Dynamic Modeling for Optimal Cryptoeconomic Policies

Pitch Proposal

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April 27, 2023

Research Question

How should we design cryptoeconomic policies (staking and burning) to respond dynamically to endogenous and exogenous shocks?

- **Staking (increases "money supply")**: mint new tokens and give to those who stake their existing tokens as interest yield
- **Burning (decreases "money supply")**: burn (remove from circulation) a portion of the transaction fee paid by users during blockchain transactions
- Problems arise due to the dynamic nature of shocks and lack of encoded response mechanism.
- Staking and burning rates are coded as rules into the underlying blockchain system.
- Policy goal: maximize welfare for good actors (i.e. users and validators) in the economy

Contributions to the Literature

Gaps in the literature:

- Most cryptoeconomic models feature fixed-schedule money supply
  - deterministic token supply (Bitcoin), fixed burn rate (Ethereum), naive dynamic burning (Binance Coin)
- Traditional models for optimal fiscal policy (e.g. Ramsey) and monetary policy (e.g. NK) are not directly transferrable to cryptoeconomies due to extra frictions in the cryptoeconomy
- No literature has been established on optimal staking and burning policies for proof-of-stake cryptocurrencies (some on CBDC and stablecoins)

Novelty of this research:

- Applies dynamic general equilibrium methods to model and optimize crypto policies for staking and burning

Literature Review

- Micro foundations:
  Biais et al. (2019), Budish (2018), Gans and Gandal (2019), Gans and Holden (2022), Huberman et al. (2021), and Nisan et al. (2007), etc.
  → **Block reward and transaction fee as incentive mechanisms**
- Pricing models of cryptocurrencies:
  Bitcoin: *Athey et al. (2016), Biais et al. (2020), Bolt and Van Oordt (2020), Catalini and Gans (2020), Chiu and Koeppl (2017), Garratt and Wallace (2018), Hinzen et al. (2022), and Schilling and Uhlig (2019a, 2019b), etc.*
  Proof-of-stake: *Catalini et al. (2020) and Saleh (2019, 2021)*
  → **Exogenous money means all shocks are absorbed by price**
- Monetary policies for stablecoins, platform tokens, and CBDCs:
  Cong et al. (2021, 2022), d'Avernas et al. (2022), Fernández-Villaverde et al. (2021), and Zhu and Hendry (2019), etc.
  → **Optimizing policy for defending peg and/or making profit**

The baseline model (Biais et al. 2020, Journal of Finance)

Idea: The fundamental value of crypto comes from the stream of future transactional benefits (Tirole, 1985)

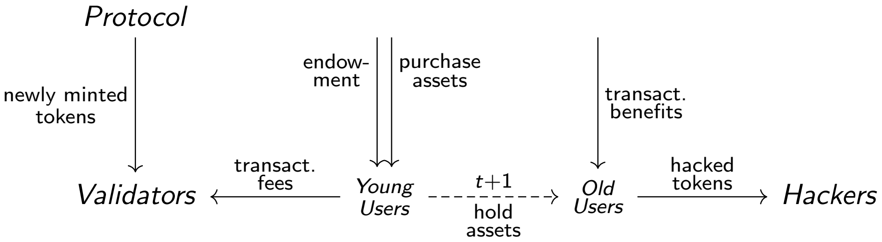
- e.g. access to unique goods, not expropriated/taxed/constrained by government, direct internet access

Setup: Two-period model with overlapping generations

- Three actors: users, validators (miners), hackers
- Three financial assets: a risk-free asset, a standard currency (dollar), a cryptocurrency (Bitcoin)
- Sources of shocks: endowment, transactional benefit, fees

Result: Bitcoin price changes partly due to changes in net transactional benefits, but mostly extrinsic volatility

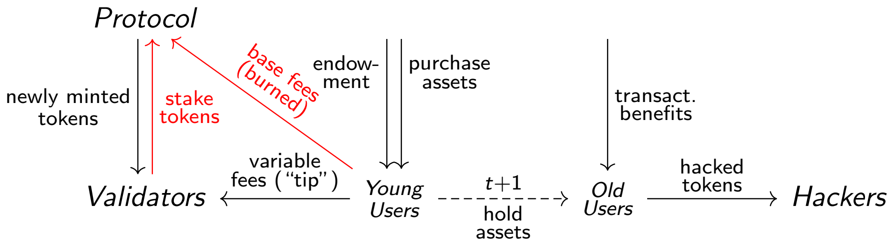
The baseline model (Biais et al. 2020, Journal of Finance)



