July 2022

CONSIGLIO
PER LE **RELAZIONI**
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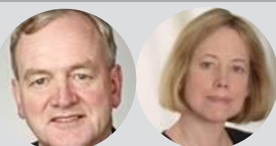
E **STATI UNITI**

STABLECOINS, RISKYCOINS, AND DODGYCOINS

(Project Syndicate – July 6, 2022)



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Recent price implosions have shown that not all so-called stablecoins are so stable after all. As policymakers draft regulations to bring some order to the crypto industry, they should focus on the economic functions that various digital tokens perform, rather than on formal legalistic labels.

NEW YORK - With no intrinsic value, no backing by anything, and a freely floating price, Bitcoin is too volatile to be appealing as a medium of exchange or a store of value. These flaws have given rise to other cryptocurrencies that are convertible on demand at a set price to something that is supposed to be more stable. But the British Financial Conduct Authority has rejected calling them "stablecoins," on the grounds that their purported stability is merely aspirational. Policymakers in the European Union and the United States also will need to consider these issues as they draft new laws regulating cryptocurrencies.

Among the different types of cryptocurrencies using the "stablecoin" moniker, some are backed by assets and some seek to maintain their value algorithmically. But the only type deserving of the name is tokenized e-money on the blockchain, fully backed by off-chain liquid financial assets with stable values.

One example is Tether, the third-largest cryptocurrency by market capitalization. According to its website, "All Tether tokens are pegged at 1-to-1 with a matching fiat currency (e.g., 1 USD₮ = 1 USD) and are backed 100% by Tether's reserves." Currently, about 86% of Tether's reported reserves are in cash or short-term liquid assets. Tether tokens can be used as a medium of exchange or as collateral in decentralized finance (DeFi). But there have been controversies over whether holders have a legal right to convert their tokens one-to-one with the dollar, and whether Tether is adequately backed and would be able to withstand a mass withdrawal.

The Responsible Financial Innovation Act, proposed by US Senators Cynthia Lummis of Wyoming and Kirsten Gillibrand of New York, might provide some regulatory relief. It refers to instruments like Tether tokens as payment stablecoins, which it would require to be 100% backed by high-quality liquid assets, redeemable at par, and subject to public disclosure of the balance sheet. This insistence on transparency and supervisory scrutiny promises to benefit both consumers and Tether. Payment stablecoins are like tokenized bank deposits. Their issuers should have access to the central bank's "lender of last resort" facility and to something akin to deposit insurance.

A second type of stablecoin is backed by off-chain, possibly illiquid, financial or real assets with variable valuations, including commodities. For example, a gold-backed stablecoin might be convertible to an ounce of gold. Such coins could be attractive to those who would otherwise hold gold, because they are more portable than gold and are divisible and easily transferable. As with physical gold, the dollar value of these assets can swing widely, which is why we refer to them as (honest) riskycoins. An informed public should be allowed to choose how much risk to bear, but regulators also must ensure that an issuing entity's claim about a token's backing is truthful.

A third category is reserved for stablecoins that are backed only by other cryptocurrencies. An example is MakerDAO's token Dai, which is soft-pegged to the dollar. The original holder of Dai trades Ethereum-based assets for it. The collateral must exceed the value of the Dai, and it is held in escrow until the Dai are returned. If the value of the collateral falls below the value of the Dai (at its dollar peg), the loan is called and the collateral is liquidated.

The allure of coins backed by other cryptocurrencies is that over-collateralization (typically 150%) provides a buffer that makes the coin less risky than the collateral cryptocurrency. But even with a large buffer stock, these

coins are not fundamentally different from Bitcoin, because they are (over)collateralized with assets that lack intrinsic value. With the peg, they are riskycoins pretending to be stablecoins, what we call dodgycoins. Here, regulators' task is to turn them into honest riskycoins by ensuring full transparency and prohibiting any firm peg to an off-chain currency.

Yet another type of "stablecoin" is not backed by anything. Instead, it relies on a "mint-and-burn" algorithm that adjusts the currency supply to maintain a peg between the coin and the dollar. Again, since there is no external value anchor, the dollar peg is vulnerable to a run if enough coin holders lose confidence in it. The risks therefore should be made clear in any prospectus, and the peg should be described as an aspiration rather than a guarantee (lest it fall into the dodgycoin category).

