Cryptocurrency and Rise of the CBDC

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From late 2020 into early 2021 cryptocurrencies ("cryptos") have surged in popularity and price bringing about a renewed interest to the space. However, lack of mainstream adoption gives us pause and begs the question of 'why?'. Why is there so much interest in cryptos again and why are investors comfortable paying 6X as much per bitcoin in the beginning of 2021 as compared to the beginning of 2020? When examining the explosion in cryptocurrency popularity, we are focusing on three possible drivers: the rapid increase in the global liquidity backdrop, the decline in barriers to purchase crypto, and finally the narrative shift of cryptocurrencies from a medium of exchange to a store of value. This narrative shift occurred because there are two distinct use cases for cryptocurrencies: a digital asset and a digital currency. Since publication of our paper in 2018, we have seen a bifurcation within the crypto space. The private community has aligned more on the digital asset/store of value side, and governments are working on the transactional/currency piece.

2020 saw the largest central bank accommodation in history. In the US, the Fed added $3.5T to its balance sheet in just 3 months due to the impact of the COVID pandemic, resulting in very high liquidity for markets. This high liquidity backdrop means there are lots of dollars looking for places to go. In common parlance, this would mean that people are "reaching" for yield/return. In order to do so, people step further out onto the risk/reward curve. For a typical investor, this might mean 70% allocated to equities rather than 60%. We believe that strong recent equity returns coupled with high valuation multiples has caused some investors to look further afield and consider positions in riskier asset classes like cryptos. Since the explosion of cryptos into public consciousness in 2017, investing in crypto has gone from a minor adventure in technology and financial regulation to as simple as downloading an app on your phone and linking a bank account or credit card. Companies like Square, Robinhood, Cashapp, and even Paypal have implemented select cryptos, allowing these nontraditional assets to reach millions of potential investors who wouldn't have previously been willing to go through the hurdles required.

Moreover, the optimism in the crypto space has undergone a narrative shift from when our last paper was published. Previously, much of the focus was on using cryptocurrencies as a digital method of transferring value – that is, as a currency. We explored some of the advantages cryptos have in that area in our last paper, so we won't rehash it here. That rhetoric has declined, giving way to the oft-repeated sentiment that bitcoin is "digital gold." If valuing an online currency/value transfer service proved difficult, wait until one tries pricing a "digital store of value" like bitcoin markets itself today. What does "store of value" mean in that context; what value is being stored? It may be helpful to examine the real life equivalent: gold. Physical uses for gold account for roughly 55% of the total demand[i], with the remainder coming from investors or central banks. Thus, bitcoin is trying to capture the 45% of demand that is unconnected to gold's physical properties. Far be it from us to determine whether that is possible, but bitcoin proponents love the comparison, noting that bitcoin is even scarcer than gold. If bitcoin can decouple the value associated with commodities from their underlying uses, then it truly could become a digital store of value.

Crypto as a Digital Asset

Three years ago, when we wrote about the potentiality in the cryptocurrency space, we briefly touched on the various quixotic potentials of some projects. Fast forward until today, and we can unanimously say, at least from a technical perspective, "Not a lot has changed." Crypto is still a fringe space, and although more people may have heard of it, and possibly even own a bit, few use it regularly or at all. The limited use of crypto has not harmed its price appreciation; the speculative projects still have great investor interest. The types of projects seeking to make big, industry-shaping changes are still fairly early in development, and few have rolled out working prototypes. Crypto's perpetual promise of big change being just around the corner is still true in 2021.

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This mindset is fueled by more institutional adoption – CME has announced they're launching futures for a second cryptocurrency, Ethereum. The Grayscale Bitcoin Trust (ticker GBTC), one of the few SEC approved vehicles for cryptocurrency investment available on traditional stock exchanges, saw explosive adoption over the past few months, and plans to roll out similar products for other popular cryptocurrencies. It's easy to understand Grayscale's desire for expansion; at one point, demand for GBTC was such that the trust was trading for 45% above net asset value. In other words, investors (retail or otherwise) were willing to pay 45% premium for exposure to bitcoin, simply because GBTC was a more convenient vehicle. On February 8th, it was revealed that Tesla converted $1.5b of its balance sheet into bitcoin[ii].

Additionally, we have seen major positions opened by investments companies: MassMutual purchased $100m and the hedge fund Skybridge purchased $300m late last year. These are the type of corporate actions to keep an eye on moving forward. As more and more institutions add bitcoin or other cryptocurrencies to their balance sheet the more pressure it puts on competitors to do the same. In addition to the sticker shock of those large balances, the most surprising part to us is the companies made their investments before highly anticipated crypto regulations have been rolled out. Sweeping regulation, although not on the roadmap at this point, could certainly cripple the cryptocurrency space. One area that will not face regulatory challenges, though maybe public perception challenges, will be Central Bank Digital Currencies (CBDC). CBDCs are an emerging area of interest, and they share many characteristics with traditional cryptocurrencies. It's likely that without traditional cryptos proving the concept, we would not see central bank interest in issuing their own digitally native currency.

