

Bitcoin Is No Longer a Currency

By Matthew O'Brien



Bitcoin might be a bubble or it might be *THE FUTURE*, but there's one thing it's not: a currency. It's a tech stock . The question is whether it's Pets.com or Paypal.

Now, for the uninitiated, Bitcoin is *supposed* to be the online currency that will free us from state-backed ones. It's a cryptographically-sophisticated virtual currency you can use to buy real things over peer-to-peer networks without leaving a trace in the real world. The idea is to create money that central banks can't debase and governments can't tax. In other words, digital gold. Actually, make that *anonymous* digital gold.

Okay, but where do Bitcoins come from exactly? Well, that's where the 21st-century alchemy comes in. Like gold, there's a limited supply of Bitcoins that grows at a limited rate. Anyone can "[mine](#)" for new Bitcoins by running a computationally-taxing program on their computer that

spits out a lot of garbage, and, maybe, a little (virtual) gold. But there aren't many new ones to be found. And there won't be any after 2040. That's when the system is expected to hit its self-imposed limit of [21 million Bitcoins](#).

In other words, Bitcoin has a massive deflationary bias. Its money supply is mostly fixed, but the menu of things it can buy is growing. The same amount of money chasing more goods means money will be worth more. Or, put another way, prices will fall in Bitcoin terms.

And that's why it's not a currency, and won't be one until it has a central bank.

Deflation is toxic for any economy, but particularly for an alternative one like Bitcoin. No matter what kind of currency we're talking about, deflation causes hoarding -- why buy something today if you can buy it for less tomorrow? -- that crushes economic activity. The question is what to do about it. In his classic essay on the Capitol Hill babysitting co-op, Paul Krugman explained that the easiest solution is to just increase the supply of money to meet the increased demand for money. In other words, get that printing press going! That stops hoarding, which gets people buying again, which sets off a new virtuous cycle.

But what if you can't print more money? Then the hoarding feeds on itself. With a normal currency, say the dollar, the prices of everything else will keep falling, since everything else is priced in dollars. Falling wages will make debts that aren't falling harder to pay back, which will force more people into bankruptcy -- and then increase demand for dollars even more. In other words, it creates a depression. But with an alternative currency, say Bitcoin, the price of everything else will stay the same, since everything is still priced in dollars, and the price of Bitcoin itself will go up. The increasing price of Bitcoin will increase demand for Bitcoin -- it's a speculative bubble -- just as hoarding is reducing supply. In other words, prices will go vertical.

Partying Like It's 1999

That's why the most mesmerizing site on the internet right now is Mt. Gox. It's the former Magic The Online Gathering Online Exchange (get it, *M-T G-O-X*) that has gone from being the go-to-place to trade fantasy cards to the go-to-place to trade Bitcoin -- or to gawk at its epic price swings.

It's hard to remember now, but Bitcoin was mostly boring before the last few months. Aside from a brief surge above \$30 in mid-2011, its price didn't move around too much. It was the

province of libertarian-leaning hackers and not really anyone else, which kept it trading in a narrow band around \$10.

How quaint.

