Intelligence MEMOS

From: Mark Zelmer and Jeremy M. Kronick

To: Canadian Crypto Watchers

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Re: CRYPTOCURENCIES NO DEFENCE AGAINST INFLATION

People have many buoyant expectations of cryptocurrencies as they look for ways to conduct their financial affairs outside the traditional financial system. They hope that, as crypto and its supporting blockchain technology mature, there will eventually be no delays in settling their transactions, cheaper cross-border transactions, and no pesky fees on bank accounts, among other advantages.

Many also imagine that crypto assets can protect them from rising inflation.

That, however, is one benefit crypto assets do not offer.

Crypto assets such as bitcoin and ethereum and their decentralized blockchain technology offer the promise that, at some point in the future, it may be possible to price goods and services and have one's savings denominated in, say, bitcoin or ethereum terms, and then conduct transactions in a quicker, more secure fashion than is possible in today's financial system with its aging IT infrastructure. Appropriate laws and regulations can help Canadians realize the benefits of privately-issued crypto assets without being unduly exposed to critical risks.

Canadians will be disappointed, however, if they think that holding and transacting in crypto assets will save them from inflation. Assets such as bitcoin and ethereum have no intrinsic value. Their prices, or exchange rates if you like, are extremely volatile from day to day and week to week, with daily price swings of up to 30 percent not uncommon. That would make it very difficult for any business to price its goods and services or for Canadians to have confidence in the value of their savings.

Consider: The public is not enthused by the volatility we see in gas prices, which can move up and down by a few cents a litre over the course of a day. Do we really think it would tolerate the extreme gyrations that could ensue if all goods and services and savings were denominated in a private cryptocurrency that was not linked to anything beyond its algorithm?

Even if the rules of the game encouraged more stable demand such that we largely eliminate the daily volatility in prices, assets such as bitcoin and ethereum are also unlikely to serve Canadians well against more persistent trends in inflation. One of the reasons the gold standard was abandoned by most countries in the 1930s was because it was too rigid a straitjacket; the supply of gold could not adjust to the shifts in demand for money over the course of an economic cycle. That led to many booms and busts and ultimately the Great Depression.

The Great Depression, of course, led to the creation of the Bank of Canada.

Now think about an economy where a private crypto asset such as bitcoin or ethereum, with a strict algorithm governing its supply, serves as money and thus the unit of account for most purchases of goods and services and as the basis for valuing personal savings. Such an economy would suffer the same shortcomings as the inflexible gold standard and leave the public on its own to cope with major shocks, such as a global pandemic or financial crisis. That was not acceptable in the 1930s. It is hardly likely to be more acceptable today.

What if bitcoin and ethereum changed their algorithms to be more responsive to changing money demand? Unfortunately, the interests of a private crypto issuer are unlikely to align with those of society more generally, which we have seen repeatedly over time with other forms of private money. The temptation to profit from over-issuing a private cryptocurrency might be too hard to resist at some point in the future. One only needs to look at many consumer loyalty programs to see how the purchasing value of their points is gradually eroded over time as program rules evolve.

There remain many benefits to be gained by having the Canadian dollar or some form of Canadian dollar-linked crypto asset continue serving as money for Canadians in the emerging crypto world. Indeed, we believe a new legal and regulatory framework for crypto assets should encourage the issuance of crypto assets that are tightly linked to the Canadian dollar.

But Canadians will likely only use such instruments as money if inflation is under control. With the most recent reading at 5.7 percent – almost a full four percentage points above target – there is a long way to go. It is the Bank of Canada, not crypto assets, that must get us there.

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