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Something to Think About

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COMMON CENTS

Whenever you question the validity of a contemporary phenomenon, you run the risk of people calling you a old fuddy duddy, Luddite, or worse. Perhaps you are "old school," or "behind the times." Regardless, not accepting the "wave of the future" is often bad for your reputation, in the short-run.

Be that as it may, I simply can't get my arms around Bitcoin, and why so many think it is such a swell idea. Oh, I grasp the concept, even if I might have a hard time decoding all the necessary algorithms. However, I guess I just don't understand the true need for Bitcoin, and I certainly don't understand how it will succeed in practice.

So, let me, um, initiate the uninitiated with a few definitions from the Internet:

> **What is Bitcoin?**
>
> Bitcoin is a distributed peer-to-peer digital currency that can be transferred instantly and securely between any two people in the world. It's like electronic cash that you can use to pay friends or merchants.
>
> **What are bitcoins?**
>
> Bitcoins are the unit of currency of the Bitcoin system. A commonly used shorthand for this is "BTC" to refer to a price or amount (e.g. "100 BTC"). There are such things as physical bitcoins, but ultimately, a bitcoin is just a number associated with a Bitcoin Address. A physical bitcoin is simply an object, such as a coin, with the number carefully embedded inside. See also an easy intro to Bitcoin.
>
> **What's the current total number of bitcoins in existence?**
>
> The number of blocks times the coin value of a block is the number of coins in existence. The coin value of a block is 50 BTC for each of the first 210,000 blocks, 25 BTC for the next 210,000 blocks, then 12.5 BTC, 6.25 BTC and so on.
>
> **How are new bitcoins created?**
>
> New bitcoins are generated by the network through the process of "mining". In a process that is similar to a continuous raffle draw, mining nodes on the network are awarded bitcoins each time they find the solution to a certain mathematical problem (and thereby create a new block). Creating a block is a proof of work with a difficulty that varies with the overall strength of the network. The reward for solving a block is automatically adjusted so that roughly every four years of operation of the Bitcoin network, half the amount of bitcoins created in the prior 4 years are created. 10,500,000 bitcoins were created in the first 4 (approx.) years from January 2009 to November 2012. Every four years thereafter this amount halves, so it will be 5,250,000 over years 4-8, 2,625,000 over years 8-12, and so on. Thus the

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A disordered currency is one of the greatest political evils.

Daniel Webster

total number of bitcoins in existence will never exceed 21,000,000.

Blocks are mined every 10 minutes, on average and for the first four years (210,000 blocks) each block included 50 new bitcoins. As the amount of processing power directed at mining changes, the difficulty of creating new bitcoins changes. This difficulty factor is calculated every 2016 blocks and is based upon the time taken to generate the previous 2016 blocks.

Where does the value of Bitcoin stem from? What backs up Bitcoin?

Bitcoins have value because they are useful and because they are scarce. As they are accepted by more merchants, their value will stabilize. See the list of Bitcoin-accepting sites.

When we say that a currency is backed up by gold, we mean that there's a promise in place that you can exchange the currency for gold. Bitcoins, like dollars and euro, are not backed up by anything except the variety of merchants that accept them.

It's a common misconception that Bitcoins gain their value from the cost of electricity required to generate them. Cost doesn't equal value – hiring 1,000 men to shovel a big hole in the ground may be costly, but not valuable. Also, even though scarcity is a critical requirement for a useful currency, it alone doesn't make anything valuable. For example, your fingerprints are scarce, but that doesn't mean they have any exchange value.

Alternatively it needs to be added that while the law of supply and demand applies it does not guarantee value of Bitcoins in the future. If confidence in Bitcoins is lost then it will not matter that the supply can no longer be increased, the demand will fall off with all holders trying to get rid of their coins. An example of this can be seen in cases of state currencies, in cases when the state in question dissolves and so no new supply of the currency is available (the central authority managing the supply is gone), however the demand for the currency falls sharply because confidence in its purchasing power disappears. Of-course Bitcoins do not have such central authority managing the supply of the coins, but it does not prevent confidence from eroding due to other situations that are not necessarily predictable.

When you add up all these definitions, mix them in the pot, and pour them in the serving dish, what do you have? You have a heaping helping of mental gymnastics that tastes awful!!!!! As my co-worker so aptly said: “I hate Bitcoin.” So do I; in fact, I loathe it.

