

The Economics of Bitcoin and Cryptocurrencies

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Contents

1	Introduction	1
I	Basic principles	3
2	What is Bitcoin?	4
3	Why use Bitcoin?	6
4	Is Bitcoin Legal?	8
5	Is Bitcoin money?	9
5.1	Legal Issues	11
5.1.1	Legal Recognition and Classification . . .	11
5.1.2	Legal Tender	12

<i>CONTENTS</i>	iv
II The Economics	13
6 Bimetallism in Bitcoin and Litecoin?	14
7 Cryptocurrencies and Inflation	16
III The Social Value	18
8 Is mining socially wasteful?	19
9 Conclusion	22
Bibliography	23
Glossary	24

Chapter 1

Introduction

In 2009 the online currency **Bitcoin** was launched by an anonymous developer known by the pseudonym Satoshi Nakamoto . Initially the project remained fairly low key, have only a small group of geeks participate in it. However, in 2013 Bitcoin quickly became a mainstream phenomenon as it was reported on in the mainstream media such as The Economics, Time Magazine, The New York Times, and many more. This increased attention created a surge in the uptake of Bitcoin both as an investment as well as transaction mechanism. However, Bitcoin also has a dark side, being initially used mostly to purchase illicit goods on online marketplaces such The Silk Road, websites that are generally only available through the dark web. However, the rise in popular attention has also brought the attention of regulators, which has caused many of the illegal marketplaces to be

taken offline, as well as introduced a range of fiscal regulation, dealing with bitcoin. This book provides a laymens introduction to the basic principles of Bitcoin and other online currencies, as well as discuss how this new phenomenon can be viewed from an economic perspective, and what that would mean for the development of such systems.

The Bitcoin system was based on a 2008 white paper by the same author (Nakamoto 2008).

Besides the fact that Bitcoin exist only digitally, its defining characteristics are decentralisation and openness. and every aspect of it is public and open source .

This quickly led to the launching of several alternative online currencies, based on the Bitcoin protocol. A currency based on cryptography, such as Bitcoin, is know as a cryptocurrency .

Cryptocurrencies come with an extensive new terminology, for reference, a glossary is provided in the back of the book.

Part I

Basic principles

Chapter 2

What is Bitcoin?

A short answer is that it is an online anonymous currency which is not controlled by any single government or entity. However, from a technical perspective there are many innovative features to Bitcoin, and I will begin by highlighting the key ones.

Bitcoin is a confusing term. It is both a monetary unit of denomination, such as Swiss franc, euro, or pound sterling, as well as, a monetary system as a whole, including the protocol, the network, and all participants. To distinguish between the two, the system Bitcoin is written with a capital letter B, and the monetary unit of account is bitcoin, is written with a small letter b. Furthermore, there is the original Bitcoin software, which is called **Bitcoin-Qt**, using this software package, or others, computer can connect to the Bitcoin network.

Bitcoin is built from the ground up to be decentralised and

anonymous. All software is open source and publicly available. Anybody can perform any function within the network (user or node), there is no central or essential node, there is redundancy in every aspect.

The essential principle is that every user has a piece of software on their computer, a **wallet**, which contains a set of public addresses (like bank account numbers), each address is mathematically linked with a **private key** (like a password). Using this secret key, users can create a digital signature, to prove that they are the owner of an address. This signature, together with a transaction is sent to a bitcoin **miner**. The miner is a node in the network, which verifies that the address and signature are linked, after which the transaction is recorded in the public ledger, or **blockchain** and disseminated throughout the network.

There are a number of other features which are important to highlight. Bitcoins are created through a process called mining, this is a computationally intensive process used as the mechanism for transaction verification. The Bitcoins created as a reward for mining becomes incrementally smaller, until finally becoming zero. This is predicted to be around the year 2140, and at that point around 21 million bitcoins will have been created. There will never be more bitcoins in the system. Furthermore, bitcoins will be lost if private keys are lost, these will never be recovered. The system is thus strictly deflationary. To keep transactions of every size possible, bitcoins are highly granular, every bitcoin can be divided into a hundred million **satoshi** (named after the pseudonym of the creator).

