THE OTHER SIDE OF THE BITCOIN

The Independent, November 30, 2013

(…) Can this internet money truly become a new global currency, as some of its more zealous supporters claim? Is the bitcoin really the shape of our financial future? It helps to go back to the economics textbooks. They describe three traditional defining features of a viable currency. First, it has to be a practical unit of account. Second, it must be a reliable medium of exchange. Finally, it must be able to serve as a store of value. So how does a bitcoin measure up?

Assets and services can certainly be priced in Bitcoins. But it's not simple since the value of a bitcoin varies from exchange to exchange. This is because it is still difficult to swap the currency for ordinary cash. The process involves using banks in different countries, which charge varying fees.

Is the bitcoin a medium of exchange? Up to a point. They are accepted by a growing number of internet vendors. They are encroaching on the offline world too. One can pay for pizza in the Netherlands with them. In America, hundreds of vendors joined a "bitcoin Friday" yesterday, selling items from plane tickets to Christmas trees in exchange for the cyber cash. A bitcoin cash machine was installed in Vancouver, Canada, last month. Richard Branson's Virgin Galactic says it will accept them as payment from people booking its forthcoming space flights. But, as of yet, one cannot pay for a copy of The Independent in Bitcoins. You can't pay your taxes in Bitcoins, or use them to buy groceries. For now, at least, the currency's reach is still very limited.

Finally, is the bitcoin a store of value? This is the biggest, and perhaps insurmountable, barrier. Devotees of the currency, particularly those on the libertarian right, cherish the fact that there is (or rather will be) a fixed stock of Bitcoins in circulation. The total number is set to top out at around 21 million, thanks to the Nakamoto algorithm that created them. This, we are told, means the bitcoin cannot be "debased" by corrupted central banks or greedy governments intent on creating ever more cash to finance their own excessive spending. But the currency has, nevertheless, been subject to large fluctuations. In April the value plummeted from $260 to $130 in a matter of hours. This raises the question of how many people will be happy to store their wealth in a currency that can lose half its worth so rapidly.
The fixed supply of Bitcoins is also likely to make them unattractive to mainstream finance. What most investors crave is liquidity. Governments and central banks provide that liquidity in times of financial-sector stress. The fact that there is no central bank for the Bitcoin, capable of being a "lender of last resort", is likely to put a ceiling on its growth possibilities. Another threat is the dubiousness of some bitcoin users. The traceless cyber currency is, understandably, popular with people who want to evade oversight from the authorities. Bitcoins were used on the *Silk Road* website, which acted as an anonymous clearing house for guns and drugs, until it was shut down by the authorities. The currency is also said to be popular on the so-called "dark net", which, among other things, facilitates the trade of child-abuse imagery.
Bitcoin users sometimes claim they are self-sufficient and have bypassed the need for governments. But that self-sufficiency is an exaggeration. The physical computer servers and the telecoms infrastructure that makes the online currency system possible could be relatively easily targeted by states if they were ever to perceive the bitcoin as a facilitator of large-scale money laundering or other crime. That's another reason to be wary about tying up your wealth in them.
The irreversibility of transactions is another danger. Once a bitcoin is spent it cannot be retrieved, even if it has been stolen. A British man who accidentally sent his hard drive to the landfill site lost £4m worth of Bitcoins. People who fail to back up their computers sometimes discover they have lost their money for good. There's no way of getting it back, no monetary authority to which to appeal. All of that, arguably, makes the bitcoin a rather precarious store of value.

Throughout history, economists noticed that when new coins were introduced whose face value was higher than the value of the metal from which they were made, the public tended to stash away the older, more valuable money and to use the new coins for exchange. The bad money tended to drive out the good. This became known as Gresham's Law, after the Tudor financier Sir Thomas Gresham. But in the case of the Bitcoin, Gresham's axiom could be reversed. The "bad" elements of this money might end up confining it to the margins.

(Adapted) 820 words