THE CRYPTO CONUNDRUM

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Bitcoin and other private cryptocurrencies have been on a bull run recently. Unlike previous rallies, the current rally in bitcoin has witnessed the increasing participation of retail investors in India. Since 2020, when the Supreme Court overturned an order by the Reserve Bank of India dated April 6, 2018, restricting the use of cryptocurrencies, traffic in domestic cryptocurrency exchanges in India has grown many-fold. Yet, the future of bitcoin and other cryptocurrencies is unlikely to be as bright as many believe it to be.

The most important feature of cryptocurrencies that is flaunted by their enthusiasts is their limited supply. In a world where central banks create a lot of money out of thin air, it is natural for investors who are looking to protect their wealth to seek abode in alternative assets whose supply cannot be cranked up as easily. Money creation by central banks causes the price of all goods to rise and also tends to accelerate the adoption of alternative assets as currencies. When central banks create a lot of money, it leads to an increase in the prices of not just goods such as food and cars but also that of commodities such as gold and silver, considered to be alternative forms of money. Yet, for various reasons, the rally in bitcoin may be no more than a case of speculative mania.

For one, scarcity alone is not sufficient to facilitate the adoption of cryptocurrencies as money. Any asset must have either use value or exchange value in order for it to possess any fundamental value. This fundamental value, in turn, is reflected in the price of these assets in the long run. Stocks and bonds, for instance, possess exchange value that is based on the expected future cash flow from these assets. Commodities such as oil and steel possess use value because these assets are used to run vehicles and build real estate. Bitcoin and other cryptocurrencies may be scarce but it is questionable whether they possess any use value or exchange value. Gold and silver have traditionally served as hedges against inflation because they possess fundamental value derived from their use as jewellery and money. But bitcoin and other cryptocurrencies neither offer direct use value nor possess significant exchange value — bitcoin can buy you very few real goods and services. In short, cryptocurrencies possess no significant fundamental value to sustain their current high prices.

Yet, many believe that the rising prices of cryptocurrencies reflect their likely future value as a currency. It is possible that investors are bidding up the price of bitcoin because they foresee a future in which private currency is widely accepted as money. After all, all investments are forward-looking. One may also grant that the extreme volatility seen in the price of cryptocurrencies, which seems unrelated to any similar fluctuations in their fundamentals, may be due to the nascent, illiquid nature of the cryptocurrency market. However, the more cryptocurrencies are accepted in exchange for goods and services, the greater the chances of governments cracking down on them.

The monopoly that governments (and central banks) possess over the issuance of money is at the root of their power and influence. This allows governments to fund their budget deficits, particularly during times of crises such as the current pandemic when tax revenues have taken an unprecedented hit. It also allows central banks to tinker with the money supply under the mandate of managing aggregate demand in the economy. In essence, monopoly control over money allows governments to indirectly tax citizens by increasing the supply of currencies, thus devaluing them. If cryptocurrencies like bitcoin are going to challenge fiat currencies like the U.S. dollar as a medium of exchange, they would essentially be challenging the authority of the government to print and spend. This is not an assault that governments will tolerate for long.

They will allow cryptocurrencies to exist only as long as these currencies remain a speculative asset and not a medium of exchange.

This is not to say that governments are justified in their crackdown against cryptocurrencies. China recently imposed a complete ban on all cryptocurrencies and plans to issue its own central bank-issued digital currency. Private alternatives to fiat currencies offer people greater choice in what currencies they choose to use as a medium of exchange. The benefits of free market competition in money were elaborated by economist Friedrich Hayek in *The Denationalization of Money*. Most notably, competition between currencies to cater to the demands of customers would ensure that fiat currencies that are printed indiscriminately simply go out of use. This is the outcome that governments fear and would fight to avoid at any cost.

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