

Investors Flee as Bitcoin's Flaws Are Exposed

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Those following bitcoin will doubtless have noticed its tremendous crash in value over the last few weeks. While cryptocurrencies have always been a volatile asset class, bitcoin's recent 30%-plus falls are impressive – even by its own standards. There's been a subsequent strong recovery – but it's been a rough ride. Investors who lack the stomach for such turbulence may have left the market, or been stopped out – with huge losses. The persistent and the bold have fared far better – as have those who've timed their trades well.

What's behind the drop?

The recent dip in price illustrated an important topic for crypto-watchers. The immediate reason for this wobble is essentially a squabble about how the underlying technology for bitcoin needs to be updated. The maximum rate at which bitcoin transactions can be settled is fixed. Recently, transaction volumes have risen to hit (and often exceed) that limit. As a result, both transaction times and processing fees have skyrocketed (to several *dollars* per transaction). This might sound a bit of an esoteric issue – but it cuts to the heart of what cryptocurrencies are, and what they are used for.

Let's go back right to basics:

What is money?

Economists have several criteria that must be met before something can be money. Two are critical here. Firstly, money is “a medium of exchange”; secondly, it is “a store of value”. Now, bitcoin could ultimately be a very valuable commodity, without being money. If you take gold down to your local corner shop, you are unlikely to be able to exchange it for a bottle of Coke. Nevertheless no will dispute that gold has value. Gold is an obviously investable asset class. Indeed, its role as a store of value underpins its use in jewellery – which has been used for millennia as a durable (but visible) store of wealth. Of course, gold has, at various times, being used as currency – but that's not often in the modern world.

Moving on to bitcoin, we can see a potentially similar story. High transaction fees, and grossly extended transaction times, mean that bitcoin has recently been trending towards uselessness as a “medium of exchange”. The technical squabbles underpinning the recent dip have seemingly been solved, and the currency has now rallied. It's thus coming back to usefulness as a “medium of exchange” – at least for a while. The problems of scaling bitcoin have not disappeared, even if they have temporarily abated.

If bitcoin won't scale, does it matter?

Nevertheless, the value of bitcoin does not necessarily hinge on whether it can ever be used practically for small transactions. Just like a gold bar, the fact that you cannot spend it in the pub does not mean it does not have value.

In coming weeks, it's likely that the recent squabbles over the bitcoin standard will be conclusively resolved. We can expect that transaction fees and times will drop back to a manageable level – albeit perhaps temporarily. The resulting solution could still be far short of what's required to ultimately create a workable replacement for small cash transactions. Just as we can't spend bitcoin in the pub now, we may also not be able to in future. Indeed, the range of online merchants willing to accept the currency has been recently falling. This suggests that bitcoin may ultimately not be used, at least in the medium term, as a true form of money. Nevertheless, that doesn't mean it will not have value – and it could still represent a very attractive investment class.

One of our writers, Sam Volkering, has written a book on cryptocurrencies [which you can get free of charge](#). In it, he will explain why he believes cryptocurrencies could be in for spectacular gains in future. If his analysis is correct, you can expect to see a growth in value which could allow you to turn mere hundreds of pounds into tens of thousands – or more. If you're interested in seeing how such a small stake in this volatile market could ultimately lead you to bank unheard-of wins, then please do check out Sam's book. Investments in this market may not be for the faint-hearted – but fortune favours the brave.

Tell us where you think bitcoin's in – both short and long term: andrew@southbankresearch.com.

Best,

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