Economic Research

WEEKLY ANALYSIS

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Bitcoin: flash crash and bursting bubble in 2018?

Bitcoin will not become a currency. Central banks hostile to private cryptocurrencies. Blockchain technology. Stricter regulatory framework. Bubble to burst in 2018?

Key points

- Bitcoin is not and will not become a legal currency in its current form
- Central banks hostile to private cryptocurrencies - overview of current views
- Stricter regulatory framework for cryptocurrencies
- Central banks will develop their own virtual currencies
- The Netherlands and the Scandinavian countries are innovating
- The BIS and IMF are advising caution
- Up 1,000%: so what?
- The influence of factors supporting Bitcoin will likely wane
- Intraday flash crash of -20% on 29 November
- Speculative bubble to burst in 2018?

Bitcoin is not and will not become a legal currency in its current form

In the mind of users, Bitcoin is clearly a virtual currency. They think of it and use it as such. They exchange their dollars and other currencies for Bitcoins, in the belief that the virtual currency is essentially equivalent to legal currencies, without considering the crucial differences that will in all likelihood prevent Bitcoin, Ethereum, and other such currencies from becoming legal currencies.

Thus, users convert their legal currency deposits into virtual Bitcoin deposits, de facto accepting to forego the guarantees provided by a secure banking system as well as the interest rate typically paid, believing they now possess a novel and modern method of payment better adapted to globalisation and the digitalisation of consumption.

The latter factor is obviously not a significant concern in a context where interest rates are close to zero. Bitcoin and other cryptocurrencies are thus increasingly becoming an easily accessible method of payment and more credible, as an increasing number of merchants are accepting to transact using digital currencies.

Is it sufficient to assume that Bitcoin is gradually becoming a currency, or is the term "cryptocurrency" itself creating confusion?

In the US, land of the Bitcoin, the media refer to cryptocurrencies, even though the government clearly considers Bitcoin an asset subject to taxation when capital gains are realised by the bearer. The definition of legal tender has changed over time, but today a legal currency is expected to fulfil a number of essential criteria, including in particular that of enabling commercial exchange and having the capacity to extinguish debt and fiscal obligations, thus representing the discharge power of a currency.

The currency must also act as a store of value and a unit of account for economic, accounting and fiscal purposes. It must be able to assure economic agents with regard to its permanence as a medium of exchange recognized and accepted by all. Modern states thus established a monopoly with respect to issuing currency by exerting permanent control on banks' creation of money via banking laws and the actions of their central banks.

While governments and central banks are indeed interested in the concept of blockchain and virtual currencies, they seem more inclined to develop their own cryptocurrencies and obviously do not appear ready to give up the privilege of being the only entities that can issue currency.

Central banks hostile to private cryptocurrencies

Central banks have long considered cryptocurrencies as microphenomena with no significant impact and no potential risks for financial and banking systems. Recent developments with regard to Bitcoin in particular, whose value currently exceeds 170 billion dollars, are starting to raise concerns. While central banks have certainly not yet taken full stock of the situation, some of them have already put in place very restrictive measures prohibiting the use of cryptocurrencies. Others have chosen to gradually regulate the use of what they consider an "asset" rather than a virtual currency.

China's central bank is among the first to have taken a clear stance on the subject. In 2017 it prohibited issuance of and transactions in Bitcoin and other cryptocurrencies, stating that current technology was not appropriate and that conditions were not ripe for the development of a digital currency. Nevertheless, the PBOC may be examining the opportunity of creating a digital currency to facilitate payments and currency control. The announcement prohibiting Bitcoin in 2017 temporarily led to a -30% drop in Bitcoin's value. In **India**, the message is similar. The central bank is staunchly opposed to the use of this type of instrument, clearly citing the risk of such currencies becoming a channel for money laundering and financing terrorism. Although the Indian central bank is likewise investigating the possibility of developing a legal digital currency, for now it has also prohibited the use of cryptocurrencies. In **South Korea**, the central bank has prohibited the use of cryptocurrencies, deemed to facilitate organised crime.

