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## Contraction in the Market for Digital Assets Highlights the Economic Risks and Need for Further Regulation

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## Contraction in the Market for Digital Assets Highlights the Economic Risks and Need for Further Regulation

In the fall of 2021, the digital asset market reached a record-high [\\$3 trillion](#) market capitalization. Since then, it has lost over [\\$2 trillion](#) in total value as a combination of rising interest rates and high-profile digital asset scandals made these risky digital assets less appealing to investors. The most notable of these scandals happened in just the last few weeks, when the [third-largest](#) cryptocurrency exchange, FTX, declared bankruptcy after it was revealed to have fraudulently engaged in risky financial bets with its customers' deposits. Its founder was also [indicted](#) on a number of charges related to defrauding investors.

The broad contraction in the digital asset market and the consistent string of hacks, scams, fraud and other criminal activity have cost everyday investors billions in market value. Unfortunately, many of these consumers bought into the crypto asset boom just as prices were peaking and are likely the least [able](#) to weather large financial losses. While the recent digital asset collapse is worrying, guardrails between the digital asset landscape and traditional finance mean that lagging digital asset values do not appear to have [spilled](#) over into the broader economy.

This recent and painful history highlights the need for greater market transparency to prevent fraud and for common-sense investor protection efforts that can be accomplished in part through [existing](#) securities regulations. While the decentralized and borderless nature of many crypto companies makes enforcement and prevention efforts [more difficult](#), this recent collapse calls for a comprehensive approach to crypto regulation that prioritizes consumer protection and economic stability ahead of unproven claims of financial innovation.

*After years of growing popularity and market size, turbulence in a number of digital assets in 2022 triggered \$2 trillion in losses to investors*

Cryptocurrencies like [Bitcoin](#) and [Ethereum](#) are digital financial assets that use specific technology to remove the need for a traditional financial institution, such as a bank, to verify financial activity. Instead of relying on a bank to keep track of account balances and transactions on their own private ledger, crypto assets claim to increase privacy and efficiency by spreading this authority across a network of users on a type of public decentralized ledger known as a [blockchain](#). Since 2009, the market for cryptocurrencies and the broader class of digital assets has grown from a niche industry to a globally significant financial market.

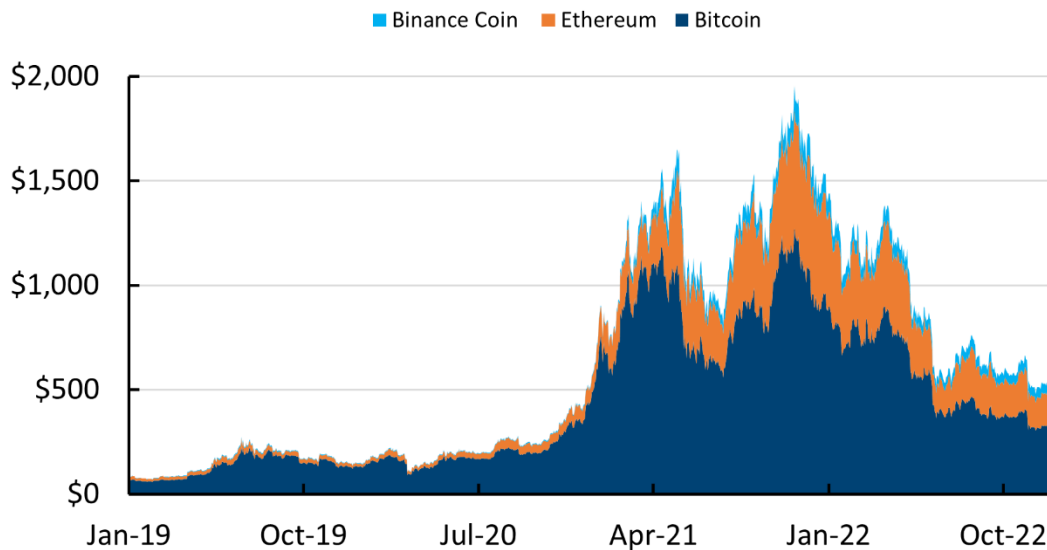
After years of digital assets being marred by the volatility of boom and bust cycles, 2021 proved to be the most profitable and optimistic time for this adolescent market as cryptocurrencies and their investors realized unprecedented returns. The total market capitalization of cryptocurrencies peaked at more than [\\$3 trillion](#) in November of 2021, with the three largest digital currencies at the time—Bitcoin, Ethereum and Binance Coin—dominating over 60% of the market (see figure below).