CBDCs

A quick look at central bank digital currency

1. What is a central bank digital currency?

CBDCs are natively digital currencies issued directly by the central bank which transact on a blockchain of some kind. This would allow for the peer to peer transactions envisioned by cryptocurrencies and remove the need for a third party such as a bank. As an example, the Fed would issue digital US Dollars. Central banks have been exploring this type of money for about a decade with some countries such as China and The Bahamas, already issuing CBDCs directly to citizens. CBDCs resemble cryptocurrencies, in that both CBDCs and cryptos are supposed to act like digital cash. However, both options have their respective limitations. Crypto prices are volatile which inhibits their value as a medium of exchange, and CBDCs, being issued by a central bank, will not enjoy all the privacy benefits of cash.

2. Why would consumers and governments want a CBDC?

There are a few different use cases for consumer CBDC adoption, and we have already outlined the appeal of the cash-like peer-to-peer exchange attributes but one we have not discussed yet is the financial inclusion aspect. As of the most recent FDIC "how America banks report"[iii], an estimated 5.4% of American households – or 7.1 million – are unbanked. The main reasons cited are "don't have enough to meet minimum balance requirements", "don't trust banks", and "avoiding a bank gives me more privacy". These 7.1 million households are effectively locked out of the electronic economy and must rely on a more costly and less efficient shadow banking system. Although CBDCs would not be a cure-all to the un-banked or underbanked problems, it would give consumers the ability to transact in normal channels.

The COVID-19 pandemic showed some of the problems with traditional cash circulation and how commerce can be constrained when the velocity of cash declines. Issuing CBDCs may help alleviate the cash crunches we saw in developed nations during this past year but are often common in emerging/developing countries. This "new way to pay" would likely increase the robustness of the financial system. Another reason central banks may want to issue CBDCs is to streamline and enhance their monetary policy tools. This area, although possibly the most interesting, is currently the most unclear and heavily debated.

3. What are the main concerns about issuing CBDCs?

Two risks, apart from the privacy concerns we noted above, which we want to highlight are potential commercial bank intermediation and CBDCs acting as a safe-haven asset leading to a run on traditional commercial banks.

US commercial banks are key players in the growth of the money supply through prudent lending and they gather the deposits needed to fund that lending by offering consumers interest as well as other transaction related services. If central banks were to offer interest bearing CBDCs directly to consumers and they were able to move/transact easily, there could be decreased need for the commercial banks from a consumer standpoint. Along those same lines, if the CBDC was considered a safe-haven asset when compared to commercial money, there is a possibility that commercial banks would see runs on their deposits into the CBDCs during times of stress. Both risks could destabilize the current banking system and central banks are carefully considering how to mitigate these risks.[iv]

Conclusion

At the end of the day, we are a bit disappointed in the slow pace of technological development in the blockchain and utility token space. But, from a digital asset and CBDC perspective we could not be more impressed. The macro landscape has changed in a way that will be hard to undo. Fortune 500 companies are actively swapping dollars for bitcoin on their balance sheet and central banks are starting to see the appeal of digital currencies over the traditional "digital" dollar. Seeing companies make this balance sheet swap is a statement to governments that the current system is no longer working in their favor. They would rather assume the risk and volatility associated with bitcoin than manage the near guaranteed loss of purchasing power that comes with holding dollars. Bridging the gap between where we are now and where some see the financial system moving, we think CBDCs would present a compelling way to transact in the future and decrease the friction currently present in the system. We are not confident enough to say they will catch on or be broadly adopted in the near term, but central bank pilots, research projects, and general interest in the concepts are increasing rapidly. It is too early to say what the implications of these projects will be on cryptocurrencies or financial markets in general, but simply moving in that direction, however slowly, is a signal to the world that governments are open to progress and development.

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[i] *World Gold Council. (2021, January 28). Gold demand Trends full year and q4 2020. Retrieved March 12, 2021, from https://www.gold.org/goldhub/research/gold-demand-trends/gold-demand-trends-full-year-2020*

[ii] *Telford, T. (2021, February 08). Tesla invests $1.5 billion in Bitcoin, will start accepting it as payment. Retrieved March 12, 2021, from https://www.washingtonpost.com/business/2021/02/08/tesla-bitcoin-musk-dogecoin/*

[iii] *How America Banks: Household use of banking and financial SERVICES, 2019 FDIC SURVEY. (n.d.). Retrieved March 12, 2021, from https://www.fdic.gov/analysis/household-survey/*

[iv] *Central bank digital currencies: Foundational principles and core features. (2020, October 09). Retrieved March 12, 2021, from https://www.bis.org/publ/othp33.htm*

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