Lesson 19: Ethereum and Smart Contracts

Module 2: Blockchain Fundamentals

Digital Finance

Bitcoin's Limitations: Why Ethereum?

Bitcoin Script:

- Not Turing-complete (no loops)
- Limited expressiveness
- Designed for simple transfers
- No complex state

Ethereum Vision (Vitalik Buterin, 2013):

- Turing-complete programming
- Decentralized applications (dApps)
- "World Computer"
- Programmable money and agreements

Bitcoin vs Ethereum: Key Differences

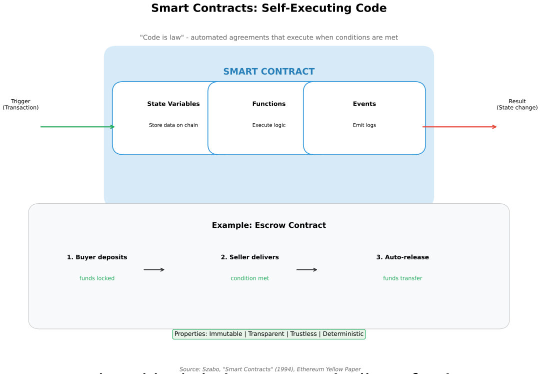
	Bitcoin	Ethereum
Purpose	Digital gold / Store of value	World computer / DApps platform
Consensus	Proof of Work	Proof of Stake (since 2022)
Block Time	~10 minutes	~12 seconds
Language	Bitcoin Script (limited)	Solidity (Turing-complete)
Supply	21M cap (deflationary)	No cap (minimal inflation)
Smart Contracts	Basic (multi-sig, timelocks)	Full programmability
Use Cases	Payments, savings	DeFi, NFTs, DAOs, gaming
Market Cap	~$800B (Dec 2024)	~$350B (Dec 2024)

Key Insight: Bitcoin = digital gold, Ethereum = programmable money

Source: CoinMarketCap, Blockchain.com, Ethereum.org (Dec 2024)

Understanding limitations helps identify appropriate use cases and avoid over-engineering.

Smart Contracts: Code as Law



Definition: Self-executing programs stored on blockchain, automatically enforcing agreements

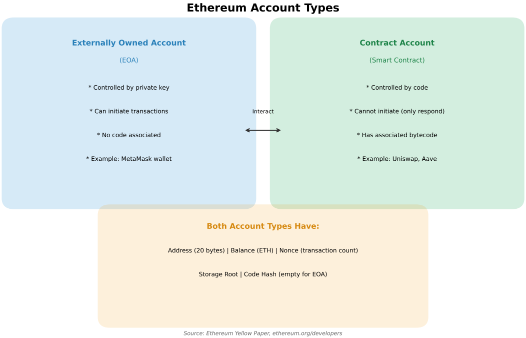
Properties:

- Deterministic execution (same input $\rightarrow$ same output)
- Immutable once deployed
- Transparent (anyone can verify)
- Trustless (no intermediaries)

Smart contracts enable programmable, self-executing agreements without intermediaries.

Two Account Types:

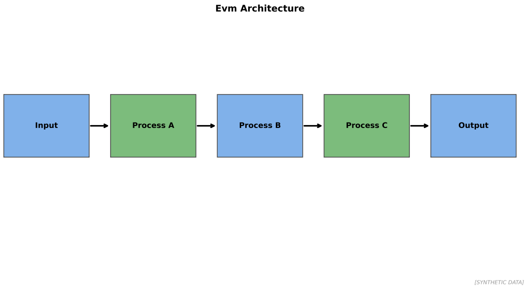
1. **Externally Owned Accounts (EOAs):**
   - Controlled by private key
   - Can send transactions
   - No code
2. **Contract Accounts:**
   - Controlled by code
   - Triggered by transactions
   - Store state



State: Each account has balance, nonce, code (contracts only), storage

Ethereum pioneered smart contracts and remains the dominant platform for DeFi and NFTs.

Ethereum Virtual Machine (EVM)



EVM Properties:

- Stack-based virtual machine (256-bit words)
- Bytecode execution (compiled from Solidity, Vyper, etc.)
- Isolated execution environment (sandboxed)
- Deterministic (no randomness or external calls without oracles)
- Replicated across all nodes

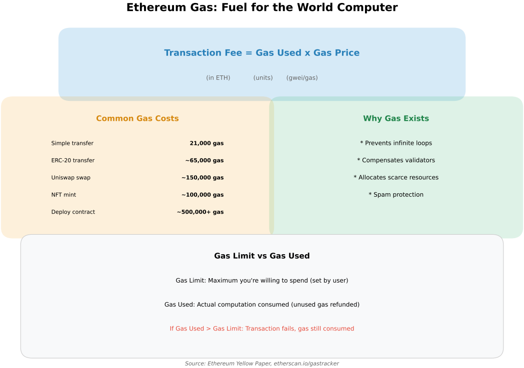
Ethereum pioneered smart contracts and remains the dominant platform for DeFi and NFTs.

