

PROS AND CONS OF BITCOIN
March 2021

Demystifying Bitcoin

As the price of Bitcoin booms, investors are taking an ever more active interest in it. But how close is the cryptocurrency to becoming a genuine investment asset?

It's no coincidence that Bitcoin is back in the headlines just as concerns about inflation start to rumble.

That's because cryptocurrencies, among which Bitcoin has the highest profile, have become barometers of sentiment about aggressive central bank monetary policy and financial repression. For the past decade, central banks have propped up their economies in the wake of the global financial crisis by driving interest rates and bond yields down below the rate of inflation, in effect forcing negative inflation-adjusted returns onto investors. That became even more pronounced as policymakers responded in even more emphatic fashion to the economic crisis caused by the Covid pandemic.

At the same time, distrust of government surveillance is growing as ever more of our lives move online. An anonymous digital currency becomes attractive.

But there's a lot that can potentially go wrong for Bitcoin. So much so, that it would be hard to justify the digital currency as anything other than among the most speculative investments.

Crypto appeal

Bitcoin has been on a tear lately amid concerns that central banks have taken quantitative easing and other stimulus measures too far. The growing fear is that monetary authorities are gradually monetising government deficits, which is to say that they're permanently funding government overspending as a means of underpinning their economies in the wake of the Covid pandemic.

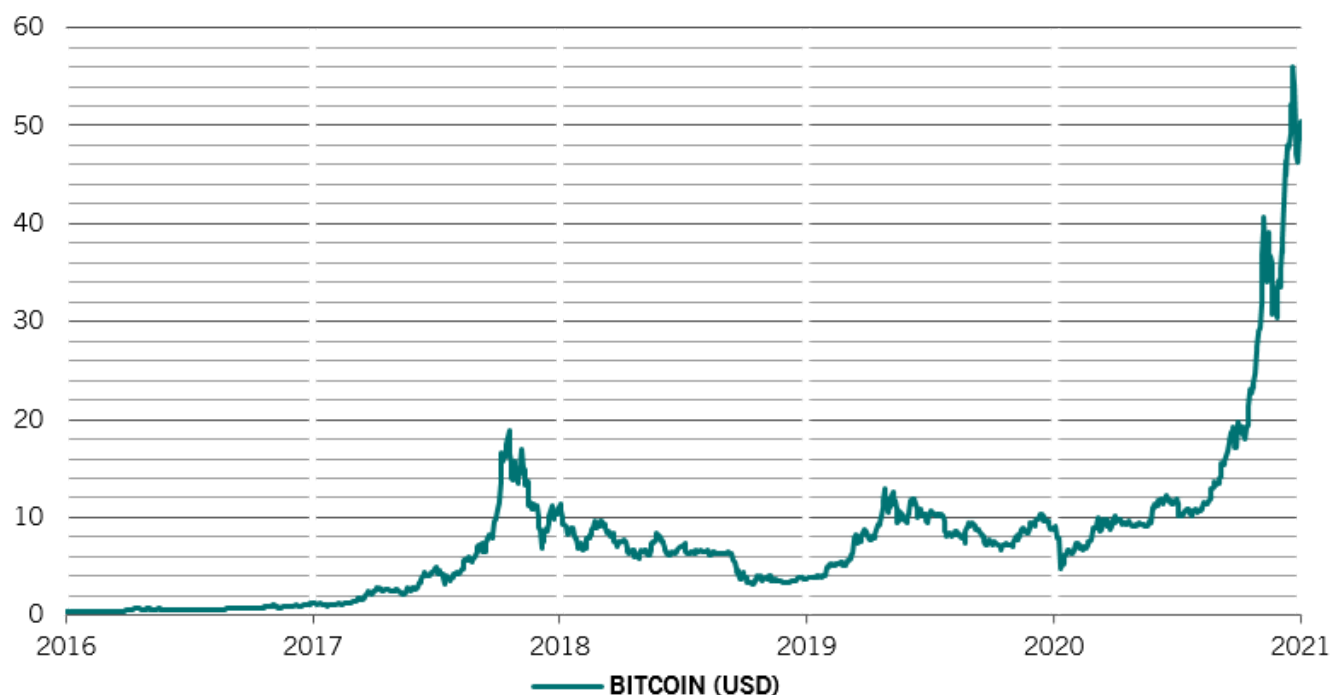
That's an issue, because historically debt monetisation has been a precursor to uncontrolled inflation.