Consider what I wrote for my Montgomery Advertiser piece this week:

What do you make of the recent Bitcoin bubble and the huge price fluctuations? Is this thing for real?

Thank you for asking.

I understand and don’t understand the Bitcoin phenomenon at the same. The basic concept is simple enough to grasp, but why anyone thinks a digital currency will eventually supplant dollars, pounds, euro, yen, etc. in the future is baffling. For those of you not familiar with Bitcoin, I will spare you the technology mumbo jumbo, and define them as: a method of payment in an open, person to person financial network, involving private online exchanges and virtual wallets for storing your Bitcoin. Okay, maybe a little mumbo jumbo.

Countries don’t issue Bitcoin, Theoretically, the peer to peer financial network does using a complicated algorithm based on perceived available supply. As it stands today, there will never be more than

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21,000,000 Bitcoin in existence, and you can buy or sell them at these online exchanges using your real currency.

For the idealist, the Bitcoin is a market driven, global currency which gets around the friction of the inefficient financial system dominated by banks which make money from the friction. For the pessimist, the Bitcoin is a clever way to launder money, and a neat way for some computer programmers to line their pockets.

Yes, it is somewhat complicated stuff, particularly for the technologically challenged. No, long-term, this thing is not for real. It is the technological and financial equivalent of a Beanie Baby.

The primary reason is simple: all it will take is one or a fistful of major economies to either disallow or otherwise try to regulate the Bitcoin network and exchanges, and, voila, the system collapses. The secondary reason is also simple: 21,000,000 Bitcoin simply ain't enough to facilitate the necessary transactions in a global economy of over 6 billion souls. As a result, the Bitcoin will not eliminate the need for national currencies, which ultimately eliminates the need for Bitcoin unless you are doing something you don't want to do through traditional channels. A tertiary reason is perhaps the simplest, if enough people take money out of their bank because they don't like paying traditional transaction fees, guess what, banks will quit charging them.

I suppose what I am trying to say is the Bitcoin concept is pretty neat, but the Bitcoin is just another option in a currency market where there are already a lot of options. Therefore, the only real advantage Bitcoin have over other currencies is a reduction in transaction costs, which really aren't all that overwhelming in the first place, and often negotiable to boot.

This takes us back to why would the average person use Bitcoin? The pessimist is probably right: to either launder money in some small fashion or to try to line pockets before the regulatory hammer finally falls.

So, I think you can guess what I think about the recent Bitcoin bubble: it is a bunch of hogwash. If you want to plop your money into unregulated, peer to peer networks, online exchanges, virtual wallets and physically non-existent currencies, please, go right on ahead. Be my guest.

However, before you do that, I have one last thing to tell you. You see, I have this property way out in Arizona. It has a beautiful view of the ocean, but I just can't seem to find any takers. You wouldn't be interested in something like that, would you?

Hey, don't get me wrong; if I lived in a country like Venezuela, perhaps Bitcoin could be a good store of value. Perhaps it would be a better than the local currency. Perhaps it would allow me to trade on a more even

Disclosure

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playing field. Perhaps this is the reason why recent polls suggest residents of emerging economies are more accepting of digital currencies like Bitcoin. Maybe folks overseas are just more trusting, I don't know.

However, let me ask this question: how much would it cost the US Government to corner the Bitcoin market, and therefore put an effective end to it? After all, after closing down the Silk Road website, the FBI is purported to be the biggest holder of Bitcoin. In the lingo: the Feds have the largest wallet.

Oh, I don't think they would have to own 100%, it could be closer to 10-15%, if that. But, let's just say the Federal Reserve wants to put Bitcoin out of business for good, how much will it cost:

21,000,000 times about $500/piece = $10.5 billion.

Hey, that is a lot of money, to be sure, but it is also only about 14% of the amount of US Treasuries the Fed will purchase in January 2014 alone. In essence, Washington can put an end, pfft, to Bitcoin for basically nothing...in the grand scheme of things. That alone is enough for me to say to heck with the whole thing.

Hmm….$10.5 billion? You don't think the nerds who developed Bitcoin in the first place had something like this in mind, do you?

In the end, you can call me an old fuddy duddy, a Luddite, or worse, but I don't like Bitcoin, and if that is bad for my reputation, I am fully convinced time will exonerate me.