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However, cryptocurrency markets experienced a sharp reversal in 2022. Financial institutions and individual investors lost over \$2 trillion in value as they divested from volatile crypto markets and adopted a risk-averse strategy amid global financial turmoil. These pronounced losses hurt many first-time time investors who poured in their savings with the promise of a new pathway to wealth. The confidence of late 2021 and early 2022 wore off as values plummeted through the end of the year.

## Market Capitalization of the Three Largest Cryptocurrencies

Bitcoin, Ethereum and Binance Coin, Jan. 2019-Dec. 2022, in billions



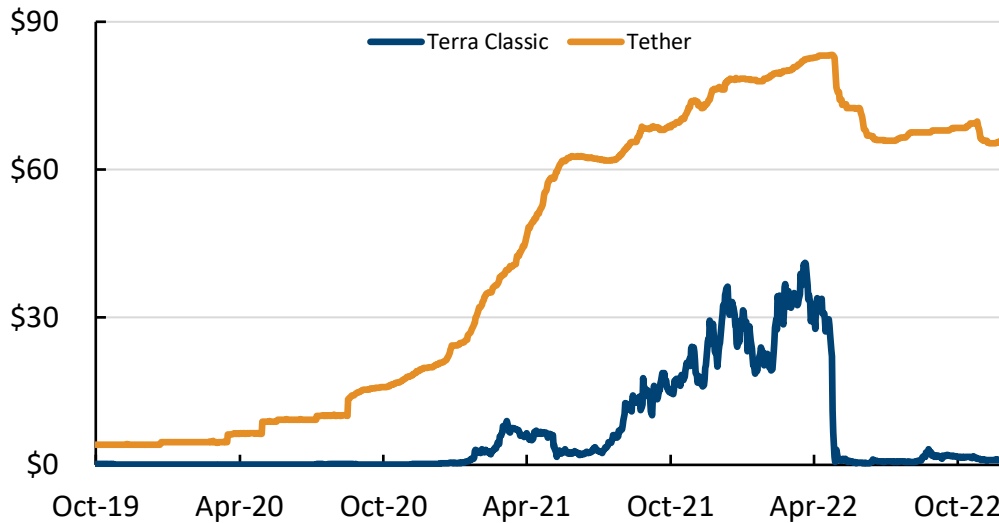
Source: CoinMarketCap Historical Data



In recent years, an asset class known as “stablecoins” have cemented themselves in the digital asset market. [Stablecoins](#) are a type of digital asset that purport to maintain a stable value against a traditional financial asset like the U.S. dollar, meaning crypto investors can use stablecoins to more easily buy and sell other digital assets directly instead of having to transfer dollars or euros into their crypto wallets. Despite the name, several major stablecoins have routinely failed to maintain a consistent value in the wake of broader turbulence in the market. In the past year, one massive stablecoin project, Terra, [collapsed](#) when investors began to doubt the provider’s ability to effectively maintain its value. The largest asset-backed stablecoin, Tether, was [revealed](#) in 2021 to likely hold insufficient reserves to maintain its stable value. If doubts about Tether’s reserves continue, then investors could trigger a digital [bank run](#) by selling off their Tether and further stressing the provider’s ability to maintain sufficient collateral.

