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Yellen, crypto, and risk of loss

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It's been a rough week in the crypto markets. The biggest news has been the performance of TerraUSD, which — borrowing a term from money market funds — " broke the buck " earlier this week, meaning that it fell below its $1 price target. That's a problem for TerraUSD, which is an algorithmic stablecoin that relied on a complex mechanism of code combined with another crypto token to balance supply and demand to stabilize TerraUSD's value at $1.

Not surprisingly, Washington has taken notice. During yesterday's House Committee on Financial Services hearing on the Financial Stability Oversight Council, Treasury Secretary Janet Yellen was asked about the recent sharp decline in the value of cryptocurrencies. Referring to the TerraUSD meltdown, Yellen said that "[w]e've had a real life demonstration of the risks," and called for a "comprehensive framework so that there are no gaps in the regulation" to guard against "the risks." Yellen agreed , though, that there's no immediate danger to the broader financial system.

While the media and some policymakers seem content to lump them together, it's important to differentiate between algorithmic stablecoins and collateralized stablecoins. All stablecoins seek to peg their value to some other asset, usually a fiat currency. But algorithmic stablecoins are not collateralized and rely on an algorithm to stabilize their value, whereas collateralized stablecoins maintain their value by maintaining a reserve of fiat currency (or commodities). These are two very different beasts.

Norbert Michel and I have proposed a regulatory framework for the unique risk presented by collateralized stablecoins: whether the issuing entity has the reserves it claims to have. There have been several thoughtful pieces of legislation floated in Congress seeking to address similar issues with respect to collateralized stablecoins.

But algorithmic stablecoins, which function without reserves, do not present this unique risk. The risks that algorithmic stablecoins may present are more in line with other digital assets, which are evaluated on the strength of their code, among other factors.

Yellen, though, didn't seem to be referring to any more sophisticated risks than the most obvious: the risk that some people will lose money by investing in crypto. But the government should not seek to protect people from loss. Individuals should be free to invest as they see fit. Moreover, risk is a natural component of markets and failure is often necessary for development. As Senator Patrick Toomey, R-PA, said earlier this week: "[F]ailure should be an option…It'll probably take some failures in this space in order for the market to figure out what works." Americans should be able to participate in that process–for better and for worse–without the government's attempts to protect them from risk.

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