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Will cryptocurrencies replace gold as an asset?

Essentially, bitcoin and other cryptocurrencies are no different from gold, apart from the fact that central banks are yet to hold them in the reserves

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As inflation raises its head across the world, there is growing debate as to whether cryptocurrencies could be a better hedge against it than gold. When people accumulate wealth, they seek a wide portfolio of assets to park their wealth in. Typically, this will include both financial and physical assets with a range of risk-return profiles. Among financial assets, there is no safer one than government securities denominated in the sovereign currency of the country, but their risk-free character is counterbalanced by low returns, sometimes barely enough to give the holder a real return after adjusting for inflation. Individuals and businesses therefore seek other financial assets – for instance, corporate bonds and equity shares – that yield adequate returns over time even if there are risks from asset price volatility and default.

Another asset class that agents accumulate are physical assets comprising of mainly real estate and precious metals, the latter primarily being gold and to a lesser extent, silver. Given the hassles in dealing with land and property and their poor liquidity, gold is an important physical asset that people continue to trust as a safe mode of holding wealth. The question is: why? Physical assets like gold are no one's liabilities and are therefore free from counterparty risks. It is also highly liquid and while there has been a great amount of volatility in its price, it has appreciated over a longer period of time, thereby providing a hedge against inflation.

Nonetheless, gold is no longer money. So, where does it derive its intrinsic value from? Is it only because agents believe that others demand it too and a market for it will always exist? While this may partly be the answer, there is another reason that gives people the confidence to accumulate gold, perhaps unknowingly. Massive quantities are still held by central banks across the world.

Out of the total quantity of approximately 200,000 tons of gold that has ever been mined, some 30,000 tons is held by central banks across the world. Among the largest holders of gold reserves are the US Federal Reserve (8,000 tons), followed by the most advanced countries in Europe (each holding between 3500 and 2000 tons), Russia, China, Japan, and India (700 tons). Interestingly, many central banks continue to add gold as an asset to their reserves. Out of the total production of 3200 tons in 2019, central banks alone purchased some 650 tons, although there was a sharp dip in purchases in 2020.

But why do central banks hold gold when they issue fiat money that is no longer convertible into precious metals? The only reason must be that the lessons of history cannot be erased from memory: if there ever is a global crisis that completely wrecks monetary systems worldwide, the only recourse may be for governments to revert back to some form of a gold-based monetary system, at least in the sphere of international exchanges of goods and services. In other words, gold could stage a comeback as the only generally acceptable international medium of exchange.

Will central banks diversify their reserves portfolio to include cryptocurrencies like Bitcoin or Ethereum? Before addressing this question, it is important to distinguish between central bank digital currencies (CBDCs) and Bitcoin. While the former is fiat money and the financial liabilities of a central bank, Bitcoin and other similar cryptocurrencies are akin to gold: they are digital assets that are no one's liabilities and therefore do not entail counterparty risks. Importantly, they operate with "no central authority or banks … nobody owns or controls **Bitcoin**." These are exactly the features that central banks might seek in an international medium of exchange during a global crisis, especially one in which there is intense hostility among the largest countries.

Governments today are, however, apprehensive about and oppose cryptocurrencies. Nonetheless, there is increasing acceptability of Bitcoin (and other similar cryptocurrencies) among private sector agents including individuals, businesses, banks and financial institutions as not only a convenient, cheap and reliable instrument to settle payments but also as an asset to hedge against inflation. Even the largest global wealth managers like Blackrock, J.P. Morgan and Goldman Sachs believe that Bitcoin is emerging as an asset class that can no longer be ignored. The market cap of above-the-ground gold stands at US$ 11 trillion while Bitcoin alone stands at US$ 1 trillion and cryptocurrencies in all amount to US$ 2.7 trillion. It should be kept in mind that gold has been in use for thousands of years whereas cryptocurrencies are just about a decade and a half old. And like gold (but unlike fiat money) they derive their value from the fact that there will always be a demand for it. While this may sound like the perfect Ponzi scheme, it is essentially no different with gold.

If the recent trend in Bitcoin and other cryptocurrency prices continue, it may only be a matter of time before some central banks are tempted to hold and exchange them for (a larger quantum of) dollars whenever necessary in order to counter volatility in their domestic currency's exchange rates. However, until major central banks continue to hold gold and do not accumulate digital assets, gold will continue to remain a dependable asset even if Bitcoin and other cryptos bite into its share among private sector agents.

Views are personal and do not represent the stand of this publication.

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