A Short History of Crypto Euphoria

An eminent economist's taxonomy of bubbles is applied to the latest financial fad

Andreas Adriano

Financial bubbles are easy to identify after the fact. But how do you spot one in advance? It's a question that has flummoxed generations of economists, not least the many who failed to foresee the global financial crisis. Now, with the rise of crypto assets, the question is taking on renewed relevance. Rather than engage in more or less informed intellectual speculation on the subject, we decided to consult the preeminent expert on bubbles: John Kenneth Galbraith.

Granted, the eminent Harvard professor and best-selling author of *The Great Crash, 1929* and *The Affluent Society* died in 2006, three years before Bitcoin came into existence. But Galbraith predicted what could happen in a caustic book, *A Short History of Financial Euphoria*, in which he analyzes major speculative events in history, from the tulip mania of 1630s Holland to the Wall Street crash of 1987, and identifies their common features. His taxonomy would have nailed the dot-com bubble and the 2008 crisis. So let's apply some of his criteria to crypto assets.

"The thought that there is something new in the world…"

"The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version," Galbraith wrote.

What does a leading crypto evangelist have to say? In an e-book titled *Bitcoin vs. the 2018 Recession*, Remy Hauxley, a self-described "cryptocurrency educator," says Bitcoin is "unlike anything we have ever seen. It'll change the world." Hauxley calls Bitcoin "a new form of gold, of money, of stocks. It's a trifecta." (He doesn't explain why a recession is so surely coming in 2018.)

"The extreme brevity of the financial memory…"

"Financial disaster is quickly forgotten," Galbraith observed. "When the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely confident generation as a brilliantly innovative discovery in the financial and larger economic world."

It has been about a decade since the 2008 crisis and almost a generation since the dot-com bubble, so the irrational exuberance of those two periods has largely faded from memory. Many Bitcoin traders are too young to remember either episode.

"The specious association of money and intelligence…"

Galbraith noted that people often think that "the more money, the greater the achievement and the intelligence that supports it." Rich people receive adulation for being rich, and those less well-off follow in their footsteps and make the same investments. This provides a stock of greater fools to keep the speculative engine running and, in the short term, reassures the rich that they are in fact smarter than the rest.

"Speculation became more and more intense…"

"The bulbs might now change hands several times at steadily increasing and wonderfully rewarding prices while still unseen in the ground," Galbraith wrote, describing the Dutch mania for tulips.

In the old days of bricks and mortar, an initial public offering, or IPO, was a kind of corporate rite of passage for a start-up. Nowadays, it's the initial coin offering, or ICO. Instead of stock, ICO investors buy tokens redeemable in the new currency once, *if,* it goes into circulation. Unlike stock, tokens don't confer any ownership rights. Block.one, in the most successful ICO so far, has raised more than $1.5 billion since July 2017, despite the clear indication that its tokens "do not have any rights, uses, purpose, attributes, functionalities and features." All told, ICOs raised $6.5 billion in 2017, and more than $4 billion in the first quarter of 2018, according to the *Wall Street Journal*.

Many speculative investors snap up tokens just to flip them to others eager to join the race.

"All crises have involved debt that has become dangerously out of scale…"

Short memory? A false sense of novelty? The supposed intellectual superiority of the moneyed folk? People eager to pour money into business plans as thin as ether? All these elements have been present in every big speculative episode in history. Crypto assets (that's what we call them at the IMF, to distinguish them from old-fashioned currencies) appear to check all these boxes. One big element is still not clear: how much debt is involved.

Debt is what drives the "insanity born of optimism and self-serving illusion," Galbraith wrote, describing how the 18th century bubbles in the United Kingdom and France became a systemic crisis. People borrow money to join the party, because other people are making tons of money. (They must know something, right?)

Just how much money investors are borrowing to buy crypto assets is still mostly unknown, because of this market's opaque and unregulated nature and early stage of development and the seemingly minimal exposure of major banks. But leverage is clearly involved. Some crypto exchanges allow investors to borrow as much as 100 times the cash balance in their accounts. A recent poll by LendEDU, a financial education website, found that a growing number of investors use credit cards to buy coins, and then carry the balance—a risky strategy.

Some people grow ridiculously rich, while others lose the farm. Anyone who bought Bitcoin in the last two months of 2017, when the price reached almost $20,000, has been played for a greater fool. Volatility isn't the only risk. Since 2011, according to *Reuters*, hackers have stolen almost 1 million Bitcoins (worth over $9 billion in early May) from several exchanges. Of course, bubbles do happen without excessive leverage. The dot-com boom is an example. Many analysts believe that is why the ensuing recession was relatively short and mild.

"The speculative episode always ends not with a whimper but with a bang…"

Galbraith concluded that, by their nature, all bubbles end badly, triggering a period of intense scapegoating, during which those previously called geniuses are blamed, but societies usually don't recognize their collective insanity—or learn from it. The current episode may produce more of a whimper than a bang. As Bank of England governor Mark Carney noted in a recent speech, even at their peak, all crypto assets combined were worth less than 1 percent of global GDP, while tech stocks at the height of the dot-com mania were valued at close to a third of global GDP.

Can any good come of this?

The so-called South Sea Bubble hit the United Kingdom during the early 18th century. For the first time, investors were able to buy shares of companies offering new and exciting products and services, like the one that promised to develop a precursor to the typewriter.

Webvan, one of the many casualties of the dot-com bubble, offered fast delivery of groceries. Founded in 1996, it went bankrupt in 2001,

The current episode may produce more of a whimper than a bang.

after burning through more than $800 million in investors' money. In July 2000, *Fortune* called AllAdvantage "the dumbest dot-com in the world." It actually *paid* people to surf the web in return for showing them ads. It, too, folded.

The typewriter, of course, turned out to be the main text processing device for more than a century. Amazon (which bought Webvan), Walmart, and many other companies now offer quick grocery delivery. Facebook made a $16 billion profit in 2017 with targeted advertising, the principle that AllAdvantage tried to develop—and without paying anyone!

Yes, many crazy ideas are thrown around during periods of financial euphoria. Some do stick. Some asset price bubbles, like the dot-com episode, are periods of creative destruction that give rise to inventions that change people's lives in a lasting way. It's too early to say whether crypto assets will have a similar impact, though the signs are promising. The problem is that, while only a few bubbles create something worthwhile, all are destructive—of value, wealth, and trust in institutions. Humanity has figured out how to innovate without euphoria. But, as Galbraith shows, it rarely learns the lessons of financial bubbles. FD

ANDREAS ADRIANO is a senior communications officer in the IMF's Communications Department.

ART: ISTOCK / 1933BKK