Source: *The Business Times*, p18
Date: 11 March 2021

A widely circulated credible currency has to serve as a convenient transaction medium, operate on a cost-competitive system, preserve reasonably stable value, and be guarded by a trusted national authority. Bitcoin and alike fail in every dimension.
PHOTO: REUTERS

Individually rational, collectively insane

A sober reflection of a practical economist after negative repo rates, GameStop saga and Bitcoin craze. **BY DUAN JIN-CHUAN**

REFERRING to the Bitcoin phenomenon as a craze must, in the eyes of its enthusiasts, reflect my bias already. As a finance academic and long-time market watcher, I can't help but see the stratospheric Bitcoin price, along with negative 10-year US Treasury repo rates (reaching minus 4.25 per cent) and how social media propelled GameStop's rise and fall, as a collective symptom of the underlying illness of the global economic system.

Were I a diehard efficient markets believer, I would scratch my head hard to find some information-motivated explanation for each of these phenomena. Being a practical economist though, I have come to a conclusion that markets have gone "rationally insane" (if that makes any sense), displaying the cumulative effect of the distortion created by the macroeconomic and financial policies of the world's major economic powers post the 2008-09 global financial crisis. The distortion has been further exacerbated by the Covid-19 pandemic. Now let me elaborate.

WHY PAY BORROWERS INTEREST?

Before going further, let's understand what this very important 10-year US Treasury repo rate is about. The repo (repurchase agreement) rate is a short-term borrowing cost by pledging 10-year US Treasury bonds as collateral. A negative repo rate at 4.25 per cent in effect suggests that the lender is willing to pay the borrower 4.25 per cent on an annualised basis in exchange for the use of collateral for a few days.

Collateral is commonly understood as a protection against the borrower's failure to return in full the borrowed amount plus interest. How weird when the collateral becomes what a lender really goes after! Simply put, so many lenders need 10-year US Treasuries to cover their existing short exposures and repo became their indirect means of obtaining US Treasuries. The technical explanation aside, one has to wonder how we get to such a bizarre situation – rational acts by lenders and borrowers but collectively defying our common sense.

Too much liquidity has driven down Treasury yields (in other words, driven up Treasury prices) for a protracted period. Markets are jittery and traders must make bets (directional or credit-risky) to earn returns expected of them. Betting on US Treasury rates rising and thus shorting US Treasuries is an understandable trade move when facing the upcoming US$1.9 trillion US Covid relief package piling on top of already enormously large accumulated budget deficits.

This additional spending will have to be financed by issuing more US Treasuries which will in turn be absorbed by the US Fed Reserve through, in laymen language, printing more money. It is therefore a certainty that more liquidity will be poured into the already liquidity-saturated markets.

SOCIAL MEDIA OVERPOWERING COOLER HEADS

GameStop, a brick-and-mortar gaming merchandise retailer, saw its stock price jumping from under US$20 at the beginning of January to reach a peak of US$483 in less than a month. Soon after, it collapsed below US$50. Its dramatic surge was propelled by social media posts under a prevailing anti-Wall Street establishment sentiment reacting to hedge funds' shorting of GameStop.

What interests an independent observer like me is the fact that GameStop, premised on a struggling retail business model, could still be hyped up to the point of absurdity when liquidity is abundant, forcing hedge funds to cut losses on their reasonably formulated short positions.

Interesting though, conventional reputable media were not caught up in this frenzy. My research team has recently completed a study of credit-focussed media sentiment on North American corporations by deploying natural language processing techniques on a sample of over 400,000 articles in three highly reputable international business presses. These conventional media clearly expressed their reservations on GameStop's stock price rise. Obviously, their voice was drowned by social media.

Self-fulfilling prophecy can be intoxicating to induce seemingly rational actions at the individual level for some period of time. Collectively, we get to witness an ugly display of insanity in which cooler heads were simply overpowered by the frenzy justified with continually rising prices.

SHOULD BITCOIN BE PRICED SO HIGH?

Notwithstanding the acceptance of Bitcoin in some circles as a medium of exchange and prized by an increasing segment of the population, Bitcoin and other cryptocurrencies aren't really currencies. A widely circulated credible currency has to serve as a convenient transaction medium, operate on a cost-competitive system, preserve reasonably stable value, and be guarded by a trusted national authority. Bitcoin and alike fail in every dimension.

The fact that Bitcoin kept on breaking new price records seems to prove the naysayers wrong. The hype now becomes self-fulfilling. Among its many champions, Jesse Powell, CEO of Kraken, a crypto exchange, was recently quoted as saying, "Bitcoin could reach US$1 million in the next decade".

Amid this hype, it is hard to stay coolheaded. After all, some in your social circles may have already made a killing from Bitcoin. I need to remind myself to focus on the power of blockchain technology and not to get caught in this crypto frenzy. Let us not forget that the vested interests want the party to go on.

Cryptocurrencies are speculative instruments armed with a fancy story. They are not in any way qualified as digital assets because they have zero intrinsic value to begin with. A Bitcoin entitles its owner nothing but a chance to wait for other willing parties to accept it later at a higher price – the good old greater-fool-theory at display yet again.

Bitcoin's price enters the stratosphere in large part due to overflowing liquidity in a financial system that is hardwired to chase returns. Many may have already forgotten how subprime mortgages were promoted in the period leading up to the global financial crisis in 2008. Offering sub-prime mortgages to individuals with no income and no assets was then justified by citing rising real estate prices. Bitcoin is now justified by hyping it up with a baseless dream price of US$1 million in ten years.

WHAT LIES AHEAD?

The US Federal Reserve reacted to the negative repo rate by releasing Treasuries to temporarily ease the shortage, but the underlying financial imbalances remain and the markets will soon be flooded with even more liquidity due to the US Covid relief package.

Humans are by nature not good at managing a soft landing because who wants to be blamed for spoiling a party to pre-empt an intangible crisis. So, serious economic imbalances tend to be resolved through spectacular collapses like a financial crisis.

No one would question the wisdom of offering a massive relief packages at a time of crisis like the Covid pandemic. Thus, exercising fiscal and monetary prudence in normal times becomes critical. Save for a rainy day, so to speak.

I am of the view that US authorities have squandered the many opportunities to restore fiscal and monetary balances in the decade post the global financial crisis. Now, the Fed is forced to absorb massive fiscal deficits by expanding its already bloated balance sheet. Ironically, this has become the reasoning behind the claim that Bitcoin could reach US$1 million in 10 years.

More asset bubbles will be in the making and many bizarre happenings can be expected until we rein in the runaway liquidity. Paying borrowers interest, the GameStop saga, and stratospheric Bitcoin price are simply the tip of the iceberg.

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