## Stablecoin Market Capitalization Has Faced Extensive Losses

Tether and Terra Classic, Oct. 2019-Dec. 2022, in billions



Source: CoinMarketCap Historical Data



Cryptocurrencies and digital assets are no longer an afterthought within financial institutions, with companies like [Fidelity](#) allowing customers to include cryptocurrencies in their 401(k) plans. The meteoric rise and fall of the digital asset market, along with notable fraud cases, have prompted a push for a crypto [regulatory framework](#) from the private sector, Congress and federal agencies.

### *2022 set records for the scale of digital asset fraud, hacks, scams and abuse, highlighting the pervasive risks to consumers in the cryptocurrency market*

More than [\\$3 billion](#) was lost in hacks of digital asset platforms in 2022, setting a new record for digital theft. October was the worst-ever month for crypto-related crimes with over \$700 million in losses. The two largest crypto hacks to date have resulted from hackers exploiting blockchain technology to steal \$625 million worth of funds from the [Axie Infinity Ronin Bridge](#) and \$325 million from the [Wormhole](#) hack. Hacks and a lack of institutional protections have also resulted in losses by more mainstream platforms like Crypto.com which [lost](#) over \$34 Million in January of this year due to poor security practices.

In addition to these hacks, the Federal Trade Commission reported that over 46,000 Americans lost a total of at least [\\$1 billion](#) in 2021 to digital asset scams in which criminals deceive unsuspecting people into paying them in difficult-to-trace cryptocurrencies. The true scale of the losses is likely even higher given the limited scope the FTC has in investigating digital asset scams, and its reliance on self-reporting by victims.

The market has also seen digital asset versions of more traditional securities fraud schemes. [EthereumMax](#) used celebrity endorsements to facilitate a “pump and dump” scheme where the company artificially inflated the price of a digital asset before insiders sold off their stakes, collapsing the price and causing unwitting victims to lose 98% of their investments. [Rug pulls](#)

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are another common form of crypto fraud. These schemes involve a team of developers getting investors to commit funds to a new digital token project through promises of sky-high returns, before then abandoning the token and absconding with the underlying funds, leaving investors with a worthless asset. Recent analysis suggests that over [97.7%](#) of cryptocurrencies listed on the exchange platform Uniswap were rug pulls, pointing to the ubiquity of these scam efforts in parts of the crypto landscape.

### *The drop in digital asset prices hit newer investors with less financial cushion the hardest, and many everyday investors lost their savings*

In recent years, as digital assets have become more mainstream, smaller retail investors increasingly entered the crypto market. Recent [survey](#) data indicate that a majority of traders do not have a college degree and over one-third had annual household incomes of less than \$60,000. Data from the Pew Research Center [shows](#) that people of color are more likely to own cryptocurrencies than their white counterparts, with 18% of Black adults reporting that they had invested in, traded or used a cryptocurrency, compared to 13% of white adults.

Though large financial institutions look a larger hit in dollar terms from the market contraction, these firms have large cash reserves and other investment portfolios that can [cushion](#) these losses. Most household investors do not have this option. Many of these more recent [investors](#) poured their life savings into digital assets based on marketing [claims](#) that digital assets represented a fundamental re-ordering of the financial system, and were then left with major losses when the market tanked. The collapse of stablecoin projects like TerraLuna [cost](#) investors \$45 billion in losses in a 72-hour period and hit everyday investors the [hardest](#). Other investors were effectively locked out of their assets. For example, exchanges like Celsius, [froze](#) user funds because the company was going bankrupt. In other instances, the markets for smaller crypto projects simply [dried up](#) with no potential buyers.

While data limitations inherent to these decentralized assets make it difficult to assess the exact number of Americans who owned crypto or the total amount lost, the market's path suggests clearly that those who invested in crypto starting in 2022 took a substantial hit. While Americans are much [more likely](#) to own stocks or buy lottery tickets than invest in crypto, growing interest in crypto and aggressive marketing could change that trend and expose people to these risky assets. For example, a number of financial firms, such as Fidelity, have increased the [prevalence](#) of crypto assets in retirement accounts. Additionally, many traditional banks now [offer](#) crypto assets to their banking customers, and consumer-facing apps like PayPal, Venmo and CashApp have also [expanded](#) their acceptance of digital asset transactions.