Why Gas?

- Prevent infinite loops (halting problem)
- Prioritize transactions
- Compensate miners/validators
- Align incentives

Gas Mechanics:

- Each operation costs gas
- User sets gas limit + gas price
- Unused gas refunded
- Out of gas → revert (but gas consumed)



Key concepts from this slide inform practical applications in finance.

Gas Costs: Operation Examples

Operation	Gas Cost	Rationale
ADD (arithmetic)	3	Simple computation
MUL (multiplication)	5	Slightly more complex
SSTORE (write storage)	20,000	Permanent state change
SLOAD (read storage)	2,100	Storage access
CREATE (deploy contract)	32,000	Base cost + code size
Transaction (base)	21,000	Minimum for any transaction

Design: Expensive operations (storage, deployment) cost more to prevent spam

Case studies provide concrete evidence of technology impact and adoption patterns.

Transaction Cost Calculation

Example: Simple ETH Transfer

- Gas limit: 21,000
- Gas price: 50 gwei (1 gwei $= 10^{-9}$ ETH)
- Total fee: $21,000 \times 50 \times 10^{-9} = 0.00105$ ETH

Example: Token Transfer (ERC-20)

- Gas limit: 65,000 (contract interaction)
- Gas price: 50 gwei
- Total fee: $65,000 \times 50 \times 10^{-9} = 0.00325$ ETH

Example: Complex DeFi Swap

- Gas limit: 300,000 (multiple contract calls)
- Gas price: 100 gwei (priority)
- Total fee: $300,000 \times 100 \times 10^{-9} = 0.03$ ETH ($\sim$\$60 at \$2000/ETH)

Key concepts from this slide inform practical applications in finance.

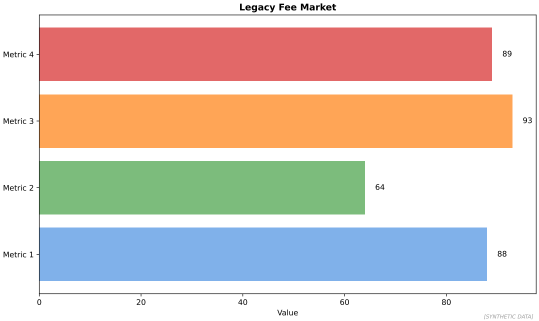
Legacy Fee Market: First-Price Auction

Pre-EIP-1559 (before Aug 2021):

- Users bid gas price
- Miners select highest bids
- First-price auction
- Overpay or get stuck

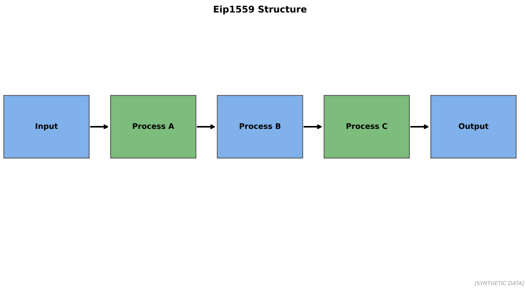
Problems:

- Fee estimation difficult
- High volatility
- Miner extractable value (MEV)



Key concepts from this slide inform practical applications in finance.

EIP-1559: Fee Market Reform (August 2021)



New Fee Structure:

$$\text{Total Fee} = \text{Base Fee (burned)} + \text{Priority Fee (to validator)}$$

Key Features:

- **Base Fee:** Algorithmically adjusted, burned (deflationary)
- **Priority Fee:** Tip to validators for faster inclusion
- **Max Fee:** User sets maximum willing to pay

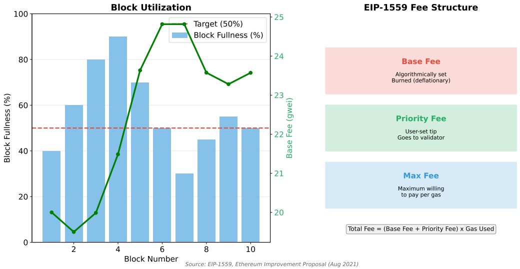
Key concepts from this slide inform practical applications in finance.

