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Rethinking the Case for Crypto Regulation

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Abstract: The United States (US) and European Union (EU) have opted to extend the regulatory perimeter to incorporate crypto-related activities. This risks the integrity and stability of the financial system. Defining features of the crypto world are fraud, theft and facilitating criminal activity; so far at least, it does little to support the real (legal) economy. The risk is that by conferring legitimacy on crypto, regulation will increase the demand for crypto assets, entrench a highly volatile asset in traditional financial institutions, undermine market discipline, and increase financial instability.

Keywords: crypto currency; regulatory perimeter; criminal activity; legitimacy; market discipline; financial instability

JEL Classification: D18; E44; G01; G18; G20; L51

1 Introduction

A substantial literature argues for expansive regulatory control of crypto assets mainly because of risks to financial stability (Catalini and Gans 2018; De Filippi and Wright 2018; Financial Stability Board 2023). The EU has taken significant steps to regulate crypto-assets through the implementation of its Markets in Crypto-Assets Regulation,¹ and the United States is implementing a strongly pro-cryptocurrency policy following the passage of its Guiding and Establishing National Innovation for U.S. Stablecoins Act (GENIUS Act).² The extension of the regulatory parameter to embrace the crypto world is a significant risk. While the literature identifies several potential benefits of crypto adoption (e.g., payments efficiency, financial inclusion, cross-border transactions, innovation), these remain so far largely

¹ Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937 (OJ L 150, 9.6.2023, p. 40).

² <https://www.congress.gov/bill/119th-congress/senate-bill/1582>.

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unrealized.³ At the same time, crypto plays an important role in the financing of illicit activities and is prone to fraud and theft.⁴ It is this servicing of the illegal economy that gives crypto its fundamental value (Rogoff 2025). Including crypto in the regulatory perimeter only serves to bestow credibility on the crypto world. It will amplify the risks that crypto poses by signaling the legitimacy of crypto assets, increasing demand for them, including from traditional financial institutions, and undermining market discipline.

2 Signaling Legitimacy

The strongest argument against regulating crypto is about conferring legitimacy because legitimacy creates responsibility (Congressional Research Service 2023). When a state regulates an activity, it implicitly communicates that the activity is lawful, recognized, and structurally integrated into the economic order. Securities markets, for example, are heavily regulated to prevent fraud and assure investors that participation occurs within a structured and supervised system. Similarly, banking licenses and deposit insurance signal safety and government backing. By extending the regulatory parameter to the crypto world, the EU and US are sending a similar signal. Retail investors who might otherwise treat crypto as a speculative or fringe activity may interpret regulatory oversight as a seal of approval. This is particularly concerning given the extraordinary volatility of crypto assets. Unlike equities, which represent claims on productive firms, or bonds, which represent contractual claims on identifiable cash flows, many crypto tokens lack intrinsic value or underlying income streams. Rather, their valuations still depend importantly on speculative demand, network effects that include criminal activity, and narrative momentum. Regulation does not change these fundamentals but, by creating a perception of stability, it obscures them. By legitimizing an activity that does little to support the real economy regulators are just draining creative resources from productive activities. Even the US's lighter touch approach to regulating crypto is likely to encourage the migration of financial activity from traditional finance to the newly legitimized crypto world. Regulation that is aimed at protecting investors will instead entice more of them into high-risk markets. Moreover, by investing political

³ On the potential benefits of crypto adoption see, e.g., Catalini and Gans (2018), Cong and He (2019), and IMF (2020), and on the limitations to date see, e.g., US Department of the Treasury (2022), Alvarez et al. (2022), Patel (2024), and Njilla and Kato (2026).

⁴ According to the June 2022 FTC Consumer Protection Data Spotlight, January 1, 2021 to March 31, 2022, more than 46,000 people have reported losing over \$1 billion in crypto to scams. That's about one out of every four dollars reportedly lost to fraud during that period. Because the vast majority of frauds are not reported, these figures reflect just a small fraction of the public harm.

and institutional capital into supervising crypto, it will become harder for regulators to distance themselves from that industry's failures. This is because regulatory oversight implies responsibility, which invites expectations of rescue in the event of investor losses. If crypto collapses after being comprehensively regulated, public trust in regulators will also erode. By contrast, leaving crypto outside of the regulatory parameter would have preserved the clarity that crypto operates at investors' own risk.

