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Bitcoin: A Cryptocurrency

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CERTIFICATE

This is to certify that the report titled **Bitcoin: A Cryptocurrency** is a bona-fide record of the Seminar presented by **Savitha K J (Reg. No. VEAKECS049)** of the Eighth Semester B.Tech CSE (2010 admissions) of Vidya Academy of Science & Technology, Thrissur - 680 501 in partial fulfilment of the requirement for the award of the Bachelor of Technology in Computer Science and Engineering from the University of Calicut.

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Abstract

Bitcoin is the world's first decentralized digital currency, allowing the easy storage and transfer of cryptographic tokens, using a peer-to-peer network to carry information, hashing as a synchronization signal to prevent double-spending, and a powerful scripting system to determine ownership of the tokens. There is a growing technology and business infrastructure supporting it.

A purely peer-to-peer version of electronic cash would allow online payments to be sent directly from one party to another without going through a financial institution. Digital signatures provide part of the solution, but the main benefits are lost if a trusted third party is still required to prevent double-spending.

The network timestamps transactions by hashing them into an ongoing chain of hash-based proof-of-work, forming a record that cannot be changed without redoing the proof-of-work. The longest chain not only serves as proof of the sequence of events witnessed, but proof that it came from the largest pool of CPU power. As long as a majority of CPU power is controlled by nodes that are not cooperating to attack the network, they'll generate the longest chain and outpace attackers. The network itself requires minimal structure. Messages are broadcast on a best effort basis, and nodes can leave and rejoin the network at will, accepting the longest proof-of-work chain as proof of what happened while they were gone.

To send money, you broadcast to the network that the amount on your account should go down, and the amount on a receivers account up. Nodes, or computers, in the Bitcoin network apply that transaction to their copy of the ledger, and then pass on the transaction to other nodes. This, with some math-based security, is really all there is–a system that lets a group of computers maintain a ledger.

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Chapter 1

Introduction

Until Bitcoins invention in 2008 by the unidentified programmer known as Satoshi Nakamoto, online transactions always required a trusted third-party intermediary. For example, if Alice wanted to send $100 to Bob over the Internet, she would have had to rely on a third-party service like PayPal or MasterCard. Intermediaries like PayPal keep a ledger of account holders balances. When Alice sends Bob $100, PayPal deducts the amount from her account and adds it to Bobs account. Without such intermediaries, digital money could be spent twice. Imagine there are no intermediaries with ledgers, and digital cash is simply a computer file, just as digital documents are computer files. Alice could send $100 to Bob by attaching a money file to a message. But just as with email, sending an attachment does not remove it from ones computer. Alice would retain a copy of the money file after she had sent it. She could then easily send the same $100 to Charlie. In computer science, this is known as the double-spending problem and until Bitcoin it could only be solved by employing a ledger-keeping trusted third party. Bit coins invention is revolutionary because for the first time the double-spending problem can be solved without the need for a third party. Bitcoin does this by distributing the necessary ledger among all the users of the system via a peer-to-peer network. Every transaction that occurs in the Bitcoin economy is registered in a public, distributed ledger, which is called the block chain. New transactions are checked against the block chain to ensure that the same bit coins havent been previously spent, thus eliminating the double-spending problem. The global peer-to-peer network, composed of thousands of users, takes the place of an intermediary; Alice and Bob can transact without PayPal. One thing to note right away is that transactions on the Bitcoin network are not denominated in dollars or Euros or yens they are on PayPal, but are instead denominated in Bitcoin. This makes it a virtual currency in addition to a decentralized payments network. The value of the currency is not derived from

gold or government fiat, but from the value that people assign to it. The dollar value of a Bitcoin is determined on an open market, just as is the exchange rate between different world currencies.

1.1 Related Works

Electronic funds transfer (EFT) is the electronic exchange, transfer of money from one account to another, either within a single financial institution or across multiple institutions, through computer-based systems. It consists of different concepts;

- Cardholder-initiated transactions, using a payment card such as a credit or debit card

- Direct deposit payment initiated by the payer

- Direct debit payments, sometimes called electronic checks, for which a business debits the consumer's bank accounts for payment for goods or services

- Electronic bill payment in online banking, which may be delivered by EFT or paper check

- Transactions involving stored value of electronic money, possibly in a private currency

- Electronic Benefit Transfer

EFTs include direct-debit transactions, wire transfers, direct deposits, ATM withdrawals and online bill pay services. Transactions are processed through the Automated Clearing House (ACH) network, the secure transfer system of the Federal Reserve that connects all U.S. banks, credit unions and other financial institutions.