In **Japan**, Governor Haruhiko Kuroda recently mentioned the principle of creating a digital currency, stating that there is no current plan to establish a central bank digital currency (CBDC) that would make central bank accounts accessible to individuals. In **Europe**, the **German central bank** has probably provided the clearest view of its assessment of the role of cryptocurrencies, citing growing concerns with regard to the indirect effects that may arise should the use of these virtual currencies intensify. A member of the Bundesbank explained this sentiment several weeks ago, claiming that the hype and the rise in Bitcoin's value had more to do with the speculative behaviour of investors that with a genuine interest in a new form of payment. The fear is that a transfer from dollar or euro deposits to cryptocurrencies could affect the banking system and the effectiveness of monetary policy. **France** seems to share this stance, given the comments of the governor of the French central bank, who noted that all the examples of private currency creation in history ended badly. According to him, those who use Bitcoin today do so at their own risk, pointing out that no institution is backing Bitcoin or guaranteeing its safety or permanency. In the **UK** on the other hand, Governor Carney spoke of a revolution in the world of finance, referring to blockchain technology as a way to strengthen the fight against financial cybercriminality and to revolutionise the way transactions are conducted between consumers and institutions – cautious remarks, which do not truly address the issue of the systemic risks that would arise from the use of cryptocurrencies on a larger scale.

In **Canada**, studies are under way. The lead researcher noted in an interview that cryptocurrencies are clearly not genuine currencies but should rather be considered an asset or a security and be treated as such. However, the researcher's views on the prospects of blockchain technology were rather positive. In **Russia**, the concern is very clearly about Ponzi schemes, which they certainly do not want legalised. The president of the central bank, Elvira Nabiullina, thus declared herself firmly opposed to any private currency, whether physical or virtual, and prohibited any website allowing consumers to trade in Bitcoin.

The Netherlands and the Scandinavian countries are innovating

One central bank in Europe is experimenting with a virtual currency. The **DNBcoin** was indeed created by the central bank of the Netherlands in 2015 to examine the possible implications of a virtual currency, restricted to internal use for now. Initial results indicate that blockchain technology could be applied in the settlement of complex financial transactions. The views of the Norwegian and Swedish central banks are similar. The Swedish central bank is exploring the creation of a registered digital currency and seems to think that an e-krona would not pose a problem for monetary policy.

The BIS and IMF are advising caution

The Bank of International Settlements – the central bank of central banks – sums up the situation by emphasising that central banks cannot ignore the evolution of technology and people's perhaps reckless enthusiasm for cryptocurrencies, which should cause central banks to consider what position to adopt with regard to these developments. In other words, central banks have to determine what are the opportunities and consequences of creating digital currencies issued and controlled directly by central banks. However, this eventuality would also have an indirect impact on the banking system. The IMF notes in its latest report on virtual currencies that the latter can provide distinct benefits but also present considerable risks as potential vehicles for money laundering, tax evasion, financing of terrorism and fraud.

The regulatory response to these issues is only in its initial stages and will have to take into account all the various aspects involved in the development of virtual currencies. Legislation will be necessary to create a regulatory framework around these virtual currencies, which they are currently partially sidestepping.

Up 1,000%: so what?

Bitcoin's soared by +1,000% in 2017, even though no one can truly ascribe an objective value to it. In fact there is no valuation model for this type of asset. Bitcoin remains an abstract concept to which network participants are willing to assign a particular value at a particular moment, but which seems rather considerably influenced by supply and demand.

However, since Bitcoin's basic algorithm restricts the absolute number of units (maximum 21,000,000) as well as timing of release (number of units released every ten minutes dropping by half every four years), supply is by definition finite. Thus, as long as Bitcoin's popularity and buyers' enthusiasm continues to grow, the market for Bitcoins will remain in constant disequilibrium, which is exactly what has been happening since Bitcoin's inception and which has intensified in 2017 to the point where the current value of Bitcoins in circulation (170 billion dollars) is comparable to the stock market capitalisation of PepsiCo or MasterCard and is three times that of UBS.

Bitcoin's current market value is already displaying the characteristics of a speculative bubble. However, the trend is robust for now and is encouraging Bitcoin holders to wait just a bit longer to take profits. That is, unless the flash crash of 29 November heralds a change in perceptions?

The influence of factors supporting Bitcoin will likely wane

Bitcoin's success seems to be due in large part to the combination of several factors that probably came into alignment simultaneously to constitute an optimal juxtaposition favouring the emergence of what many erroneously consider a new currency. This alignment is unlikely to persist in the sense that most of these factors are surely about to reach the limits of their influence.

However, for the time being Bitcoin is benefitting from growing enthusiasm, broadly relayed by the media, which regularly report on the record increases in value and on the enthusiasm shared by part of the population for this new phenomenon so closely in sync with the technological advances accompanying the advent of the digital age. The oft-mentioned defiance of part of the public with regard to government policies stemming from the financial crisis of the past ten years remains alive and likely still constitutes a factor supporting the demand for Bitcoin.

