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The Rush to Cryptocurrencies

by Richard W. Rahn

A JUSTIFIED FEAR OF INFLATION FUELS THE SEARCH FOR MONEY ALTERNATIVES

Last week, the Federal Reserve announced that it had reached its goal of a 2 percent inflation rate. Why not 1 percent or 4 percent or better yet, zero? The act creating the Federal Reserve back in 1913 tasked the Fed with the goal of price stability — which in normal (not Washington) speak should mean an inflation rate of zero.

The United States and most other countries were on the gold standard in 1913, which had given the world a high degree of price stability. After the United States finally totally decoupled the dollar from gold in 1971, the country went through a bout of high inflation, which, by the late 1970s, had reached a rate of above 13 percent and caused the prime interest rate to climb as high as 21 percent.

To bring down the inflation rate, the Fed forced a severe recession on the country. That disaster of four decades ago is still deep in the memories of us who were alive at the time.

People see the debt buildup in the United States and most other major countries and correctly ask, "How long before the next great inflation?" This justified fear of a new inflation is one of primary motivations of many in the search for money alternatives that are independent of the irresponsible world political class.

The great economist/philosopher F.A. Hayek wrote a classic book in 1976, "Denationalisation of Money," which not only made the economic case for non-government money, but described how private commodity-backed monies could come about.

In addition to inflation, there are other factors that motivate the search for non-government monies. The U.S. dollar is de facto the world's currency. Most commodities — oil, most internationally traded grains and metals, and many others are denominated in U.S. dollars. Most foreign governments hold a major portion of their monetary reserves in U.S. dollars.

People in countries with unstable currencies, such as Venezuela, Argentina and many others, use paper U.S. dollars both as a transactional currency and store of value — in fact, much more physical U.S. currency is held outside of America than within.

The foreign holdings of U.S. dollars and very low-interest dollar-denominated debt means that the rest of the world is, in essence, giving the United States a subsidy in the form of interest-free or very low-interest loans. Obviously, this situation causes resentment in the rest of the world — poorer countries subsidizing the biggest rich country.

Another resentment is caused by U.S. financial imperialism. The United States is able to impose its tax law outside of its own borders, and regulate foreign banks, other financial institutions, and even non-financial institutions. Most international commerce is done in U.S. dollars — and the U.S. government sets the rules for dollar usage.

All businesses need banks, and banks need other banks — called corresponding banks— to transmit and receive funds both within and outside their own national borders. The corresponding banks need to have their own corresponding banking relationships with even bigger, and usually international, banks. The biggest banks deal directly with the U.S. Fed to clear both domestic and international payments (checks and wire transfers) among each other and the banks that have corresponding relationships with them.

If the U.S. government tells a primary bank that has an account with the Fed not to deal with another bank, because that bank deals with banks or businesses that engage in things the U.S. government disapproves of — terrorist or drug dealing finance, or facilitating U.S. tax evasion, or violations of other U.S. tax regulations or securities laws, etc., the bank has almost no choice but to comply — or be shut down.

Such financial power enables the U.S. government to impose sanctions on countries like Iran or North Korea. In sum, the U.S. government tells businesses and banks throughout the world, "Comply with our sanctions or we will make life hell for you if you make or receive payments that are ever converted to U.S. dollars anyplace in the world."

The U.S. government, in co-operation and encouragement of some other governments, notably the Europeans, uses its power to strip away virtually all financial privacy from both individuals and companies, and even governments. And finally, the costs of all of the regulations have resulted in high fees for international payments through banks.

Many governments, such as Chinese, Russian, Swiss and others, as well as millions of private individuals and companies, want to free themselves from the U.S. financial yoke. Hence, the search for a functional cryptocurrency.

Bitcoin, with its blockchain technology, was a great step forward, by enabling peer-to-peer transactions (outside the banking system) with a high degree of financial privacy. But it has failed to provide stability given its huge price swings, and it has proved to be cumbersome to use and slow, and much more-costly — including the amount of electrical power used in its "mining" operations — than envisioned by its creators.

Hayek was probably right in that any new currency will need to be backed by real commodities. A computer algorithm, such as that behind Bitcoin and most of the other cryptocurrencies, is unlikely to meet the test. The effort to find alternatives to the dollar is almost certain to succeed given the global political and financial interest, and the amount of brainpower at work.

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