For example, when you use your debit card to make a purchase at a store or online, the transaction is processed using an EFT system. The transaction is very similar to an ATM withdrawal, with near- instantaneous payment to the merchant and deduction from your checking account.

Direct deposit is another form of an electronic funds transfer. In this case, funds from your employers bank account are transferred electronically to your bank account, with no need for paper-based payment systems.

The increased use of EFTs for online bill payments, purchases and pay processes is leading to a paper- free banking system, where a large number of invoices and payments take place over digital networks. EFT systems play a large role in

this future, with fast, secure transactions guaranteeing a seamless transfer of funds within institutions or across banking networks.

EFT transactions, also known as an online transaction or PIN-debit transaction, also offer an alternative to signature debit transactions, which take place through one of the major credit card processing systems, such as Visa, MasterCard or Discover, and can cost as much as 3% of the total purchase price. EFT processing, on the other hand, only charges an average of 1% for debit card transactions.

1.2   Existing System

The first crypto currency to begin trading was Bitcoin in 2009. Since then, numerous crypto currencies have been created. Fundamentally, crypto currencies are specifications regarding the use of currency which seek to incorporate principles of cryptography to implement a distributed, decentralized and secure information economy. When comparing crypto currencies to fiat money, the most notable difference is in how no group or individual may accelerate, stunt or in any other way significantly abuse the production of money. Instead, only a certain amount of crypto currency is produced by the entire crypto currency system collectively, at a rate which is bounded by a value both prior defined and publicly known.

In centralized economic systems such as the Federal Reserve System governments regulate the value of currency by simply printing units of fiat money or demanding additions to digital banking ledgers, however governments cannot produce units of crypto currency and as such governments cannot provide backing for firms, banks or corporate entities which hold asset value measured in a decentralized crypto currency. The underlying technical system upon which all crypto currencies are now based was created by the anonymous group or individual known as Satoshi Nakamoto for the purpose of creating an economy within which the practice of fractional reserve banking would be fundamentally impossible.

Hundreds of crypto currency specifications now exist, most are similar to and derived from the first fully implemented crypto currency protocol, Bitcoin. Within crypto currency systems, the safety, integrity, and balance of all ledgers is ensured by a swarm of mutually distrustful parties, referred to as miners, who are, for the most part, general members of the public, actively protecting the network by maintaining a high hash-rate difficulty for their chance at receiving a randomly distributed small fee. Subverting the underlying security of a crypto currency is mathematically possible, but the cost may be unfeasibly high.

Most crypto currencies are designed to gradually introduce new units of currency, placing an ultimate cap on the total amount of currency that will ever be in circulation. This is done both to mimic the scarcity (and value) of precious metals

and to avoid hyperinflation. As a result, such crypto currencies tend to experience hyper deflation as they grow in popularity and the amount of the currency in circulation approaches this finite cap. Compared with ordinary currencies held by financial institutions or kept as cash on hand, crypto currencies are less susceptible to seizure by law enforcement. Existing crypto currencies are all pseudonymous, though additions such as Zerocoin and its distributed laundry feature have been suggested, which would allow for anonymity.

1.3   Proposed System

Bitcoin is a form of digital currency, created and held electronically. No one controls it. Bitcoin arent printed, like dollars or euros theyre produced by lots of people running computers all around the world, using software that solves mathematical problems. Its the first example of a growing category of money known as cryptocurrency.

Bitcoin can be used to buy things electronically. In that sense, its like conventional dollars, euros, or yen, which are also traded digitally.

However, bit coins most important characteristic, and the thing that makes it different to conventional money, is that it is decentralized. No single institution controls the Bitcoin network. This puts some people at ease, because it means that a large bank cant control their money.

This currency isnt physically printed in the shadows by a central bank, unaccountable to the population, and making its own rules. Those banks can simply produce more money to cover the national debt, thus devaluing their currency.

Instead, Bitcoin is created digitally, by a community of people that anyone can join. Bitcoin are mined, using computing power in a distributed network. This network also processes transactions made with the virtual currency, effectively making Bitcoin its own payment network.

Bitcoin has several important features that set it apart from normal fiat currencies.

1. Its decentralized

   The Bitcoin network isnt controlled by one central authority. Every machine that mines bitcoin and processes transactions makes up a part of the network, and the machines work together. That means that, in theory, one central authority cant tinker with monetary policy and cause a meltdown or simply decide to take peoples Bitcoin away from them, as the Central European Bank decided to do in Cyprus in early 2013. And if some part of the network goes offline for some reason, the money keeps on flowing.