Chapter 3

Why use Bitcoin?

There are some key benefits to cryptocurrencies such as Bitcoin, a few of which I will mention here.

Firstly, the system is self-regulating, meaning that no government or institution controls it. For the user that means that their holdings cannot be used as a policy instrument. Conventional fiat currencies are owned by a government, which means that they can be used to e.g. stimulate economic growth by printing extra money, which lessens the value of individuals holdings.

Secondly, users control their own holdings on their own computer, which eliminates the need for a bank. This brings the advantage that users are not dependent on open hours, waiting lines, or e-banking websites, it also means no fees. Additionally a user's holdings cannot be wiped out by his or her bank bank-

rupting after speculative investing or something of that sort.

Thirdly, transactions are as easy, instant, and costless as sending an email. Bitcoin exists online digitally, which means that there is no physical counterpart that needs to be moved, such as with gold, or paper money. Additionally, it is equally valid across countries, which means that there is no need to exchange it. This makes Bitcoin an ideal mechanism for remittances, which nowadays can cost as much as 10 percent. Additionally no government can apply capital restrictions on these remittances.

Lastly, the instant nature of transactions means it is well suited for online retailing. Credit card transactions seem instant, but in fact are not. A significant percentage is in fact reversed after initial clearance. This is very costly for retailers, this often occurs after packaging of shipping has started.

Chapter 4

Is Bitcoin Legal?

The short answer is yet, of course this does not mean that anything that you use Bitcoin for is legal. That is to say, it is still illegal to purchase illicit goods, or hide holdings from the tax bureau.

Chapter 5

Is Bitcoin money?

What is money? Some answers are obvious, well established currencies such as the US Dollar are. But the Euro is not a national currency, it is not owned by a state. Zimbabwe owns their own currency, but this has become essentially useless. What if money is moved from one, bank account to another bank account at the same bank in the same country, through ebanking. No physical change will occur (save for a few bits on a computer driver somewhere in some remote datacentre). In some places sea shells or other rare commodities such a gold or ivory are accepted. Just as the number of possible moneys is almost infinite, so is the number of definitions, but a contemporary (pre-Bitcoin) consensus would dictate something like:

an object or entry in a record that is generally ac-

cepted as payment for goods and services and debts
in a certain socio-economic context or country **CITE!!**.

We can observe a number of things from this definition. Firstly, money does not have to be an object (such as a coin), but can also be an entry in a record (such as a bank account balance). Secondly, it assumed to be generally accepted (though not universally). Thirdly, a money is not limited to only being accepted in a country, but can also be accepted in a certain context. Lastly, the existence of one money does not rule out the existence of others.

Bitcoin, the blockchain public ledger is a record. Generally accepted, but generally accepted within a certain context. Also, coexistence of moneys.

The question of whether Bitcoin is money is a complicated question, there are some standard which are used in academia to evaluate whether something is money or not. Besides this there are the issues of legal tender, and legal recognition. We will start by discussion the academic criteria for a money, after which we will look at legal tender and legal recognition. The standard criteria used in academia for analysing money are:

1. medium of exchange
2. unit of account or numéraire
3. store of value

These criteria can broadly be interpreted as follow. A medium of exchange

The criteria (1.) and (3.) are clearly fulfilled. Since cryptocurrencies are virtual goods, and multiple copies can be made, there is no degeneration over time. Furthermore, cryptocurrencies are a good medium of exchange, transactions are quick and relatively cost less. The unit of account is not a criterium that is currently well met. The volatility of cryptocurrencies vis-vis fiat currencies makes it difficult to denominate goods or services in these in cryptocurrencies. However, in that sense it is again similar to gold, which also has a highly volatile price as denoted in fiat currency.

5.1 Legal Issues

As mentioned above, there are two legal issues, recognition as being legal, alongside a legal classification of Bitcoin, as well as the issue of legal tender. We will discuss these here.