But even those who don't worry about this sort of extreme outcome have reasons to like Bitcoin. Just the fact that central banks are depressing government bond yields to below even today's low rate of inflation – known as financial repression – has reduced the opportunity cost of holding assets that don't generate income, assets like Bitcoin.

More recently the cryptocurrency has had a modest positive correlation with equities and gold and a negative correlation with US Treasuries and the dollar.

Bitboom

Bitcoin price (USD, '000)



Source: Refinitiv Datastream, Bitstamp. Data as at 04.03.2021.

Meanwhile, Bitcoin has seen an increase in companies' willingness to use it for its original purpose: as a means of exchange. Tesla, the electric car company, has said it would sell cars priced in Bitcoin and has converted some of its cash dollar holdings into the cryptocurrency. And financial firms Mastercard and BNY are also looking to transact in Bitcoin or hold it on clients' behalf, while CME, the US derivatives exchange, offers Bitcoin futures, which could smooth the way for a more liquid market in future.

Transaction detraction

Bitcoin may be making inroads into normal commerce, but it has a long way to go before it becomes a substitute for currencies. It is still cumbersome to use, it isn't widely accepted and stories are legion of people forgetting their passwords or suffering hardware problems so that

they no longer have access to their Bitcoin wallets – some 20 per cent of the cryptocurrency is said to be in this limbo.¹

Furthermore, blockchain, the database used to record Bitcoin transaction, is limited in how many transactions it can execute – estimated at between three and nine per second. Factor in high transactions costs and Bitcoin's attractions fade relative to more liquid assets.

US Treasury Secretary Janet Yellen recently warned that Bitcoin is extremely inefficient for conducting transactions, and at the same time warning that it is a highly speculative asset.

Its recent price moves have raised doubts over Bitcoin's potential as an alternative to safe assets or as a store of value. On Feb 21 it peaked at USD58,000. The following day it had dropped back down to USD47,000 – where it was a week earlier. Nor is this sort of volatility new – Bitcoin's dollar price has always swung wildly.

One key problem for investors is that Bitcoin is impossible to value. It's not a claim on any underlying asset – it is the asset. It generates no income. And unlike, say, gold, it has no long history during which it's been able to develop a widely held reputation as an alternative store of value. It is thinly traded, frequently associated with illicit transactions and subject to wild swings of sentiment.

And it subject to considerable risks.

Attracting the wrong sort of attention

The more Bitcoin attracts speculative interest from amateur investors, the more regulators that exist to protect them will take note. At its recent peak, the total value of all Bitcoins in existence was estimated to have reached USD1 trillion. Although not yet seen as a potential systemic risk for the financial system, that's a big enough market to draw regulatory scrutiny. That's aside from the fact that legal authorities are already taking an interest in its role in the black economy. Meanwhile, Bitcoin mining is highly concentrated, mainly among Chinese operators.

Although Bitcoin's big appeal is its anonymity, there's the possibility that existing authorities could chip away at that if they were to provide something similar. Yellen recently noted that while there are a great many issues that would have to be resolved before digital dollars could be created, the venture "is absolutely worth looking at." She added that a "digital dollar could result in faster, safer and cheaper payments." A digital dollar that also gave its users anonymity would potentially be attractive – dependent on the sorts of guarantees the government would be willing to provide.

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Bitcoin's biggest remaining draw would then be its limited supply – there is a built-in supply limit of 21 million units. And it takes ever more computing power to mine each additional Bitcoin, making it immune to the sort of debasement of traditional currencies that many of its supporters fear.

But even here, Bitcoin faces threats. Bitcoin mining already consumes more electricity than Argentina, according to one estimate.² The Iranian government has blamed local blackouts on power hungry Bitcoin mining operations.³ Which gives governments just another reason to take aggressive action against Bitcoin.

The cryptocurrency routinely captures headlines and has substantial and vocal support on internet chatrooms. But the risks are heavily stacked against it ever becoming a serious and substantial investment vehicle, much less a replacement for the dollar.

[1] <https://www.nytimes.com/2021/01/12/technology/bitcoin-passwords-wallets-fortunes.html>

[2] <https://www.bbc.com/news/technology-56012952>

[3] <https://apnews.com/article/iran-media-social-media-bitcoin-coronavirus-pandemic-6d1c703a7faa1f85b0f94011259>

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