WED, DEC 29, 2021 | UPDATED 20:05 PM IST

THE TIMES OF INDIA

MARKETS

Crypto's future is murky but its legacy has lasting value

October 3, 2021, 8:32 AM IST / Eswar Prasad in Voices, Markets, TOI

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Bitcoin's timing could not have been better. This original cryptocurrency came into being in early 2009, a period, right after the global financial crisis got underway, when trust in national governments and commercial banks was at its nadir in the US and other western economies. The notion of being able to conduct transactions without the use of central bank money and without the intervention of a financial institution had immediate appeal.

Bitcoin, a medium of exchange that could facilitate transactions using only digital identities of the transacting parties (referred to as pseudonymity), initially fuelled the dark web, where illicit commerce such as drug and sex trafficking was conducted. As it gained in popularity, it became apparent that its users' anonymity could not be guaranteed. An extensive set of transactions using Bitcoin or the purchase (and delivery) of real goods and services using the cryptocurrency make it possible to unravel users' real identities. Hackers who get ransomware payments in Bitcoin have to be quite sophisticated to hide their digital trails. Moreover, Bitcoin is unstable and transactions using it are slow and expensive. The network also cannot process large transaction volumes in a timely manner.

While it has failed in its stated objective as a pseudonymous medium of exchange, Bitcoin has somewhat paradoxically turned into a financial asset. Since Bitcoin lacks intrinsic value, its adherents seem to believe that its scarcity is the basis for its high price. The algorithm that governs the process of creating the cryptocurrency posits a hard cap of 21

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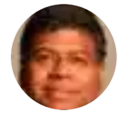

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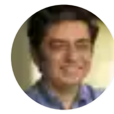

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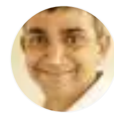

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million Bitcoins (about 18.5 million have been created so far). But scarcity by itself can hardly be a durable source of value, and at this stage, the sky-high prices of Bitcoin and similar cryptocurrencies seem to reflect pure speculative plays, with their value dependent entirely on investors' faith.

Over the years, various cryptocurrencies have emerged that attempt to overcome Bitcoin's flaws. Cryptocurrencies such as Monero and Zcash have sophisticated encryption algorithms that more effectively mask users' identities but they are cumbersome to use. A new breed of cryptocurrencies called stablecoins attempts to fix the problem of unstable value but they do require designated intermediaries to validate transactions. Somewhat ironically, stablecoins derive their stable value — a key desideratum for an effective medium of exchange — from their backing by stores of fiat currencies or government bonds. The business case for stablecoins is that they provide low-cost and easily accessible digital payments within and across national borders. Sensing an opportunity, even Facebook has proposed its own stablecoin, Diem, which would initially be backed by reserves of hard currencies such as US dollars and by US government bonds. Given the wide reach and financial clout of corporations such as Facebook and Amazon, it is not hard to conceive of their cryptocurrencies gaining wide acceptance.

However, the prospect of such corporations someday issuing unbacked digital currencies of their own is an unsettling one as it would infringe on the monetary sovereignty of national central banks. That these unregulated cryptocurrencies could be misused to fuel illicit activities such as money laundering and terrorism financing across borders is troubling as well.

China's ban on Bitcoin and other cryptocurrencies highlights how some governments see them as a threat. Other governments too are pressing hard to regulate cryptocurrencies and related speculative financial products. They also pose financial risks, especially to naïve retail investors who might not understand the risks of investing in crypto assets.

This is not to say that cryptocurrencies have not generated any real benefits. The technology that underpins Bitcoin, referred to as blockchain, is finding uses in other areas of finance. It will soon be possible to conduct a broad range of transactions, even purchasing a house or car, without traditional intermediaries such as lawyers and real estate brokers. Of course, even if ownership transfers of various financial and physical assets can be conducted on public digital ledgers using the blockchain technology, governments will still be needed to enforce property and contractual rights.

Equally importantly, central banks have

started designing their own digital versions. Countries such as Japan and Sweden have initiated trials and many others, including India, have plans to do so. Thus, cryptocurrencies are indirectly hastening the demise of physical currency. While the future of cryptocurrencies as financial assets is murky, they have clearly set off a revolution that will make low-cost digital payments broadly accessible. These new technologies will also help democratise finance by making a range of basic financial products and services easily and widely available to the masses. This might well be the true legacy of Bitcoin, one we should be thankful for.

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