5.1.1 Legal Recognition and Classification

In the initial days of Bitcoin, especially when it was mainly used for purchasing illicit goods, some held the belief that most governments would perceive Bitcoin as a threat to their monopoly on currency and for this reason would ban it. This already being contrasted by governments of the EMU member states, who have voluntarily surrendered their monetary monopoly for a 'foreign' currency. It turned out most government where more interested in taxing it. For this reason Bitcoin has in many places been classified as a financial instrument. If Bitcoins are

derived from mining, they are to be taxed using income tax. If Bitcoins are purchased these will be taxed as financial holdings.

5.1.2 Legal Tender

What is legal tender? why do we need it, why dont we need it in bitcoin, refer to the chapter of why bitcoin

Part II

The Economics

Chapter 6

Bimetallism in Bitcoin and Litecoin?

The situation of multiple currencies, especially in light of the gold analogy, brings to mind the idea of bimetallism, the monetary system where the currency is based not just on gold, but also on silver. The two being interchangeable at a fixed rate.

Also in the light of bimetallism, we can consider Gresham's law. Bad money drives out good. In the case of bimetallism, the most circulated specie will be the one which is currently considered to be undervalued by the official exchange rate. Meaning that if silver becomes more abundant, its relative value will decrease, and people will first spend their silver coins, before they spend their gold ones. Since exchange rates between cryptocur-

*CHAPTER 6. BIMETALLISM IN BITCOIN AND LITECOIN?*¹⁵

rencies are freely floating, there is no 'bad money', since each currency is valued at market rate. Interestingly enough, the rate between Bitcoin and Litecoin seems to trade in a very narrow band, especially considering the volatility vis-a-vis fiat currencies.

However, there is a crowding out of sort. This is perhaps best compared to international currency competition. Where there is a competition for the privilege of being a reserve currency. A foreign investor can choose exchange his national fiat currency for e.g. the US Dollar or the Euro. In these markets, the good currencies drive out the bad.

Chapter 7

Cryptocurrencies and Inflation

As the value of bitcoin goes up, more people will choose to engage in the lucrative mining. As extra computational power comes in, the difficulty of mining automatically goes up, which means more computing power is used for the same transactions. This is necessary to safeguard the integrity of the network.

Having established the key features of the Bitcoin system, we will now focus on two often heard economic concerns about the Bitcoin system. Namely the issue of deflation and the issue of socially wasteful mining.

As mentioned above, there will only ever be around 21 million bitcoins, and some will be lost, this makes the system de-

*CHAPTER 7. CRYPTOCURRENCIES AND INFLATION*17

flationary, which is troubling to economists. Deflation provides a disincentive to spend, causing economic slowdown (see e.g. Fisher 1933). Since deflation causes the price of products to fall, it incentivises people to save and spend later. Additionally, these savings are not invested properly, since deflation simultaneously provides a disincentive for borrowers, by making future paybacks more expensive, raising the effective interest rate.

Part III

The Social Value

Chapter 8

Is mining socially wasteful?

The second issue is the value of the mining process. As described above, the process of mining is the solving of computational problems, in order to secure the integrity of the Bitcoin network. However, the actual social value of the arithmetic solution itself is zero, since it has no application other than Bitcoin integrity. As the number of bitcoins is limited, and more money is invested in it, the value can only increase. The increase in value will make it more lucrative to engage in bitcoin mining, which means more computational power will be devoted to this. To keep the system secure in face of this extra computing power, the difficulty goes up. However, if the extra power had not come in, this would

not have been necessary. The extra computers which engage in bitcoin mining thus do not add any social value.

It has to be noted, that the bar for social value is being set very high. Extraction, storage, and transfer of value is a resource intensive enterprise. Consider the gold mining industry (note, this is the origin of the term bitcoin mining). The extraction of gold is a very resource intensive, dangerous, and pollutive process. After the extraction, purification, and moulding, most gold is stored highly guarded in vaults. Finally then, gold can be utilised to conduct transactions, which involves shipping bars of gold across the ocean under maximum security, only to be stored in another highly protected vault, upon arrival (see e.g. Friedman and Schwartz 2008).

