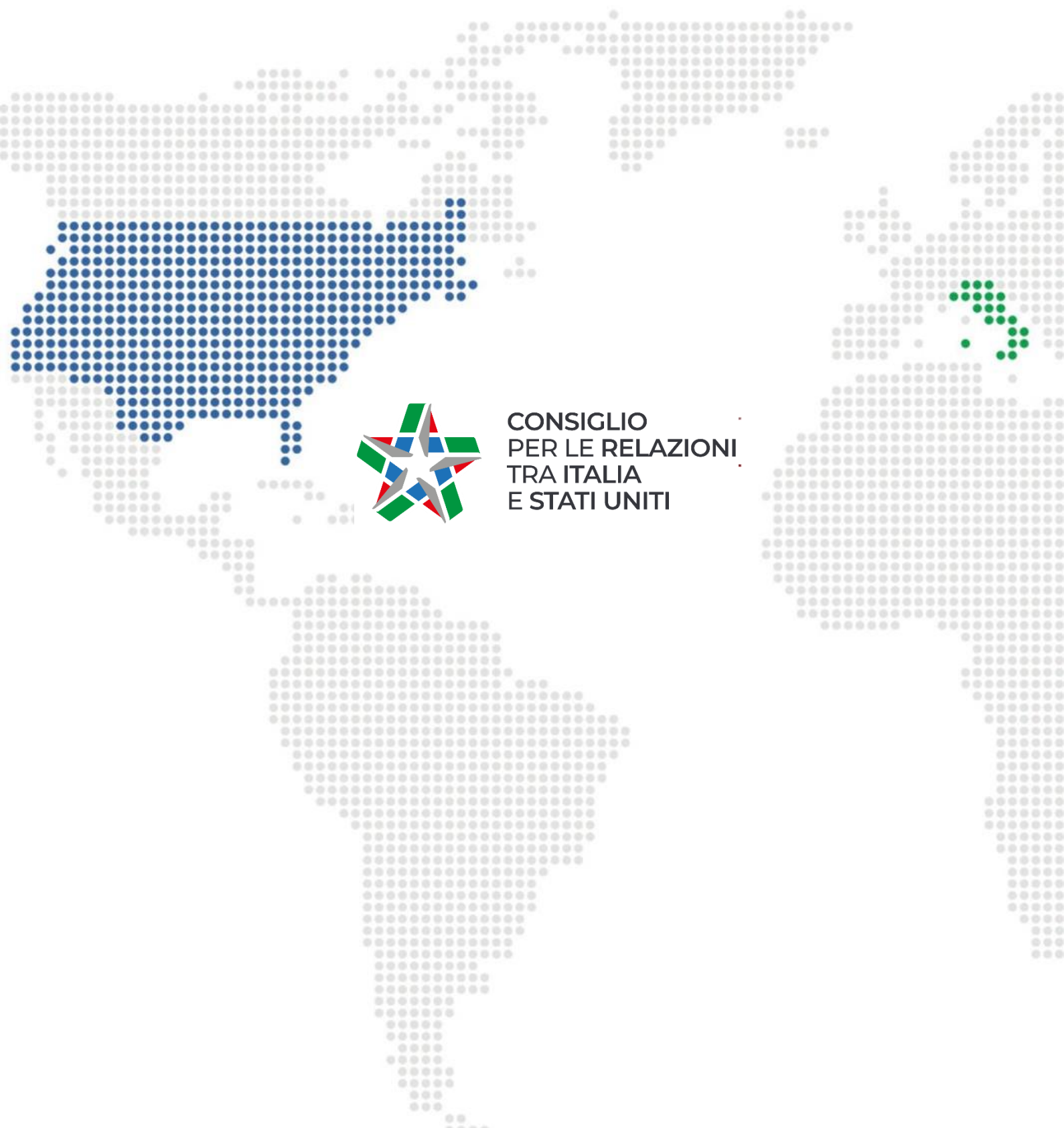


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REGULATING THE CRYPTO WILD WEST

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The explosive growth of cryptocurrencies and digital assets has left financial authorities scrambling to understand what is going on. But though this burgeoning sector is known for its frontier spirit and commitment to innovation, plenty of the risks it poses should already be familiar to regulators.