In fact, it fosters hopes or fantasies regarding sustainable alternative solutions that would eliminate the regulatory constraints on financial transactions, in particular by facilitating the emergence of non-controlled currencies as alternatives to the main currencies with the status of legal tender, while providing all the guarantees of discretion and anonymity that no longer prevail in the financial system of developed countries.

The development of cryptocurrencies in 2017 has likely exceeded the stage at which most governments and central banks believe they must start to intervene.

It now seems increasingly likely that governments and central banks will see the need to more heavily restrict the use of Bitcoin and other cryptocurrencies, or even to prohibit their use by the public. Bitcoin has indeed benefitted from an insufficiently specific regulatory environment that is naturally poorly adapted to the accelerated evolution of technology. The future regulatory framework will likely impede the development of cryptocurrencies by eliminating the attributes that have allowed them to circumvent the efforts of the international community to put in place an international framework capable of effectively combatting suspicious financial transactions.

Bitcoin is increasingly accepted as a means of payment and has become an alternative method of storing value for an ever larger number of users. However, it its present form, it cannot be deemed a currency, nor even a virtual currency. At most governments will define it as an asset, as is already the case in a number of countries, subject to tax laws mandating the collection of taxes on capital gains. The advent of Bitcoin has undoubtedly caused governments to become more conscious and concerned about not sharing their exclusive prerogative in regard to issuing currency with private, non-controlled systems that are insufficiently regulated. In the near future we will thus likely see legal virtual currencies created by central banks based on blockchain technology, which will then spell the end of the current cryptocurrencies.

Speculative bubble to burst in 2018?

In the shorter term, the future of Bitcoin as an investment vehicle remains rather uncertain. First, while Bitcoin is indeed increasingly used as a means of payment, it would be simplistic to simply associate its development with that of e-commerce. Even though Bitcoin is used by more and more people, thereby increasing demand, it seems unlikely that e-commerce businesses will take the risk in the long term of holding on to Bitcoin obtained via sales. They should instead almost immediately exchange it for legal currency, thus increasing supply by the same amount. This factor is likely positive, but it is not the most determining factor in the equation. Speculative demand thus likely remains one of the factors bolstering the current rise of Bitcoin. It is not a new phenomenon, and it is worth recalling that, while Bitcoin's value during the past decade has experienced several phases of expansion such as the one under way in 2017, these were followed by brutal corrections. In 2011, Bitcoin's value plummeted -91%, and in 2013 it dropped -50%, while it plunged -85% between 2014 and 2015.

Bitcoin's value thus seems to be extremely dependent on the level of demand in terms of transactions and speculative activities, since as mentioned above the creation of new Bitcoin units is marginal.

Thus, as long as current Bitcoin holders remain confident and hold on to their units, it is likely that increasing demand bolstered by a still favourable media environment will be sufficient to push Bitcoin's value up just a little higher. However, we must of course encourage network participants to pay attention to the risks inherent to speculation, which in our view is becoming frenzied.

The increase in the value of Bitcoin continues to appear unfounded to us, and the speculative bubble clearly appears set to burst, as probably foreshadowed by the -20% flash crash of 29 November.

The consequences of the bursting of the third speculative Bitcoin bubble of the decade in 2018 would inevitably be more significant than those of the previous bubbles given the number of participants and the sums involved. Indeed, the previous Bitcoin crashes (2011, 2013, 2015) affected only a limited number of users, and the sums involved remained rather marginal, as even central banks concede. Recent developments in the market have completely changed the context and the potential risks. Cryptocurrencies now represent over 230 billion dollars, namely, 6% of the ECB's balance sheet by comparison. An increasing number of financial products are linked to cryptocurrencies, whose value is still limited, but which could grow rapidly with the introduction in the US of a Bitcoin futures market and the development of regulation opening the door to the creation of ETFs.

In such an environment, it is difficult to predict when the enthusiasm of participants in this market will wane and when the desire to take profits will produce a lasting reversal in the current upward trend. That said, once this process gets under way, the correction will likely be swift and brutal.

Bitcoin at USD 5,000 or 1,000 in 2018 is just as likely as an increase to USD 12,000 or 15,000, since it is difficult to obtain an objective valuation. Holders or buyers of Bitcoin for the purposes of investment or speculation will have to draw the necessary conclusions themselves before simply betting on the future.

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