UNCTAD YSI
Summer School
3-7 September 2018

Governing Cryptocurrencies Through Forward Guidance

Goldmann, Matthias
Pustovit, Grygoriy

Goethe University Frankfurt & Research Center SAFE

The views expressed are those of the author and do not necessarily reflect the views of UNCTAD

Governing Cryptocurrencies through Forward Guidance

Contribution UNCTAD YSI Summer School

Matthias Goldmann and Grygoriy Pustovit
Goethe University Frankfurt & Reseach Center SAFE

While the last year saw the free trade in goods struggle against trends towards protectionism, cryptocurrencies seemed to tear down one border after the other – physical, geographic, and legal ones alike. Opinions about the 'whether', 'what', and 'how' cryptocurrencies should be regulated are sharply divided. Unsurprisingly, financial regulators and supervisors chose for the most part a 'wait and see' tactic until late in 2017, treating cryptocurrencies as a minor glitch in the world of international finance.

The unprecedented price hikes of cryptocurrencies towards the end of 2017, however, made the need for regulation imminent. Several factors accounted for this development: On the one hand, the technological potential of distributed ledger technology as a market infrastructure for financial services, among others, became more and more apparent, and their connections to the real economy became stronger. On the other hand, access to cryptocurrencies became easier. Not long ago, only IT and finance geeks knew how to buy, sell, and assess the risks of cryptocurrencies. The advent of user-friendly services, which allow ordinary consumers to effortlessly buy cryptocurrencies, blended with a human greed prepared a fertile ground for a rush on the market for cryptocurrencies.

Regulating indirectly: Manage expectations by public statements

And then the unexpected happened: A sort of regulation kicked in much more quickly than foreseen, and much more effective than imagined. It began at the height of the Bitcoin bubble, when the French government thought loudly about putting the regulation of cryptocurrencies on the agenda of the G20. Others followed soon.

Some of the interventions seem to have triggered sharp declines in the value of Bitcoin. Others have hardly any perceptible effect. Our interpretation is that factors determining the (potential) impact of a statement on the value of Bitcoin include: (1) the importance of the actor for financial markets in general and the size of the respective national or regional market; (2) the novelty of the announcement; and (3) the character of the announcement. Warnings addressed to consumers have usually triggered a much milder market reaction than proposals to find international agreement on a regulatory framework, or even concrete unilateral steps to ban cryptocurrencies or specific aspects of them.

The market seems to inscribe these public proclamations in its collective shared memory, which functions like a ledger, a virtual public record. Words are deeds here: Every public

statement by a government or supervisor produces an entry in the virtual ledger of cryptocurrency markets. To the extent that the ledger reflects a consensus among regulators, it provides forward guidance in a market fraught with regulatory uncertainty.

This guidance has been largely virtual, consisting in warnings, programmatic statements and declarations of intent. Only in a few cases did the statements quickly give rise to concrete regulatory measures. For example, China took a stalwart position against cryptocurrencies by actually banning initial coin offerings, ordering the closure of cryptocurrency exchanges and trying to shut down Bitcoin 'mines'. By contrast, the majority of regulators and supervisors have confined themselves to alerts and proposals to regulate cryptocurrencies, but rarely resorted to concrete actions.

Why have these public statements effective? The technology has not changed. Regulators would still find it difficult to control the use of cryptocurrencies in many respects. But they do control many of those buying, selling, brokering, accepting cryptocurrencies as payment, and holding them, and they can restrict their ability to do so. For example, governments could discontinue the tax deductibility of expenses paid in cryptocurrencies, impose specific taxes on such transactions, or impose rigorous capital requirements or anti-money laundering requirements on cryptocurrency intermediaries. Nothing hits cryptocurrencies harder than restricting their ability to connect to the real economy. It is therefore possible to regulate cryptocurrencies indirectly.

The experience of the supervisory response to the cryptocurrency bubble of the past months keeps important insights for any prospective regulation of cryptocurrencies: First, public statements are a highly effective tool for the regulation of blockchain platforms in the short term. Financial markets are all about expectations of future returns. Public statements manage these expectations, a fact well-known in monetary policy as forward guidance that now becomes more relevant for financial regulation. This raises a number of legal issues, such as the question of appropriate procedural safeguards that ensure legitimacy but without compromising the effectiveness of these highly discretionary instruments. Moreover, it appears necessary to extend the scope of judicial review accordingly.

Need for an incubator for regulation

The second insight relates to the incredible speed of fintech innovations. Regulation needs to keep up with it, yet it requires lengthy negotiations at the domestic and possibly also at the international levels. One should not run the risk of a large bubble with potentially systemic effects just because it is not possible to put regulation in place quickly enough. So far, some domestic regulators have addressed this challenge by adopting a 'sandbox' approach. It

relies on experimentation and supervisory discretion, allowing startups to set up a business within a defined area for a certain time under relaxed regulatory requirements.

However, a sandbox approach clearly call for international coordination. Otherwise, it is likely to cause risks by incentivizing regulatory arbitrage and potentially harmful competition. What should such international coordination look like? To achieve a balance between safety and innovation, it should emulate the experimental character of sandboxes. One could conceive of a 'sandbox for regulators': an arrangement that would not immediately and prematurely engage in legal regulation, but facilitate, first, the exchange of information among regulators and supervisors, and second, coordinated communication and forward guidance. Regulators and supervisors could flag their views as experimental, temporary, and subject to revision. Ultimately, the sandbox for regulators might become an incubator for faster, more flexible, incremental, and more sustainable regulation at the European and international levels. International standard-setting bodies could provide a framework for the sandbox for regulators, including the Financial Stability Board, the BIS / Basel Committee or the IMF. Alternatively, domestic authorities could provide the necessary momentum for international cooperation. A recent initiative proposed by the UK Financial Conduct Authority (FCA) is the Global Financial Innovation Network (GFIN) which aims to unite various domestic regulators and supervisors in the frame of a 'global sandbox', allowing joint policy work and regulatory trials. However, there is a risk that domestically driven initiatives may end up in regulatory arbitrage on a larger scale.