A well-functioning financial system is a key component of any successful economy. Without efficient payments and broadly accessible financial services, people cannot engage easily in commerce, save for a rainy day, invest in new innovations and business models, or insure against risk. But precisely because the financial sector is so central, developments within it are highly consequential. If the digital revolution has shown us anything, it is that one seemingly minor innovation can upend or even eliminate entire industries.

The promise of financial technology (fintech) is that it will enable even faster, less costly commerce (including across international borders), improve the allocation of capital toward productive investments, and make financial services even more efficient and accessible, not least to the world’s 1.7 billion unbanked or underbanked people. But technological innovation is not inherently “good” or “bad.” Some changes yield broad benefits for society, but others may benefit the few at the expense of the many, and most will bring a mix of benefits, costs, and complications.

The rapid growth of digital assets is a case in point. Though there are many scams, there are also many opportunities, and the countries that can harness these new technologies effectively may stand to gain a competitive edge. How should governments – and democratic electorates – weigh the risks and rewards? Raghuram G. Rajan, a former governor of the Reserve Bank of India, recently offered his views on this and related questions for Project Syndicate’s “Finance 3.0” event.

Do cryptocurrencies need more regulation than traditional financial instruments?

Well, cryptocurrencies serve many purposes, but let’s focus on just a few. For starters, they are an investment vehicle for a lot of people. Any investment vehicle requires a certain amount of regulation to exclude fly-by-night operators who will take your money and run. This is especially important when you have more than 6,000 different cryptocurrencies, and when you have a lot of people who have issued tokens, cryptocurrencies, versions of the same kind of digital asset, and so forth. Who knows whether they are legitimate or not? Answering that basic question requires a certain amount of regulation, by at least requiring that everyone register to show that they are on the up and up.

A second issue concerns instruments that could pose a risk to the financial system. For example, the issuer of a “stablecoin” basically says, “I’m going to take your money. Whenever you want to redeem your token or your crypto, you will get that money back.” This is the same kind of promise that a bank makes with your deposits. For it to work, you as a depositor need to be fairly confident that the money will be there – or that the bank can access that money if necessary to pay you back – even if everybody else comes for their money, too. A stablecoin thus has “run risk,” which is one of the reasons why traditional banks are regulated. If everybody thinks everybody else is coming for their money, they will want their money, too. Any institution that says “you’ll get your money back” therefore must be required to show that it can raise enough liquidity to keep that promise.

There are also other “normal banking” reasons for regulating cryptocurrencies and the companies that issue them. Are you becoming a vehicle that people can use to make illegal payments? Are you yourself making payments to entities that might be illegal? Are illegal entities – the mafia, drug dealers – big players in your payment system? One concern that regulatory authorities should bear in mind is that regulation shouldn’t become a stamp of approval. The message shouldn’t be, “Because we have regulated these things, their value is now certified. Go ahead and invest.” If you are a regulator, I don’t think you want to put that kind of stamp on crypto at this point – not until we better understand the nature of the beast.

What sort of regulation is most appropriate for cryptocurrencies?

At the very least, you should be required to register when you want to issue any token, providing some description of what you're going to do with the money, where it is going to be lodged, and what access investors will have to that money in the future. That would be a minimal level of regulation.

Beyond that, I think it depends a lot on the quantum that is being issued, as well as on how long investors must keep their money there. Some of this activity falls under the remit of a securities regulator like the Securities and Exchange Commission in the United States, and some of it is liquidity or solvency regulation.

For banking regulators thinking about stablecoins, the main concern is whether the issuer has enough access to liquidity. Moreover, there are regulations governing who is allowed to participate, such as "know-your-customer" norms. Do you know who is using your service, whom they are sending money to, and where it's going. Regulation is needed to address all of these questions.

Do cryptocurrencies present a challenge that regulators haven't seen before, or do they represent more of the same?

Regulators have seen many of these issues before, but there are new challenges as well. Can your cryptocurrency be hacked? Are there security procedures to protect not just the asset itself but also the exchanges that use it? Can wallets be raided? What about user data? Who collects that information, and how is it stored? What kind of privacy should crypto users be able to expect? Many of these data and cybersecurity challenges are new. While similar issues obviously show up in different forms within the existing financial system, they become much more acute with digital assets.

