INNOVATION PATHWAYS IN SCIENCE EDUCATION AND RESEARCH



CRYPTOCURRENCY REGULATION AND MONETARY POLICY TRADE-OFFS IN TRANSITION ECONOMIES

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Abstract: Transition economies across Eastern Europe, Central Asia, and Latin America face unique macroeconomic structural challenges, including currency substitution, shallow financial markets, and weak monetary policy transmission mechanisms. The rapid global expansion of cryptocurrencies and decentralized finance (DeFi) presents both severe risks and strategic opportunities for central banks in these developing market contexts. This paper explores the core trade-offs between regulatory approaches—ranging from total bans to sovereign regulatory sandboxes—and monetary policy autonomy. It analyzes how the proliferation of unbacked crypto-assets and foreign stablecoins drives digital dollarization, weakens central bank interest rate channels, and threatens capital flow management. Furthermore, the article evaluates counter-policy measures, notably the implementation of Central Bank Digital Currencies (CBDCs) and hybrid regulatory frameworks, as strategic tools for protecting monetary sovereignty in transition states.

Keywords: Cryptocurrency regulation, monetary policy, transition economies, monetary sovereignty, crypto-dollarization, central bank digital currency (CBDC), regulatory sandbox, financial stability.

Introduction

Over the past three decades, transition economies have worked systematically to build independent monetary authorities, establish reliable local currencies, and modernize domestic banking infrastructure. However, the rise of decentralized digital assets has disrupted traditional financial governance. Cryptocurrencies offer friction-free, cross-border payments, making them highly appealing in regions dependent on international worker remittances and burdened by costly traditional banking corridors.

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At the same time, the widespread adoption of volatile crypto-assets (e.g., Bitcoin) and USD-pegged stablecoins poses direct risks to economic stability in developing contexts. For central banks in transition states, managing digital assets is not merely a



technical challenge of financial supervision; it is a fundamental struggle over **monetary policy trade-offs**, capital account control, and monetary sovereignty.

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Key Monetary Policy Trade-offs

Monetary authorities in transition economies operate under tight structural constraints. Incorporating private digital assets into these ecosystems forces central banks to balance competing policy objectives:

Policy Objective	Opportunity with Cryptocurrencies	Core Trade-off / Macroeconomic Risk
Monetary Transmission Efficiency	Faster, low-cost cross-border settlement and remittance flows.	Loss of interest rate channel control due to asset disintermediation.
Financial Inclusion & Innovation	Broader financial access for unbanked populations.	Heightened exposure to extreme market volatility and systemic losses.
Capital Account Management	Bypassing legacy intermediary fees in international trade.	Unregulated capital flight and evasion of foreign exchange controls.
Fiscal Transparency & Tax Base	Immutable ledger traceability on public blockchains.	Expansion of shadow economy operations and tax evasion risks.

Structural Vulnerabilities in Transition States

The Threat of "Crypto-Dollarization"

Transition economies historically struggle with currency substitution (traditional dollarization), where citizens convert local currency holdings into foreign reserves to protect against domestic inflation. The advent of USD-pegged stablecoins (such as USDT and USDC) accelerates this trend digitally. Because digital stablecoins can be transferred peer-to-peer without passing through local commercial bank accounts, they drastically reduce the demand for domestic currency, shrinking central bank seigniorage and severely weakening the domestic unit of account.

Disintermediation of Commercial Banks

If retail deposits shift out of traditional banking systems into high-yield decentralized financial protocols or off-shore crypto platforms, domestic banks lose their primary source of stable, low-cost funding. This bank disintermediation restricts commercial lending capacity, drives up borrowing costs for local businesses, and neutralizes central bank benchmark interest rate signals.

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Capital Flight and Foreign Exchange Arbitrage

Many transition nations maintain capital controls to protect domestic exchange rate stability. Cryptocurrencies function as an unmonitored channel for cross-border capital outflow. When domestic investors execute peer-to-peer asset transfers out of the country, domestic central banks lose visibility over capital accounts, making national reserve management highly vulnerable during macroeconomic shocks.

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1. **The Sandbox & Strict Licensing Framework:**Transition countries such as **Uzbekistan** have pioneered a "special legal regime" or regulatory sandbox approach. Under this framework, cryptocurrencies are strictly prohibited from serving as legal tender or general local payment instruments, but crypto-asset trading is permitted through licensed domestic crypto-exchanges subject to heavy anti-money laundering (AML) oversight. This contains speculative spillovers while preserving state control over capital movements.

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2. **CBDCs as a Counter-Policy Mechanism:** To counter foreign stablecoins and maintain direct monetary liabilities, central banks are accelerating retail and wholesale **Central Bank Digital Currency (CBDC)** projects. A sovereign digital currency (such as the Digital Som/Soum models in Central Asia) enables monetary authorities to offer modern digital payment speeds while maintaining central bank control over liquidity, interest rate transmission, and monetary policy sovereignty.

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5. Conclusion and Strategic Policy Imperatives

For transition economies, ignoring cryptocurrency integration is no longer viable, nor is total prohibition completely effective given the borderless architecture of decentralized networks. Achieving a balanced regulatory equilibrium requires a three-tier policy approach:

- **Protect the Domestic Unit of Account:** Mandate that all local commercial transactions remain strictly denominated in the sovereign currency, preventing private digital assets from assuming legal tender status.

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- **Implement Target-Driven Sandboxes:** Restrict speculative trading to specialized, state-supervised digital exchanges equipped with real-time financial tracking and identity verification standards.

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- **Deploy Interoperable Sovereign Digital Infrastructure:** Accelerate the launch of Central Bank Digital Currencies (CBDCs) and low-cost retail payment rails to eliminate the efficiency advantage currently held by unregulated private stablecoins.

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