Base Fee Adjustment:

- Target: 15M gas per block
- If block $>$ 15M: base fee $\uparrow$ 12.5%
- If block $<$ 15M: base fee $\downarrow$ 12.5%
- Max block size: 30M gas

Formula:

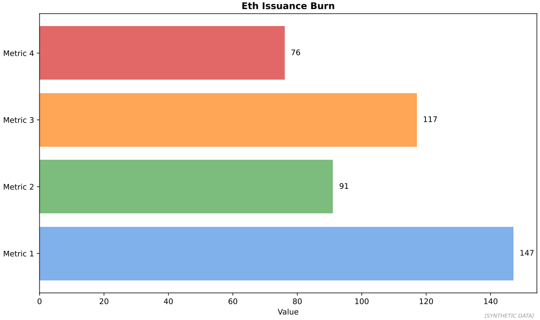
$$\Delta_{\text{base}} = \frac{\text{Gas Used} - 15M}{15M} \times \frac{\text{Base Fee}}{8}$$



Source: EIP-1559, Ethereum Improvement Proposal (Aug 2021)

Key concepts from this slide inform practical applications in finance.

Fee Burning: Deflationary Pressure

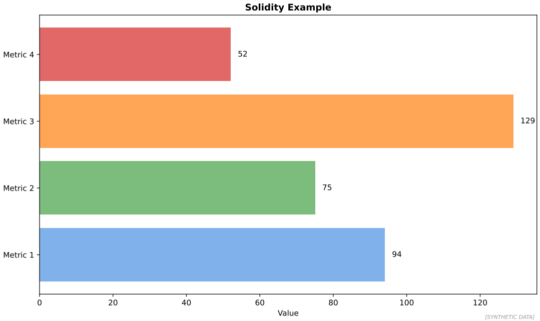


Issuance: ~1,600 ETH/day (PoS rewards)
Burn: Variable, depends on network usage (avg ~1,000–2,000 ETH/day)

Net Result: Ethereum can be deflationary when usage is high (burn > issuance)

Key concepts from this slide inform practical applications in finance.

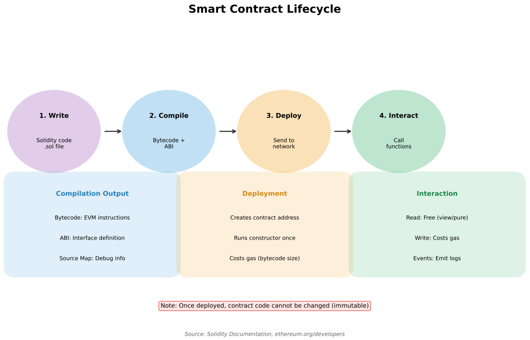
Example: Simple Token Contract



Key Features:

- Syntax similar to JavaScript/C++
- Compiles to EVM bytecode
- Supports inheritance, libraries, interfaces
- Built-in types: address, uint256, mapping, array

Smart contracts enable programmable, self-executing agreements without intermediaries.



Stages:

1. **Development:** Write Solidity code
2. **Compilation:** Compile to bytecode + ABI
3. **Deployment:** Send creation transaction (costs gas)
4. **Interaction:** Call functions via transactions
5. **Immutability:** Cannot modify code (only state)

Technology adoption follows predictable patterns—timing matters for investment decisions.

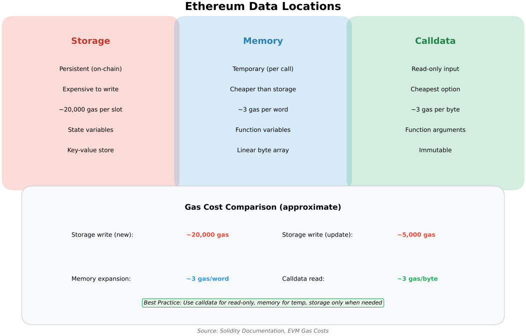
Contract Storage: Persistent State

Storage Layout:

- Key-value store (256-bit slots)
- Permanent (persists between calls)
- Expensive (SSTORE = 20,000 gas)
- Optimizations: packing, mappings

Memory vs Storage:

- **Storage:** Permanent, expensive
- **Memory:** Temporary, cheap, cleared after execution



Key concepts from this slide inform practical applications in finance.

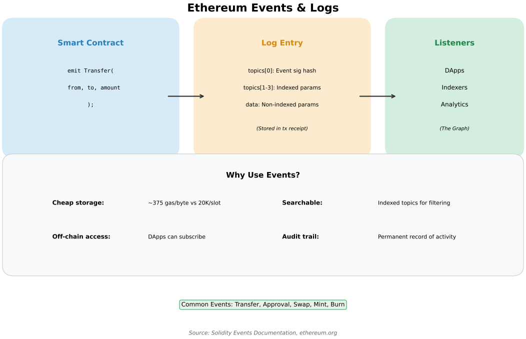
Events and Logs

Purpose:

- Emit structured data from contracts
- Stored in transaction receipts
- Indexed for efficient querying
- Off-chain applications listen to events

Use Cases:

- Token transfers (Transfer event)
- Price updates (oracles)
- Audit trails
- UI updates (wallets, dApps)



Key concepts from this slide inform practical applications in finance.