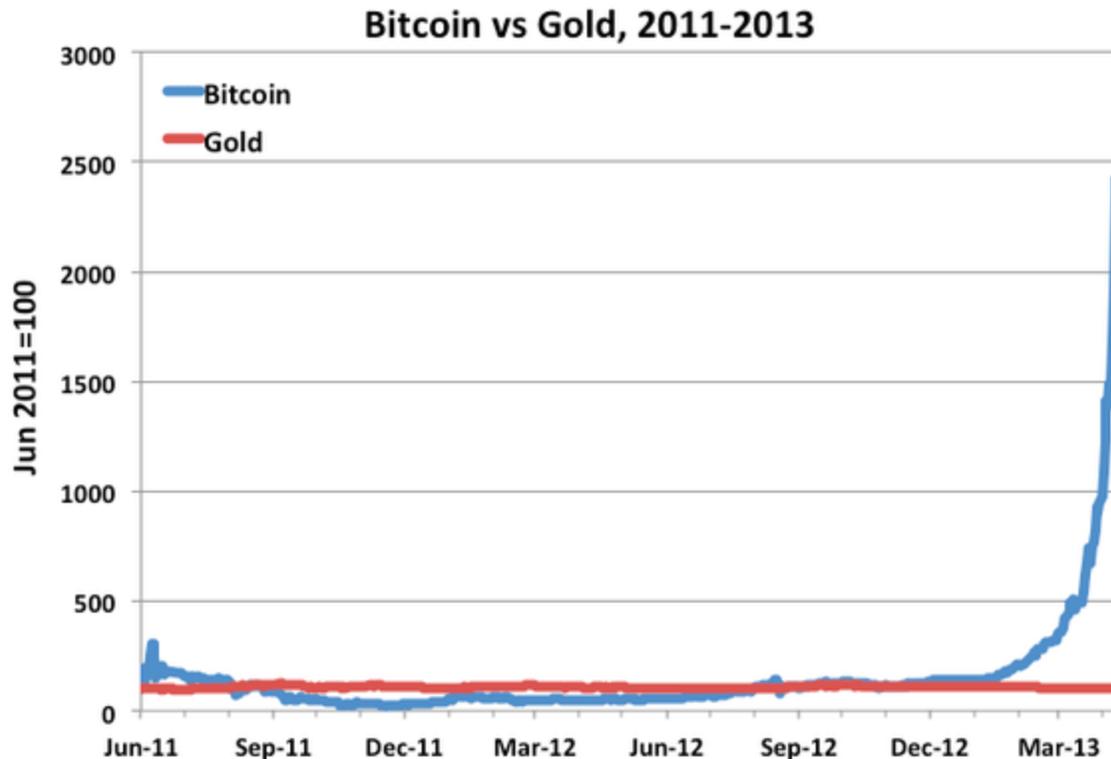
Every bubble has a story, and Bitcoin has been no exception. Prices quickly doubled, then tripled, and finally quadrupled in early 2013 as more and more companies began accepting Bitcoin payments. This made some sense if you thought the digital currency was moving from the far fringes to the not-quite-as-far fringes as a payment system. But what happened next did not make much sense at all. The new story was that the botched Cypriot bank bail-in scared so many people into thinking their deposits weren't safe that they moved into Bitcoins instead. Prices quadrupled *again* -- from \$65 to \$266 -- in just three weeks.

Then it halved in half a day.

As you can see in the chart below, via Bitcoin Charts, the virtual currency hit an intraday high of \$266 on Wednesday, promptly collapsed to \$105, rebounded to \$180, and then collapsed again to \$120. Trading has now been halted until 10 p.m. Thursday night. That's what happens when early adopters cash out their winnings in an illiquid market.



Remember, Bitcoin is supposed to be a safe haven from supposedly unreliable fiat currencies. It's supposed to be like gold. Well, as you can see below, gold and digital gold grew (or rather, didn't) at about the same rate between mid-2011 and early-2013 -- until Bitcoin went on its rampage. Now, we'd certainly expect Bitcoin to grow faster than gold as it goes more mainstream, but we'd also expect some kind of Cyprus-effect, if there is one, to show up in gold too. Even if it's just a blip. There wasn't one.



That's not what a currency looks like. That's what a tech IPO, circa 1999, looks like.

How Much Is That In Bitcoin?

Let's get philosophical for a moment. What is money? Well, the textbook answer is it's a medium of exchange, a unit of account, and a store of value. In other words, it's something we can use to buy stuff that has a standard that doesn't change too much. We know a dollar will buy roughly the same amount of stuff from day-to-day, though not year-to-year. But even though inflation eats away at the dollar over the long-term, it does so predictably -- which lets us slowly adjust our expectations about how much stuff a dollar will buy.

How much stuff will a Bitcoin buy in a month? A day? An hour? Nobody has any idea. There are no fundamentals when it comes to Bitcoin, so there is no right answer. It could be worth anything. But there is one thing we do know. *The more Bitcoin is worth, the more worthless it is as a currency.* Suppose its recent collapse just turns out to be a detour on its way to Bitcoin 36,000. Who's going to want to part with their Bitcoins to buy things then? Nobody. It's no different if we suppose it keeps bouncing around. Who's going to want to accept Bitcoins as payment if it might lose half its value in a matter of hours? Again, nobody.

Bitcoin isn't a currency. It's a commodity. A currency needs a relatively stable value to function as a medium of exchange. If it goes up too much, everyone will hoard it. If it goes down too much, nobody will want it. In 2013, Bitcoin's annualized volatility has been 105 percent. That's compared to 5.5 percent for the dollar and 8.5 percent for the euro. Unless the hacker(s) behind it figures out a way to match the supply of Bitcoins with the demand for Bitcoins -- i.e., adding a central bank -- it won't be much more than a curio for people who don't think fiat is a four-letter word.

That leaves one final question. What kind of commodity is Bitcoin if it's not a currency? Well, it's a technologically-impressive product out to revolutionize the world with absolutely no fundamentals to justify its billion-dollar valuation. It's the ultimate dotcom stock, minus the sock puppet.

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