Assuming proper regulation has been achieved, what are the most promising features of today's fintech?

The potential reduction in transaction costs (from automation) is certainly one of the most important features of digital finance - and one can layer new possibilities on top of that. Owing to the new technology, lenders won't just make the same old loans the same old way; they will collect new kinds of information, and there will be new kinds of collateral.

For example, if somebody defaults on you, that information is immediately going to be available throughout the system, and it's going to be very difficult for that person to borrow again from anyone else within the system. You are therefore dealing with a kind of implicit collateral, the borrower's reputation for repayment, even when there is no explicit collateral.

Another possibility lies in micropayments. For example, you could make a micropayment every time you read an article, rather than paying for a full year-long subscription. Reducing transaction costs makes that possible.

Another potentially promising application is the smart contract. Contracts today require a trusted counterpart. In international trade transactions, for example, you need correspondent banks that trust each other on each side. But with a smart contract that settles the transaction automatically once pre-agreed conditions are met, you could eliminate the need for fee-charging intermediary individuals or institutions.

What kinds of problems or opportunities would these introduce in developing and emerging-market countries?

Financial inclusion is a very big issue for developing and emerging-market countries. When you want to get more people into the financial system, any reduction in transaction costs or improvements to access can be very helpful. If I'm living on a mountaintop and I need to get cash, I have to go to the valley, which is ten miles down, and then climb back up with the cash. But if I can use digital cash, I can skip the trip. I will be much more willing and able to participate in the formal economy.

That's a positive. The negative is that there tends to be much less financial literacy in developing and emerging-market countries, so running scams is easier. Moreover, digitization can create more volatility. If I suspect my bank has a problem, it now takes me just a click of the mouse to move my cash out of that bank into digital assets, whereas I previously would have had to line up at the bank to withdraw my money. The ease of withdrawal creates the possibility of greater volatility if there is in fact risk in the system.

Is there any jurisdiction that is getting crypto policy and regulation right?

Different places are experimenting to different degrees. Singapore comes to mind as a country that is trying its level best to be on the frontier, while still making sure that there is proper regulation. It's trying to encourage innovation by maintaining safe spaces where people can experiment, but it's also trying to understand what

financial authorities need to know to keep the risks in check.

Has the situation in Ukraine told us anything new about how we could approach crypto?

It has reinforced some of the concerns about crypto as a means of payment. You saw some pretty volatile movements in the value of cryptocurrencies before and around the start of the war, which suggests that, as assets, they aren't necessarily immune to real-world events. There's also been some concern about crypto being used for capital flight or to evade sanctions against Russia. At this point, it needs further investigation.

That said, I do think we are going to see more efforts to create alternative global currencies, given the scale of the new sanctions regime that has been imposed on Russia. Crypto will be part of that menu. But this development also will further increase the incentive for reserve-currency central banks to regulate crypto. Ultimately, I think the war has shaken things up, but I don't see it fundamentally changing the direction of crypto development or the regulatory response.

What's your capsule view of where we stand today? Is crypto useful?

This is an emerging area. There are lots of new ideas and new ways of transacting. Some of the energy-inefficient processes - like "proof-of-work" mining - are being shelved and more energy-efficient methods are being sought. There is a lot of innovation, and that is a good thing.

But regulators are still trying to understand what is going on, and I hope and pray that nothing blows up in the meantime. The global cryptocurrency market has already grown much larger than anyone should be comfortable with without regulation. On a good day, it's over \$2 trillion.

I don't think we have seen a crypto "killer app" yet. There are possible candidates, but there's nothing that you can put a finger on and say, "This is really useful for that particular kind of transaction or to fulfill that particular need." In the early days, crypto primarily served the needs of those who wanted to conduct transactions that didn't catch the eyes of the authorities. That's becoming less and less feasible nowadays.

So, the search is on for better uses. What can this technology potentially do? The dilemma for regulators is to allow that search while limiting the extent of risk to the financial system, the crypto system, and the public.

At this point, it's largely a process of muddling through. My hope is that in a few years, regulators will be able to look back and say, "Well, we did it reasonably and we allowed for innovation. We also learned as regulators, and there was a happy medium, which has allowed the crypto world to become useful after all."