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outline

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orange is the new green

introduction

The transformative power of Bitcoin as a savings technology is now widely acknowledged. No other asset class in history has been able to rival its long-term returns, underpinned by the unique combination of Bitcoin's scarcity and the commitment of its holders to long-term accumulation.

During a recent interview, legendary investor Stanley Druckenmiller shared an insight he gained from Paul Tudor Jones II perfectly illustrating this dynamic: when Bitcoin's price plummeted from $17,000 to $3,000, an astonishing 86% of those who acquired it at its peak did not sell.(1) This steadfast "hodl" mentality is vividly illustrated in the "hodl waves" chart, as shown below in Figure 1, a graphical representation of Bitcoin supply categorized by time held.

The chart demonstrates the gradual reduction in circulating supply as long-term holders transfer their coins into cold storage. This process explains in part Bitcoin's appreciation, but also its characteristic volatility, as a significant influx of capital into an asset with a fixed supply naturally leads to pronounced price swings.(2)

This general dynamic is what makes Bitcoin arguably the greatest savings vehicle ever invented, and yet, at the same time, an inadequate solution for storing short-term cash balances. Whether for individuals or businesses, maintaining short-term cash balances in Bitcoin is ill-advised due to this volatility. Even Bitcoin-only businesses acknowledge the necessity of holding fiat currency to navigate the uncertainties of daily operations.

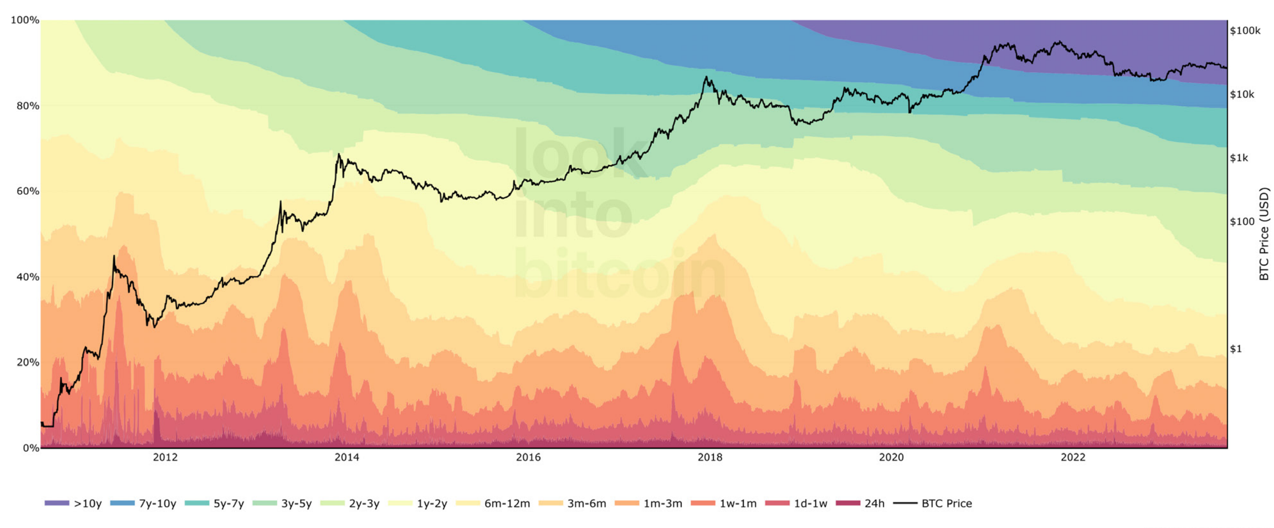

Figure 1 - Bitcoin HODL Waves

That said, I believe there is a plausible scenario in the medium-to-long term in which Bitcoin absorbs short-term cash balances. To be clear, this would be before attaining anything like the status of a global unit of account, and despite its seemingly disqualifying volatility relative to fiat competition. This may seem self-contradictory at first glance. But I believe that by introducing Bitcoin into a flawed incentive structure, and teasing out its less-than-obvious properties, a compelling solution emerges, incentivizing holders of cash balances to actively contribute to Bitcoin's adoption.

This article delves into this intriguing prospect. It commences by dissecting the challenges faced by holders of cash balances. Subsequently, it explores how Bitcoin can offer a deposit facility superior to existing alternatives. I conclude by examining current prototypes of Bitcoin money market funds and contemplating alternative designs. Unlike "basically risk free" Crypto yield products,(3) throughout the article I will draw attention to the intricate trade-offs integral to designing the types of product discussed.

I. finding stability admist uncertainty

In the realm of economic theory, the rationale for holding cash and its equivalents is rooted in the anticipation of future uncertainty. In practice, however, the erosion of fiat currency's value skews this rationale, compelling economic agents to seek refuge in "highly liquid securities." Indeed, these securities may be offered as collateral to credit suppliers when cash is needed, and also safeguard purchasing power, a feat that cash alone struggles to achieve in the modern fiat system predicated on a foundation of never-ending increases in the money supply.

The term "highly liquid securities"(4) warrants careful consideration, as liquidity is context-dependent rather than an inherent property of an asset. Liquidity translates to the ability to promptly find a buyer or seller and settle a trade at prevailing market prices. Particularly within a credit-based economic structure, the propensity for leverage to accumulate until a tipping point triggers a destabilizing market downturn, colloquially referred to as a "Minsky moment," underscores the contextual nature of liquidity: everything is liquid until nothing is. In such scenarios, the notion of a "liquid" portfolio loses its luster, as selling under duress occurs at less than favorable terms.

While traditionally perceived as exceedingly rare occurrences in so-called "developed markets," liquidation cascades are becoming increasingly commonplace. Within our financial framework, liquidity primarily hinges on credit acquisition through collateral pledging, thus laying the groundwork for a cycle intertwining collateral face value and market liquidity. As the value of collateral depreciates, the issuance of credit diminishes – or goes into reverse – exerting a downward pressure on market prices. Consequently, this prompts liquidation events, subsequently intensifying the erosion of asset values and liquidity. Especially so considering that government securities and other debt instruments, rapidly depreciating in value due to rate hikes, constitute the bulk of such collateral.

A compelling illustration of this concept emerged in the UK last October when the Gilt market teetered on the edge of collapse. The rise in Gilt yields subsequent to fiscal policy announcements from the Chancellor of the Exchequer triggered margin calls for pension institutions that had pledged long-dated Gilts as collateral. In a rush to raise cash to meet their margin requirements they dumped large amounts of Gilts, ironically due to their being thought to be the most "liquid" asset, which further depreciated the capital value of their collateral, thus forcing them to sell even more Gilts. The Bank of England then intervened to avert calamity by buying large amounts of 30-year Gilts, spurred by the realization that such a downturn could imperil the pension industry and decimate a substantial portion of British savings.(5)