One recent hybrid stablecoin scheme relied on a combination of backing with another cryptocurrency and an algorithmic "mint-and-burn" mechanism. The blockchain protocol and payment platform Terra maintained a freely floating cryptocurrency, Luna, and a stablecoin, UST, pegged at $1. Users could swap one dollar worth of Luna for one UST.

When the UST rose above a dollar and users swapped Luna for UST, the traded amount of Luna was burned and more UST were minted. But when the UST fell below a dollar, users swapped UST for Luna, and UST was burned and Luna was minted. Luna went from a peak price of $116.39 on April 5, 2022, to nearly zero on May 12, 2022. UST was worth a penny on June 19, 2022. It is now clear that UST was a complex, highly risky instrument pretending to be a stablecoin. When regulators permit such complex, hybrid riskycoins to be marketed as pegged, that makes them dodgycoins indeed.

The regulatory challenges posed by cryptocurrencies and DeFi are manageable, provided that policymakers focus on the economic functions and risks of the e-money tokens and other crypto assets themselves. They must not be taken in by the formal, legalistic labels and the institutions that happen to be issuing these instruments. Most are pursuing regulatory arbitrage. Policymakers must not make it easy for them.

THE NEW PRODUCTIVISM PARADIGM?

(Project Syndicate – July 5, 2022)

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There are signs of a major reorientation toward an economic policy framework that is rooted in production, work, and localism instead of finance, consumerism, and globalism. It might just turn into a new policy model that captures imaginations across the political spectrum.

CAMBRIDGE - A new economic paradigm becomes truly established when even its purported opponents start to see the world through its lens. At its height, the Keynesian welfare state received as much support from conservative politicians as it did from those on the left. In the United States, Republican presidents Dwight Eisenhower and Richard Nixon bought fully into the paradigm's essential tenets – regulated markets, redistribution, social insurance, and counter-cyclical macroeconomic policies – and worked to expand social-welfare programs and strengthen workplace and environmental regulation.

It was similar with neoliberalism. The impetus for it came from economists and politicians – such as Milton Friedman, Ronald Reagan, and Margaret Thatcher – who were market enthusiasts. But the paradigm's eventual dominance was due in no small part to center-left leaders like Bill Clinton and Tony Blair, who had internalized much of its pro-market agenda. These leaders pushed for deregulation, financialization, and hyper-globalization, while paying lip service to ameliorating the consequent rise in inequality and economic insecurity.

Today we are in the midst of a transition away from neoliberalism, but what will replace it is highly uncertain. The absence of a solidified new paradigm is not necessarily bad. We do not need yet another orthodoxy offering cookie-cutter solutions and ready-made blueprints for countries and regions with different

circumstances and needs.

But economic policy must be guided by an animating vision. History suggests that the vacuum left as neoliberalism wanes will soon be filled by a new paradigm that eventually will need support across the political spectrum. Such an outcome may seem impossible given current political polarization. In fact, there already are signs of convergence.

In particular, a new bipartisan consensus may be emerging around "productivism," which emphasizes the dissemination of productive economic opportunities throughout all regions and all segments of the labor force. Unlike neoliberalism, productivism gives governments and civil society a significant role in achieving that goal. It puts less faith in markets, is suspicious of large corporations, and emphasizes production and investment over finance, and revitalizing local communities over globalization.

Productivism also departs from the Keynesian welfare state by focusing less on redistribution, social transfers, and macroeconomic management and more on supply-side measures to create good jobs for everyone. And productivism diverges from both of its antecedents by reflecting greater skepticism toward technocrats and expressing less knee-jerk hostility to economic populism.

The rhetoric of US President Joe Biden's administration – and some of its policies – feature many of these elements. Examples include the embrace of industrial policies to facilitate the green transition, rebuild domestic supply chains, and stimulate good jobs; blaming large corporate profits as a culprit behind inflation, and refusing (so far) to revoke former President Donald Trump's tariffs against China. When the administration's most senior economist, Secretary of the Treasury Janet Yellen, extols the virtues of "friend-shoring" – sourcing supplies from US allies – over the World Trade Organization, we know the times are changing.