### *Disruptions in the digital asset market could pose additional risks to broader financial stability*

As the digital asset market has both grown and become more interconnected, developments have revealed significant [risks](#) to broader financial stability. In a recent [report](#), the U.S. Department of the Treasury's Financial Stability Oversight Council highlighted how the digital asset market currently has a lack of basic risk controls, no limits on excessive borrowing and is more interconnected than ever. If this trend continues, the collapse of one large cryptocurrency could disrupt the traditional banking sector in ways that undermine economy-wide stability.

The 2008 financial crisis [exposed](#) how interconnected firms making risky financial bets with borrowed funds in the absence of sufficient regulation can eventually cripple the banking system.

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Recent developments in the digital asset landscape raise similar red flags about the overall health of the crypto system. The recent collapse of one of the largest digital asset exchanges, FTX, was driven by excess [leverage](#) and their CEO, Sam Bankman-Fried's choice to use customers' deposits to make risky investments through an affiliated hedge fund, Alameda Research.

Given the size of FTX and its [inextricable](#) position in the broader crypto ecosystem, its collapse [contributed](#) to another massive drop in the total value of digital asset as many customers rushed to [sell](#) their crypto holdings and close their accounts. The full fallout from FTX's collapse remains to be seen, as Bankman-Fried's recent [arrest](#) for securities crimes will likely uncover additional dimensions to this crisis, but the broader collapse has made clear the fundamental instability of the digital asset market built on false promises of financial innovation.

The event has also drawn [parallels](#) to the infamous collapse of Lehman Brothers in the fall of 2008, where the bankruptcy of one over-leveraged financial firm signaled a coming economic catastrophe. Thankfully, the crypto market has yet to embed itself in the broader economy and is nowhere near as important to overall economy as the housing market was in 2008. This is due in part to [prudent decisions](#) by financial regulators. That said, there are lingering concerns that [other parts](#) of the digital asset market could fracture in ways that threaten broader economic stability.

*The digital asset market—if it survives—requires additional government oversight to protect consumers and maintain financial stability*

Though the high-profile collapse of FTX likely means that customers are more aware of the risks inherent in these digital assets, the allure of building financial wealth outside the traditional banking system will likely continue. Wealth [inequality](#) across race and class lines has worsened in recent decades, as pathways for lower-income families to [move up](#) the economic ladder and earn [higher wages](#) have deteriorated. Longstanding racial [inequality](#) in the U.S. financial system has contributed to these inequities and likely increase the allure of digital assets to families who want to achieve financial security but are otherwise excluded from traditional ways to build wealth. When lower-risk pathways to economic security are out of reach, it is understandable that struggling families would look to other opportunities, like Bitcoin, to try to build wealth and achieve a better life.

While [investments](#) made by the Biden administration will help increase economic mobility and strengthen these more stable pathways to financial security, the demand for crypto assets among those who are least-prepared to weather losses will likely continue. As long as digital assets are primarily used for financial speculation, they will continue to pose significant risks to consumers. It is thus vital that U.S. regulations ensure that digital assets are kept separate from the broader economy and investors are better informed about ongoing risks. Former CFTC Chairman Timothy Massad has argued that existing U.S. securities regulations can expand federal oversight over [stablecoins](#) and the [broader](#) digital asset market. Separately, the 117<sup>th</sup> Congress saw a wide range of legislative [proposals](#) for digital asset regulation, and the Joint Economic Committee held one of several hearings [exploring](#) the role of cryptocurrencies in the broader economy. Regardless of the approach taken by the federal government, the last year of turbulence in the cryptocurrency market makes clear that further action is needed to protect the U.S. economy and everyday investors.