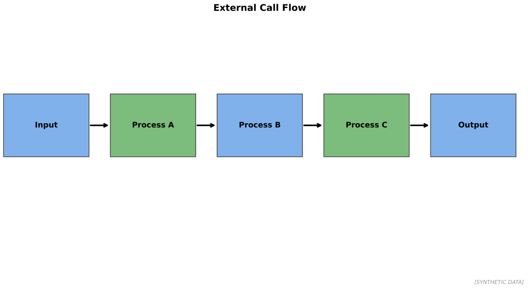
External Calls: Composability and Risks

Contract Interactions:

- Contracts can call other contracts
- Enables composability ("money legos")
- DeFi protocols build on each other

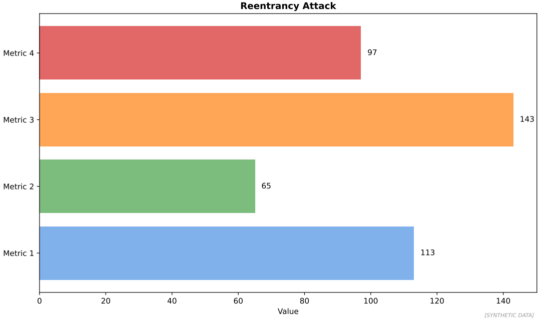
Risks:

- Reentrancy attacks
- Uncontrolled gas consumption
- Malicious contract logic
- Dependency vulnerabilities



Risk management is essential for financial stability and profitability.

Reentrancy: The DAO Hack (2016)



Vulnerability:

- Contract sends ETH before updating balance
- Recipient (attacker contract) calls back into vulnerable contract
- Recursively drains funds before balance updated

The DAO Result: 3.6M ETH stolen ($70M), led to Ethereum hard fork (ETH/ETC split)

Key concepts from this slide inform practical applications in finance.

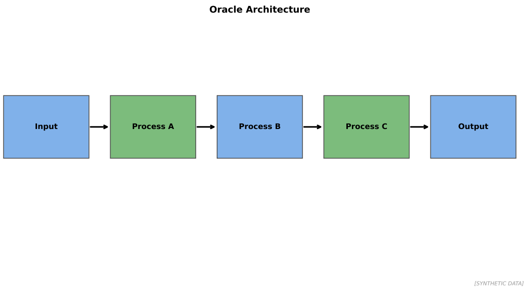
Oracles: Bridging On-Chain and Off-Chain

Problem:

- Smart contracts cannot access external data
- No internet, APIs, randomness
- Determinism requirement

Oracle Solution:

- Third-party data feeds
- Price feeds (ETH/USD)
- Weather data
- Sports scores



Chainlink: Decentralized oracle network, aggregates multiple data sources

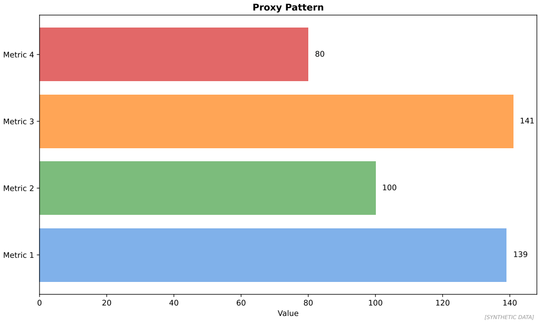
AI and ML are transforming financial services through automation and prediction.

Gas Optimization Strategies

- **Storage Packing:** Use uint128 instead of uint256 where possible (fit in one slot)
- **Avoid Storage Writes:** Use memory for temporary data
- **Short-Circuit Logic:** `require` checks early, minimize wasted gas
- **Batch Operations:** Aggregate multiple actions in one transaction
- **Events over Storage:** Emit events instead of storing historical data
- **Minimal Contract Size:** Lower deployment costs
- **Use Libraries:** Reusable code via DELEGATECALL

Example: Storing 100 values individually: $\sim$2M gas. Packed into single array: $\sim$500K gas

Key concepts from this slide inform practical applications in finance.



Design:

- **Proxy Contract:** Fixed address, DELEGATECALL to implementation
- **Implementation Contract:** Contains logic, upgradeable
- **Storage:** Stored in proxy, preserved across upgrades

Trade-off: Flexibility vs decentralization (admin can change logic)

Key concepts from this slide inform practical applications in finance.

Summary

- **Ethereum:** World computer, Turing-complete smart contracts, account model
- **EVM:** Stack-based VM, executes bytecode, deterministic, replicated
- **Gas:** Meters computation, prevents infinite loops, aligns incentives
- **EIP-1559:** Base fee (burned) + priority fee, deflationary pressure
- **Solidity:** High-level language, compiles to bytecode
- **Risks:** Reentrancy, oracles, immutability challenges

Next Lesson: Tokens – ERC-20, ERC-721 (NFTs), and token economics