2. It's easy to setup

   Conventional banks make you jump through hoops simply to open a bank account. Setting up merchant accounts for payment is another Kafkaesque task, beset by bureaucracy. However, you can set up a Bitcoin address in seconds, no questions asked, and with no fees payable.

3. It's anonymous

   Well, kind of. Users can hold multiple Bitcoin addresses, and they arent linked to names, addresses, or other personally identifying information.

4. It's completely transparent

   Bitcoin stores details of every single transaction that ever happened in the network in a huge version of a general ledger, called the block chain. The block chain tells all. If you have a publicly used bitcoin address, anyone can tell how many Bitcoin are stored at that address. They just dont know that its yours. There are measures that people can take to make their activities more opaque on the bitcoin network, though, such as not using the same Bitcoin addresses consistently, and not transferring lots of bitcoin to a single address.

5. Transaction fees are miniscule

   Your bank may charge you a 10 fee for international transfers. Bitcoin doesnt.

6. It's fast

   You can send money anywhere and it will arrive minutes later, as soon as the bitcoin network processes the payment.

7. It's non-repudiable

   When your bitcoins are sent, theres no getting them back, unless the recipient returns them to you. Theyre gone forever.

Chapter 2

Bitcoin: A Peer-to-Peer Electronic Cash System

2.1   Introduction

Commerce on the Internet has come to rely almost exclusively on financial institutions serving as trusted third parties to process electronic payments. While the system works well enough for most transactions, it still suffers from the inherent weaknesses of the trust based model. Completely non-reversible transactions are not really possible, since financial institutions cannot avoid mediating disputes. The cost of mediation increases transaction costs, limiting the minimum practical transaction size and cutting off the possibility for small casual transactions, and there is a broader cost in the loss of ability to make non-reversible payments for nonreversible services. With the possibility of reversal, the need for trust spreads. Merchants must be wary of their customers, hassling them for more information than they would otherwise need. A certain percentage of fraud is accepted as unavoidable. These costs and payment uncertainties can be avoided in person by using physical currency, but no mechanism exists to make payments over a communications channel without a trusted party.

What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party. Transactions that are computationally impractical to reverse would protect sellers from fraud, and routine escrow mechanisms could easily be implemented to protect buyersA solution is proposed to the double-spending problem using a peer-to-peer distributed timestamp server to generate computational proof of the chronological order of transactions. The system is secure as long as honest nodes collectively control more CPU power than any

cooperating group of attacker nodes.

2.2 Transactions

We define an electronic coin as a chain of digital signatures. Each owner transfers the coin to the next by digitally signing a hash of the previous transaction and the public key of the next owner and adding these to the end of the coin. A payee can verify the signatures to verify the chain of ownership.

Figure 2.1: Transaction

The problem of course is the payee can't verify that one of the owners did not double-spend the coin. A common solution is to introduce a trusted central authority, or mint, that checks every transaction for double spending. After each transaction, the coin must be returned to the mint to issue a new coin, and only coins issued directly from the mint are trusted not to be double-spent. The problem with this solution is that the fate of the entire money system depends on the company running the mint, with every transaction having to go through them, just like a bank. We need a way for the payee to know that the previous owners did not sign any earlier transactions. For our purposes, the earliest transaction is the one that counts, so we don't care about later attempts to double-spend. The only way to confirm the absence of a transaction is to be aware of all transactions. In the mint based model, the mint was aware of all transactions and decided which arrived first. To accomplish this without a trusted party, transactions must be publicly

announced [1], and we need a system for participants to agree on a single history of the order in which they were received. The payee needs proof that at the time of each transaction, the majority of nodes agreed it was the first received.

2.3   Timestamp Server

The solution we propose begins with a timestamp server. A timestamp server works by taking a hash of a block of items to be timestamped and widely publishing the hash, such as in a newspaper or Usenet post. The timestamp proves that the data must have existed at the time, obviously, in order to get into the hash. Each timestamp includes the previous timestamp in its hash, forming a chain, with each additional timestamp reinforcing the ones before it.
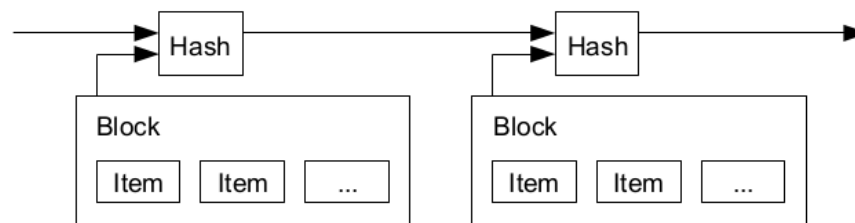
Figure 2.2: Timestamp Chain