But many strands of this thinking exist on the political right as well. Alarmed by China's rise, Republicans have made common cause with Democrats in pushing for investment and innovation policies to bolster US manufacturing. US Senator Marco Rubio, a past and likely future Republican presidential candidate, has made impassioned pleas for industrial policy – promoting financial, marketing, and technological assistance to small businesses and to manufacturing and high-tech sectors. "In those instances, in which the market's most efficient outcome is one that's bad for our people," said Rubio, "what we need is targeted industrial policy to further the common good."

Many on the left agree. The architect of Trump's China trade policy, Robert Lighthizer, has won many progressive fans for his hardball tactics vis-à-vis the WTO. Robert Kuttner, a leading voice on the left, has argued that Lighthizer's views on trade, industrial policy, and economic nationalism "were more those of a progressive Democrat."

The Niskanen Center, named after the libertarian economist William Niskanen (a principal adviser to Reagan), has made "state capacity" one of its main planks, emphasizing that governments' ability to provide public goods is important for a healthy economy. Oren Cass, an adviser to the Republican Mitt Romney during his 2008 and 2012 presidential campaigns and a former senior fellow at the pro-market Manhattan Institute, is a critic of financialized capitalism and supports reshoring supply chains and investing in local communities.

Likewise, Patrick Deneen, one of the leading intellectuals of the US "populist right," advocates "pro-worker policies" and "the encouragement, through government policy, of domestic production." During a recent interview in which Deneen discussed these and other economic policies, the New York Times writer Ezra Klein remarked: "What's funny about that to me is that they seem to me to resemble what the current Democratic Party is."

As James and Deborah Fallows found when they traveled across America in their single-engine plane to study local economic development, pragmatism can override political partisanship when it comes to fostering businesses, job creation, and public-private partnerships. Local politicians confronted by the challenges of economic decline and joblessness engaged with community groups, entrepreneurs, and other stakeholders in extensive policy experimentation. And in many cases their political affiliation made little difference to what they did.

Whether this kind of cross-party collaboration and fertilization of ideas will amount to a new paradigm remains to be seen. There are deep divides between Republicans and Democrats on social and cultural issues such as abortion rights, race, and gender. Many Republicans, including prominent figures such as Rubio, have yet to renounce their allegiance to Trump, who remains a threat to US democracy. And there is always the danger that

the "new" industrial policies favored by both conservatives and progressives will fizzle out or turn into the old measures of the past.

Nonetheless, there are signs of a major reorientation toward an economic-policy framework that is rooted in production, work, and localism instead of finance, consumerism, and globalism. Productivism might just develop into a new policy model that captures imaginations of even the most polarized of political opponents.

A STAGFLATIONARY DEBT CRISIS LOOMS

(Project Syndicate – June 29, 2022)

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There is ample reason to worry that major economies like the United States are heading for a recession, accompanied by cascading financial turmoil. Some of the worst elements of both the 1970s and the 2008 crash are now in play, with equity markets likely to move deeper into bear territory.

NEW YORK - The global financial and economic outlook for the year ahead has soured rapidly in recent months, with policymakers, investors, and households now asking how much they should revise their expectations, and for how long. That depends on the answers to six questions.

First, will the rise in inflation in most advanced economies be temporary or more persistent? This debate has raged for the past year, but now it is largely settled: "Team Persistent" won, and "Team Transitory" – which previously included most central banks and fiscal authorities – must admit to having been mistaken.

The second question is whether the increase in inflation was driven more by excessive aggregate demand (loose monetary, credit, and fiscal policies) or by stagflationary negative aggregate supply shocks (including the initial COVID-19 lockdowns, supply-chain bottlenecks, a reduced US labor supply, the impact of Russia's war in Ukraine on commodity prices, and China's "zero-COVID" policy). While both demand and supply factors were in the mix, it is now widely recognized that supply factors have played an increasingly decisive role. This matters because supply-driven inflation is stagflationary and thus raises the risk of a hard landing (increased unemployment and potentially a recession) when monetary policy is tightened.

