Is It Time to Regulate Bitcoin?

As the digital currency grows in size, it will be hard for regulators to resist the urge to step in

By James Mackintosh

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Bitcoin has been the ideal proving ground for investment's most powerful advice: caveat emptor, buyer beware.

Individuals who lose money day trading a cryptocurrency hyped as a way to avoid central bank meddling can hardly expect to appeal to governing institutions when things go wrong. Watchdogs have intervened occasionally to restrict money laundering. But financial regulators have mostly steered clear.

Regulators are unlikely to sit on the sidelines much longer, and that is a shame. People gulled into putting a small amount of bitcoin into a worthless initial coin offering or persuaded to day trade bitcoin on margin are taught important lessons in trust and security. It is better for the bitcoin naif to lose a little quickly and learn that if an investment looks too good to be true it probably is, than never learn and end up losing their life savings on some wild speculation later on.

Unfortunately, cryptocurrencies are getting too big for regulators to ignore much longer. Aside from a change of heart on consumer protection, there are two decent reasons for them to interfere, both of which would have potentially catastrophic results for the survival of bitcoin and other digital currencies.

The first and most important is the danger to the financial system as it becomes increasingly entangled with bitcoin. Those links are just starting to be developed, with dozens of new funds pitching bitcoin to mainstream investors, while futures contracts will next week open bets on bitcoin to ordinary speculators.

It is easy to make light of the dangers: the top 1,000 or so cryptocurrencies are worth $350 billion, less than Facebook Inc., and if they all went to zero tomorrow banks would barely notice.

But the more that traditional investors are involved with bitcoin, the stronger the lobby will be pushing for regulators to keep their noses out. That will make it harder for regulators to clamp down the longer they wait, suggesting a need to step in soon.

To get a sense of the scale, if bitcoin repeats this year's rise next year it would be worth more than all Canadian-listed companies, or half the market value of all London stocks.

Still, size alone isn't the danger. When bubbles have burst in the past, the effects depended both on their size and how much they relied on debt. The far-bigger dot-com bubble popped in 2000 with nasty results for the stock market, but the lack of leverage helped the U.S. economy avoid the standard definition of a recession, as it didn't shrink for two consecutive quarters.

Compare that with one of the biggest bubbles in percentage terms: Kuwait's 1982 Souk Al-Manakh stock-market collapse. The frenzy of speculation on Kuwait's unregulated over-the-counter exchange—a former camel market—made it the ninth-most active world stock market in 1981. Fueled by postdated checks, the value of the second-rate Gulf companies traded there soared 20-fold before the bubble burst, leaving the tiny state with more than $90 billion of uncashed checks, widespread bad debts and a deep recession.

If bitcoin crashes soon it won't be a big problem. But the more the traditional financial system interacts with bitcoin, the more of a danger it will pose, as speculators borrow

dollars to bet on bitcoin moves, and the more regulators should worry.

There is another danger, perhaps even more serious from the point of view of the central banks and regulators: bitcoin might not crash. If the speculative fervor in the cryptocurrency is merely the precursor to it being widely used as an alternative to the dollar, it will threaten the central banks' monopoly on money.

Bitcoin can't carry out enough transactions speedily enough to become a true currency, but modifications to the code or another cryptocurrency might succeed. No central banker could allow that to happen, both because she would be out of a job and because it would be economically disastrous.

Bitcoin enthusiasts tend to worry about the inflationary effects of central bank money-printing, despite the absence of any significant inflation in the eight years since the Federal Reserve started to pump up its balance sheet. There is an irony is the fact that bitcoin creation is running at about 4% a year, while the Fed has begun to shrink the U.S. monetary base, but it is true that ultimately bitcoin will have deflation, since its supply is capped.

For enthusiasts, bitcoin's widespread use would be a welcome digital return to the 19th-century gold standard, where no one attempts to match the supply of money to the demand. Central bankers are more realistic, recognizing that it is politically impossible for authorities to ignore a crisis. The gold standard was suspended repeatedly by the U.K. whenever it became too onerous. The U.S. went even further in the Great Depression, banning private holdings of gold coins and bullion for decades after its 1933 devaluation of the dollar.

Central bankers, says Tony Yates, an economist and former Bank of England official, "are taking [bitcoin] seriously because they don't want to lose control of the money supply."

Central banks can't print bitcoin, so if the world switches away from fiat currencies, they would be unable to create new money to alleviate a crisis.

Bitcoin might go up a lot more before regulators get serious. But if bitcoin ever threatens to become a runaway success, governments won't stand by and watch the currencies they issue wither.

The in-between outcome would be that Bitcoin fails as a currency and finds a role as another alternative to gold, instead. If that is all bitcoin becomes, regulators will be less

worried. Unfortunately for the speculators, they should be less excited about it, too.

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