In each period:

- **Young users** receive endowment, spend on consumption goods & financial assets. Pay fees on crypto purchased
- **Old users** consume savings (some savings get hacked), and receive transactional benefits
- **Validators** receive newly minted tokens as block rewards
- **Hackers** hack a portion of users' crypto

Extensions to the baseline model: endogenous money supply



I introduce:

- Two-part transaction fee with burning
- Interest-bearing staking
- The protocol controls the staking yield ("interest rate") and the base transaction fee rate (burn rate)

More extensions to model & estimation

1. Modify validators' budget constraint: incorporates costs of validation under PoS and PoW (Biais et al., 2019; Saleh, 2019, 2021)
2. Improvement in model calibration
    - novel time series data on Ethereum price and transaction fees
    - estimate transactional benefits using the NVT (network value to transaction ratio) or RVT (realized value to transaction ratio) metric instead of event-based index
3. Use vector autoregression models for exogenous process in variable transaction fees and transaction benefit (e.g. sign restrictions)

Proposed Project Timeline

- Spring '23: As final project for ECMA33603 (Macro & Financial Frictions), replicate the baseline model and implement extensions part 1 (endogenous money supply)
- Summer '23: Implement extensions part 2 and seek analytical solutions; gather ideas from industry internship in Ethereum research & dev
- Fall '23 - Winter '24: Extensions part 3: Data collection, model calibration (likely using Ethereum data)
- Spring '24: Finish paper

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The baseline model: Users

$$
\begin{aligned}
\text{Young users: } c_t^y &= e_t - s_t - (1+\varphi_t)q_t p_t - \hat{q}_t \hat{p}_t \\
\text{Old users: } c_{t+1}^o &= s_t(1+r_t) + (1-h_{t+1})q_t p_{t+1} + \hat{q}_t \hat{p}_{t+1} \\
&\quad + \theta_{t+1} q_t p_{t+1}
\end{aligned}
$$

e_t: endowment
s_t: quantity of risk-free assets held
$q_t, \hat{q}_t$: quantities of crypto and dollars held
$p_t, \hat{p}_t$: prices (in units of consumption goods) of crypto and dollars
h_{t+1}: portion of crypto hacked by hackers
φ_t: transaction fees involved in using crypto (exog.)
θ_{t+1}: transactional benefits from using crypto (exog.) (assume $\theta_{t+1} \geq 1$)

The baseline model: Validators and hackers

$$\text{Validators: } c^v_{t+1} = (X_{t+1} - X_t)p_{t+1} + \varphi_{t+1} q_{t+1} p_{t+1}$$
$$\text{Hackers: } c^h_{t+1} = h_{t+1} q_t p_{t+1}$$

X_t: stock token supply
$X_{t+1} - X_t$: increase in token supply (newly minted tokens)

The baseline model: Market clearing

Markets for financial assets:

$$\begin{aligned} \text{crypto: } q_t &= X_t \\ \text{dollars: } \hat{q}_t &= m \\ \text{risk-free assets: } s_t &= 0 \end{aligned}$$

Market for consumption goods (by Walras's Law):

$$c_t^y + c_t^o + c_t^v + c_t^h = e_t$$

The baseline model: Solution

A young user in period t solves:

$$\max_{s_t, q_t, \hat{q}_t} u(c_t^y) + \beta \mathbb{E}_t u(c_{t+1}^o)$$
$$\text{s.t.} \quad c_t^y \geq 0$$

* Information set at period t includes $\{\theta_t, \varphi_t, \pi_t\}$

From FOCs obtain the equilibrium pricing equation:

$$p_t = \underbrace{\frac{1}{1+r_t}}_{\text{discount}} \mathbb{E}_t \left[\underbrace{\frac{u'(c_{t+1}^o)}{\mathbb{E}_t[u'(c_{t+1}^o)]}}_{\text{risk-neutral prob}} \underbrace{(1-h_{t+1})}_{\text{hack risk}} \underbrace{\frac{1+\theta_{t+1}}{1+\varphi_t}}_{\substack{\text{net transact.} \\ \text{benefits}}} p_{t+1} \right] \tag{1}$$