An Overdue - and Necessary – Cryptocurrency Bloodbath: The party's over'

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The American Spectator

July 14, 2022

Cryptomania has been riven by fear, doubt, and economic reality. Investors and entrepreneurs envisioned cryptocurrencies and decentralized finance as the revolution that would upend reigning payment systems like Mastercard, Visa, PayPal, Western Union, Swift, fiat currencies, and traditional financial intermediaries. The seductive narrative was too good to be true.

The cryptocurrency sector has been roiled by plummeting prices, runs on deposit-taking lenders, and bankruptcy filings. The crypto bloodbath was overdue.

Existing payment systems work effectively, have network critical mass, and are habitual. While the Federal Reserve can't be trusted to defend its value, next to the around 10,000 existing cryptocurrencies, the dollar is a veritable Rock of Gibraltar, is legal tender, and enjoys global use. And, while critics decry the financial industry's fees, current capital markets are highly competitive and effectively allocate capital to its optimal uses.

The cryptocurrency bubble, fueled by easy money and cascading risk-taking, has burst. From Nov. 8, 2021 to June 30, 2022, the total cryptocurrency market cap, bitcoin, ether, and XRP declined 70 percent, 72 percent, 79 percent, and 70 percent, respectively. In June, bitcoin nosedived, falling 40 percent. Luna is down 100 percent. Two trillion dollars in cryptocurrency value has evaporated. The undertow is pulling hyped high-flyers under.

Facing runs, cryptocurrency lenders like Celsius Network, Babel Finance, CoinFlex, Voyager Digital, Finblox, and Vauld restricted customer withdrawals.

Bank-bashing Celsius CEO and founder Alex Mashinsky, sporting a T-shirt emblazoned with the phrase “Banks are not your friends,” had urged prospective customers to “unbank yourself” and trumpeted Celsius as less risky and offering better returns than banks. Ralph Waldo Emerson’s quip, “The louder he talked of his honor the faster we counted our spoons,” comes to mind. Celsius gave depositors annual yields up to 18.6 percent. Even a fifth-grader knows you don’t generate higher returns by taking lower risks. On July 13, Celsius Network filed for Chapter 11 bankruptcy protection in New York.

Riskier financial businesses, *ceteris paribus*, should employ less leverage. Cryptocurrency lenders, however, did the opposite, leveraging aggressively to amplify returns if there were returns.

Celsius’ assets-to-equity ratio was a thin 19. By contrast, lower-risk Chase has a more conservative assets-to-equity ratio of 14. Synchrony Bank, which issues private-label credits cards, has a yet more conservative assets-to-equity ratio of 7. Chase and Synchrony provide real value to millions of consumers and businesses.

As of March 31, crypto-lender Voyager Digital had an assets-to-equity ratio of 23. Reeling from crypto hedge fund Three Arrow Capital's default on a $650 million loan, Voyager Digital filed for Chapter 11 bankruptcy protection on July 5.

Three Arrow Capital was ordered to liquidate by British Virgin Islands regulators, filed for bankruptcy in New York City on July 1, and is being investigated by the Singapore Monetary Authority. It offered rates as high as 9 percent on dollar stablecoin deposits, in turn lending to and borrowing from risky crypto businesses.

Ballyhooed crypto platform Coinbase has rescinded job offers, laid off 18 percent of its workforce, and been downgraded to "sell" by Goldman Sachs. Its stock price tanked from its high on Nov. 9, 2021, falling 87 percent by June 30, 2022.

Berkshire Hathaway's sage billionaire vice chairman, Charlie Munger, aptly derides the cryptocurrency sector as "an open sewer."

Years of negative real interest rates and easy equity fueled cryptocurrency inflation and highly speculative crypto businesses. Failures will cull weak and flawed businesses and cryptocurrencies and reallocate people and capital to better uses.

Munger lambasts cryptocurrencies as “an investment in nothing.” If there’s a silver lining, it’s that crypto has been a self-referential world of investors buying electronic bits in the hope that the proverbial greater fool will pay more for them next month, and of crypto deposits earning high yields on financing crypto trading.

Thus far, crypto hasn’t been used in the real economy. Licit goods and services are paid for using traditional payment systems in fiat currencies. Banks, public debt, and equity markets continue to fund airlines, fracking companies, gyms, wineries, and hospitals — real stuff. Crypto funds crypto. It’s like pet rocks being used to finance trading pet rocks.

Crypto’s self-contained ecosystem and tiny size relative to the financial system and broader economy mean there’s little danger of contagion.

Evangelists bent on changing the world, service providers promoting crypto to generate fees, the naïve and credulous hoping to get rich, promoters, and outright hucksters — Munger calls them the “delusional” or the “evil” — created a heady climate and a bubble. The party’s over.

Decentralized finance apostles promised a world without financial intermediaries with terms enforced by the code. But financial institutions’ role in allocating capital between savers and investors, and investees and consumers, is enshrined in law, custom, and market practices that evolved over centuries. The system works.

With healthy skepticism replacing giddy boosterism and faith, perhaps something genuinely promising will emerge out of the crypto carnage. Perhaps not.