The solution for both these lies in the multiplicity of cryptocurrencies. As mentioned above, every aspect of Bitcoin is open and publicly accessible, it is therefore relatively easy to start an alternative Bitcoin, and this has been done. There are in fact many currencies based on the Bitcoin protocol, collectively referred to as cryptocurrencies. It is relatively easy and cheap to construct a cryptocurrency, whereby the number of available coins can be set by the creator. The most popular alternative to Bitcoin is called Litecoin, its main difference is that it processes transactions faster, and the total number of coins is four times as high. Aside Litecoin, there are many other alternative cryptocurrencies, most of which never gain momentum and the value of which remains only trivially above zero. However, a significant number does succeed. The momentum mechanism could perhaps best be compared with a positive variation on currency attacks (Obstfeld 1986, 1995, 1996). Unlike the cre-

ation of new coins in an existing cryptocurrency, the creation of new cryptocurrencies is relatively cheap.

The key point to observe here, is that cryptocurrencies do have value, but only as a transaction mechanism. Hereby the biggest bottleneck is probably the number of cryptocurrencies that merchants are willing to accept simultaneously. However, due to their similarity, it is very straightforward for e.g. merchants to accept multiple currencies. When we combine the value with the relatively cost-less creation of cryptocurrencies, we see an equilibrium in the number of cryptocurrencies that is far higher than in the current situation.

Inflation is impossible within the Bitcoin network, as well as within most other cryptocurrencies. However, inflation in the cryptocurrency economy is still possible, through an expansion the number of cryptocurrencies.

It is also through this multiplicity that wasteful mining will be limited. As noted above, cryptocurrencies have value, because they are effective mechanisms for transactions. However, this is the only source of value. If a cryptocurrency becomes too expensive (which causes excessive mining), a new, lower valued, cryptocurrency will arise. Since the value of this currency is lower, but it is equally effective in transactions, value will flow out of the overvalued cryptocurrency and into the undervalued one. This lowers the value of the overvalued cryptocurrency, and less mining will be done here, reducing the waste.

Chapter 9

Conclusion

In conclusion, cryptocurrencies such as Bitcoin have an enormous potential as a transaction mechanism, giving users control of their own holdings and making transactions instant and costs negligible. Two commonly heard issues with cryptocurrencies are deflation and wasteful mining. It can be shown that these issues are not pervasive, when the cryptocurrency economy as a whole is considered. Cryptocurrencies derive their value only from being an efficient transaction mechanism, if they appear to become overvalued (causing excessive mining), other cryptocurrencies will arise. This will increase the total number of cryptocurrencies (between all cryptocurrencies), which will drive down the price, and limit excessive mining.

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Glossary

B

Bitcoin

The original cryptocurrency. 1, 4

bitcoin

the unit of account in the Bitcoin system. 4

Bitcoin-Qt

The original Bitcoin software, it is still used, but many other packages have also been developed.. 4

blockchain

the public ledger of the Bitcoin system, it contains all transactions ever recorded. 5

C

cryptocurrency

the generic term for online, cryptography based currencies, Bitcoin is the original cryptocurrency. 2

M

miner

a computer which participates in the Bitcoin transaction verification process. 5

O

open source

Software of which the source code is publicly available for inspection. 2

P

private key

the code which can be used to commit transactions. 5

S

satoshi

The atomic unit of account in the Bitcoin system, it is equal to $1/1,00,000,000$ bitcoin, named after the Bitcoin creator Satoshi Nakamoto. 5

Satoshi Nakamoto

The pseudonym of the original Bitcoin inventor and creator. 1

signature

a digital code used to verify that the originator of a transaction owns the sending address. 5

W

wallet

the collection of private and public codes used to commit transactions. 5