3 Institutional Entrenchment

Without state backing or integration into mainstream finance, speculative bubbles (e.g., The South Sea Bubble in 1720, shadow banking and money market mutual funds in the late 1970s, the dot.com boom and bust 1995–2000) often collapse under their own weight.⁵ It is also the case that there are regulated markets for high-risk assets that function reasonably well (e.g., junk bonds, ETFs, listed options and retail-oriented derivatives), but these tend to be assets that are not systemically imbedded in the financial system, and that have a value anchored to fundamentals through defined income streams or asset prices, and are held mainly by nonbank institutions (e.g., hedge funds, mutual funds, pension funds) that can absorb losses without triggering immediate defaults. By contrast, when financial instruments become regulated and integrated into the banking system, they can become “too big to fail.” For example, mortgage-backed securities were not fringe products; they were regulated, rated, and widely held and their apparent legitimacy, reinforced by regulatory frameworks and institutional participation, encouraged investor participation on a large scale. When the underlying risks materialized in 2008, governments were compelled to intervene (e.g., Shiller 2008). If crypto assets become similarly entrenched through regulation and banks build up large exposures, crypto volatility will impact the financial system more generally. By bringing crypto within the perimeter of official finance, policymakers have transformed a speculative niche into a potentially systemic vulnerability. Leaving crypto largely outside of the regulated financial core would have left in place a firewall, ensuring that the extreme volatility of crypto, while sometimes painful for investors, was largely self-contained. Regulation is dissolving that firewall.

⁵ For an entertaining description of these events see Aliber et al. (2023).

4 Market Discipline

Proponents of financial regulation sometimes argue that crypto markets are rife with fraud, manipulation, and opacity. This is true (see, e.g., Yaffe-Bellany et al. 2025; Tiwari et al. 2025) but it is not a reason for including it in the regulatory perimeter. The absence of regulation serves a disciplining function: investors understand that they are operating in a high-risk environment and the lack of government guarantees encourages investors to carry out due diligence. When investments fail, losses are borne by those who voluntarily assumed risk. Introducing regulation can remove this market discipline (Billett et al. 1998). If investors believe that regulators have vetted projects, they will reduce scrutiny. This is especially problematic in a space characterized by rapid innovation and technical complexity. Regulators may lack the expertise or agility to meaningfully assess risk, yet their involvement may be interpreted as effective oversight. Moreover, regulatory capture is a real concern. Large crypto firms may lobby for rules that entrench their dominance, raising barriers to entry while maintaining speculative dynamics. Regulation, rather than curbing excess, will formalize and protect incumbent players.

5 Expanding Demand

Financial markets are highly sensitive to perceptions of legitimacy. The expansion of derivatives markets in the late twentieth century, for example, was facilitated by regulatory accommodation that allowed institutional investors to participate (Muellerleile 2015). Similarly, regulatory clarity around exchange-traded funds opened new channels of demand (Congressional Research Service 2018). Giving the crypto world comparable clarity and integration, including the widespread approval of crypto investment vehicles or comprehensive licensing frameworks, will expand its investor base dramatically. Previously hesitant investors may enter the market under the assumption that compliance reduces risk. This expansion of demand would likely inflate valuations beyond sustainable levels. Crypto markets are already prone to boom-and-bust cycles driven by speculative enthusiasm. The new regulatory credibility will intensify these cycles by drawing in participants who underestimate volatility. When another inevitable downturn in asset prices takes place, political pressure for bailouts or restitution will follow, especially if crypto asserts have become imbedded in the financial system and threaten its stability. By choosing to regulate the market, EU and US regulators will be perceived as responsible for its stability, which risks converting private speculative losses into public political liabilities.

6 Alternatives to Regulation

Rejecting regulation does not mean endorsing lawlessness. Fraud, theft, and misrepresentation are illegal under existing EU and US laws, and both the EU and US already have enforcement mechanisms to address these activities. But prosecutors should do this by enforcing existing laws aggressively. Governments can also focus on improving financial literacy (Burke et al. 2022; Ibrushi et al. 2026) and warn the public about get rich quick schemes that are rampant in the crypto world. Public agencies can issue warnings about volatility and risk without constructing elaborate licensing regimes. Clear communication that crypto lacks government backing would deter naive participation more effectively than complex regulatory structures. Another approach would have been to ensure that core financial institutions maintained little or no exposure to crypto assets. By restricting the integration of crypto into systemically important entities, policymakers would have protected financial stability without endorsing the asset class. Keeping crypto outside of the regulatory perimeter would have treated crypto as the speculative technology that it is – allowing investor engagement while quarantining it to avoid adverse credibility effects and spillovers.

7 Conclusions

Crypto presents genuine policy challenges. Its volatility, susceptibility to fraud, and potential use in illicit finance are real concerns. But extending the regulatory perimeter to it should have been better weighed against the signaling power of regulation itself. By regulation crypto the EU and US have conferred legitimacy on it. They have reassured investors, invited institutional capital, and risked embedding within the financial system an asset class that is characterized by extreme price swings, criminal activity, speculative narratives, and very limited intrinsic value. Rather than protecting investors, the regulation of crypto will expand participation under a false sense of safety, undermine market discipline, and undermine financial stability. Leaving crypto largely outside of the regulatory perimeter would have made it clear crypto is a speculative experiment in which investors participate at their own risk.

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