That leads directly to the third question: Will monetary policy tightening by the US Federal Reserve and other major central banks bring a hard or soft landing? Until recently, most central banks and most of Wall Street occupied "Team Soft Landing." But the consensus has rapidly shifted, with even Fed Chair Jerome Powell recognizing that a recession is possible, and that a soft landing will be "very challenging."

Moreover, a model used by the Federal Reserve Bank of New York shows a high probability of a hard landing, and the Bank of England has expressed similar views. Several prominent Wall Street institutions have now decided that a recession is their baseline scenario (the most likely outcome if all other variables are held constant). In both the United States and Europe, forward-looking indicators of economic activity and business and consumer confidence are heading sharply south.

The fourth question is whether a hard landing would weaken central banks' hawkish resolve on inflation. If they stop their policy tightening once a hard landing becomes likely, we can expect a persistent rise in inflation and either economic overheating (above-target inflation and above potential growth) or stagflation (above-target inflation and a recession), depending on whether demand shocks or supply shocks are dominant.

Most market analysts seem to think that central banks will remain hawkish, but I am not so sure. I have argued that they will eventually wimp out and accept higher inflation – followed by stagflation – once a hard landing becomes imminent, because they will be worried about the damage of a recession and a debt trap, owing to an excessive build-up of private and public liabilities after years of low interest rates.

Now that a hard landing is becoming a baseline for more analysts, a new (fifth) question is emerging: Will the coming recession be mild and short-lived, or will it be more severe and characterized by deep financial distress?

Most of those who have come late and grudgingly to the hard-landing baseline still contend that any recession will be shallow and brief. They argue that today's financial imbalances are not as severe as those in the run-up to the 2008 global financial crisis, and that the risk of a recession with a severe debt and financial crisis is therefore low. But this view is dangerously naive.

There is ample reason to believe that the next recession will be marked by a severe stagflationary debt crisis. As a share of global GDP, private and public debt levels are much higher today than in the past, having risen from 200% in 1999 to 350% today (with a particularly sharp increase since the start of the pandemic). Under these conditions, rapid normalization of monetary policy and rising interest rates will drive highly leveraged zombie households, companies, financial institutions, and governments into bankruptcy and default.

The next crisis will not be like its predecessors. In the 1970s, we had stagflation but no massive debt crises, because debt levels were low. After 2008, we had a debt crisis followed by low inflation or deflation, because the credit crunch had generated a negative demand shock. Today, we face supply shocks in a context of much higher debt levels, implying that we are heading for a combination of 1970s-style stagflation and 2008-style debt crises – that is, a stagflationary debt crisis.

When confronting stagflationary shocks, a central bank must tighten its policy stance even as the economy heads toward a recession. The situation today is thus fundamentally different from the global financial crisis or the early months of the pandemic when central banks could ease monetary policy aggressively in response to falling aggregate demand and deflationary pressure. The space for fiscal expansion will also be more limited this time. Most of the fiscal ammunition has been used, and public debts are becoming unsustainable.

Moreover, because today's higher inflation is a global phenomenon, most central banks are tightening at the same time, thereby increasing the probability of a synchronized global recession. This tightening is already having an effect: bubbles are deflating everywhere – including in public and private equity, real estate, housing, meme stocks, crypto, SPACs (special-purpose acquisition companies), bonds, and credit instruments. Real and financial wealth is falling, and debts and debt-servicing ratios are rising.

That brings us to the final question: Will equity markets rebound from the current bear market (a decline of at least 20% from the last peak), or will they plunge even lower? Most likely, they will plunge lower. After all, in typical plain-vanilla recessions, US and global equities tend to fall by about 35%. But, because the next recession will be both stagflationary and accompanied by a financial crisis, the crash in equity markets could be closer to 50%.

Regardless of whether the recession is mild or severe, history suggests that the equity market has much more room to fall before it bottoms out. In the current context, any rebound – like the one in the last two weeks – should be regarded as a dead-cat bounce, rather than the usual buy-the-dip opportunity. Though the current global situation confronts us with many questions, there is no real riddle to solve. Things will get much worse before they get better.