Which way are cryptocurrencies headed?

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The emerging view is that virtual digital assets (VDAs) and cryptocurrencies shall remain part of the formal economy for the long haul and that discouraging their existence is not a solution. This is a reasonable inference since India is one of the largest markets for cryptocurrencies. Imposing a unilateral blanket ban is not wise. The finance minister shared a reasoned view that the decision to ban or prohibiting these intriguing assets should be undertaken after "significant international collaboration on the risks, benefits, evolution of common taxonomy and standards."

A fiat currency supported by the Indian rupee would facilitate speedier and low-cost inward remittances as well as fast worldwide payments. However, there is scepticism about its acceptability as a store of retail value. With the Reserve Bank of India (RBI) undertaking its inescapable journey of the digital rupee as a Central Bank Digital Currency (CBDC), keeping a close eye on developments outside India's political and financial capitals is crucial. Understanding how other countries are going about adopting and regulating their CBDCs will be as important as assessing the impact on commercial and retail banking.

The recent rapid meltdown in the crypto market has further cemented this view. In the past several weeks, more investors have exited the crypto markets rather than enter it. Vauld, a once promising digital asset-based borrowing and lending platform founded in 2018, is one of many projects that have collapsed recently. The majority of investors and users of Singapore-based Vauld are Indians. These developments correlated with the precipitous decline in the value of crypto assets, including Terra UST and Luna.

Several decentralised finance (DeFi) projects were considered big, but they failed to preserve the wealth of the investors. The resulting erosion of billions of dollars from the market dented the confidence and value ascribed to the evolving global DeFi ecosystem. In the aftermath of these financially destructive events, the Governor of RBI reiterated that cryptocurrencies are a "clear danger" and a "make-believe idea" with a sophisticated name.

At the time of writing this article, Bitcoin and some other strong cryptocurrencies and stable coins are making a gradual recovery. Unlike previous trends where prices of most cryptocurrencies were away with the fairies, the markets will not be witnessing a striking boom for some time. Nevertheless, it would be a gaffe for regulators and investors to assume that crypto markets have lost their footing.

The first step towards indirectly curbing crypto trading was taken in the announcement of the Union Budget in March 2022. The finance minister (FM) announced the imposition of a 30% tax for transactions in digital assets from July 2022. Confusion prevailed in the industry and tax circles about the real meaning and operational dynamics that might be caught between the traditional ways of taxation and the unconventional nature of the technological beast.

In the same budget speech of March 2022, the FM announced that India would be releasing its own digital currency as a digital rupee to give the economy a big boost. It is important to understand that although CBDCs are significantly dissimilar from cryptocurrencies, regulatory bodies are racing to develop a fiat-based model that would integrate the most exemplary characteristics of the crypto environment.

The looming uncertainty in the Indian regulatory environment pushed the Internet and the Mobile Association of India (IAMAI) to dissolve the Blockchain and Crypto Assets Council (BACC) in July 2022. Three days later, replying to questions in the Parliament, the FM alluded to two key messages. She stated that digital or crypto currency cannot be treated as 'currency', and their value rests solely on the speculations and expectations of high returns that are not well anchored. Some clarity emerged when last month, the Lok Sabha cleared the Finance Bill 2022 giving its approval to the proposal of taxing VDAs (or, crypto tax) in India.

The advocates of a stable cryptocurrency ecosystem have been arguing that as digital assets and their foundational technical architecture gain momentum and recognition over time, the volatility would reduce and security of the technical architecture would strengthen. Only time will tell if this claim will hold true. But systems need to be built ahead in time so that small-time investors do not see their wealth erode. These stakeholders have extended arguments criticising RBI's conservative approach towards a promising technology.

We can be sure that there will be synergies and non-complementarities that will have implications for the profitability of some financial institutions. When combined with the dual dynamics of Open Data Policy and inter-industry digital ecology, CBDCs can accelerate the transformation of the rigid exchange paradigm that exists today to an innovative, technology-led, equitable paradigm of the future.

The RBI has been candid about its aversion towards cryptocurrencies, which it believes to be risky and disruptive to the financial system. In a circular released last year, RBI urged regulated entities to proceed in carrying out customer due diligence procedures for digital asset transactions in accordance with regulations for KYC (Know Your Customer), AML (Anti-Money Laundering), CFT (Combating Financing of Terrorism), and commitments under the PMLA (Prevention of Money Laundering Act), 2002. The objective was to ensure adherence with applicable provisions under the Foreign Exchange Management Act for all kinds of digital overseas transactions.

While countries are polarised in how and what kind of regulations should be framed, there is consensus that the crypto markets must be regulated. Instead of adopting the traditional methods of taxation, India can take some inspiration from other countries to create legislations to monitor, regulate and tax digital assets.

The current stand of the United States (US) Securities and Exchange Commission (SEC) is that the crypto tokens and stable coins must be treated as 'securities' irrespective of how much and where investors channel their money. The UAE government is putting in place a system for digital assets to be reported to tackle money laundering in real estate and anti-terrorism laws.

Japan and Australia have accorded legal status to cryptocurrencies. China, US, and the UK have created frameworks to keep a close check on them. The Financial Conduct Authority of Britain is firm on the need for harmonised international norms that govern the cryptocurrency market. Singapore, the hub of cryptocurrency companies, has recently released regulations for its crypto-players. The Monetary Authority of Singapore (MAS) currently monitors the digital asset sector through laws prohibiting money-laundering and terrorism. MAS is proactively thinking about creating and strengthening a forum where users or investors can lodge complaints for fraud committed by crypto companies, platforms or exchanges.

Russia, a critical node in the global cryptocurrency ecosystem, has expressed concerns of potential financial instability of digital assets due to extreme volatility. However, Russia continues to allow the use of cryptocurrencies for international settlements along with related transactions in digital assets. This will help track transactions and identify users – an anathema to the crypto community that considers anonymity, encryption and untraceability as the holy grail of the system. The point is that Russia avoided a knee-jerk reaction of imposing a blanket ban or a blanket tax net.

The plummeting of crypto valuations could be linked with the larger macroeconomic fluctuations, including inflationary pressures, bull run in the equity markets, outflow of FIIs, and global shocks in metals and crude oil. Some believe that the risk profile of crypto markets is NOW similar to those of oil prices and technology stocks. However, data also suggests that while the overall value of the crypto market tumbled by two-thirds to $1 trillion, there is still unwavering faith in the future of crypto and blockchain technology.

Despite the hit the sector took in the past few months, large investors and venture capitalists are not pulling their money out. In fact, they have been pouring more money than the last year into digital currencies, digital financials backed by blockchain, and fintech startups that have promising use case for these technologies. The Indian government is also trying to move forward. RBI hiking the repo rate by 50 basis points to 5.4% to control surging inflation is unlikely to impact the prices or trade pressures in the crypto market in India.

At the end of the day, if we believe in market efficiency view, then prices of major cryptocurrencies are a reflection of the overall assessment of the future prospects of digital assets. There is a need to have serious deliberations on the rules, regulations, and laws governing sale, purchase, investment, transfer and overseas transactions in cryptocurrencies. For this to happen, globally harmonised international rules and standards are vital for all stakeholders.

The article has been authored by Ashish Bharadwaj, dean, O.P. Jindal Global University and Parishti Kaushik, law student, Gujarat National Law University.