2.4   Proof-of-Work

To implement a distributed timestamp server on a peer-to-peer basis, we will need to use a proof-of-work system similar to Adam Back's Hashcash, rather than newspaper or Usenet posts. The proof-of-work involves scanning for a value that when hashed, such as with SHA-256, the hash begins with a number of zero bits. The average work required is exponential in the number of zero bits required and can be verified by executing a single hash. For our timestamp network, we implement the proof-of-work by incrementing a nonce in the block until a value is found that gives the block's hash the required zero bits. Once the CPU effort has been expended to make it satisfy the proof-of-work, the block cannot be changed without redoing the work. As later blocks are chained after it, the work to change the block would include redoing all the blocks after it.

Figure 2.3: Block Chain

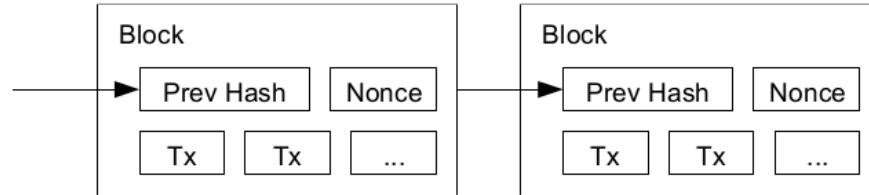The proof-of-work also solves the problem of determining representation in majority decision making. If the majority were based on one-IP-address-one-vote, it could be subverted by anyone able to allocate many IPs. Proof-of-work is essentially one-CPU-one-vote. The majority decision is represented by the longest chain, which has the greatest proof-of-work effort invested in it. If a majority of CPU power is controlled by honest nodes, the honest chain will grow the fastest and outpace any competing chains. To modify a past block, an attacker would have to redo the proof-of-work of the block and all blocks after it and then catch up with and surpass the work of the honest nodes. We will show later that the probability of a slower attacker catching up diminishes exponentially as subsequent blocks are added.

To compensate for increasing hardware speed and varying interest in running nodes over time, the proof-of-work difficulty is determined by a moving average targeting an average number of blocks per hour. If they're generated too fast, the difficulty increases.

2.5 Network

The steps to run the network are as follows:

1. New transactions are broadcast to all nodes.

2. Each node collects new transactions into a block.

3. Each node works on finding a difficult proof-of-work for its block

4. When a node finds a proof-of-work, it broadcasts the block to all nodes.

5. Nodes accept the block only if all transactions in it are valid and not already spent.

6. Nodes express their acceptance of the block by working on creating the next block in the chain, using the hash of the accepted block as the previous hash.

Nodes always consider the longest chain to be the correct one and will keep working on extending it. If two nodes broadcast different versions of the next block simultaneously, some nodes may receive one or the other first. In that case, they work on the first one they received, but save the other branch in case it becomes longer. The tie will be broken when the next proof- of-work is found and one branch becomes longer; the nodes that were working on the other branch will then switch to the longer one.

New transaction broadcasts do not necessarily need to reach all nodes. As long as they reach many nodes, they will get into a block before long. Block broadcasts are also tolerant of dropped messages. If a node does not receive a block, it will request it when it receives the next block and realizes it missed one.

2.6   Incentive

By convention, the first transaction in a block is a special transaction that starts a new coin owned by the creator of the block. This adds an incentive for nodes to support the network, and provides a way to initially distribute coins into circulation, since there is no central authority to issue them. The steady addition of a constant of amount of new coins is analogous to gold miners expending resources to add gold to circulation. In our case, it is CPU time and electricity that is expended.

The incentive can also be funded with transaction fees. If the output value of a transaction is less than its input value, the difference is a transaction fee that is added to the incentive value of the block containing the transaction. Once a pre-determined number of coins have entered circulation, the incentive can transition entirely to transaction fees and be completely inflation free.

The incentive may help encourage nodes to stay honest. If a greedy attacker is able to assemble more CPU power than all the honest nodes, he would have to choose between using it to defraud people by stealing back his payments, or using it to generate new coins. He ought to find it more profitable to play by the rules, such rules that favour him with more new coins than everyone else combined, than to undermine the system and the validity of his own wealth.

2.7   Reclaiming Disk Space

Once the latest transaction in a coin is buried under enough blocks, the spent transactions before it can be discarded to save disk space. To facilitate this without

breaking the block's hash, transactions are hashed in a Merkle Tree, with only the root included in the block's hash. Old blocks can then be compacted by stubbing off branches of the tree. The interior hashes do not need to be stored.
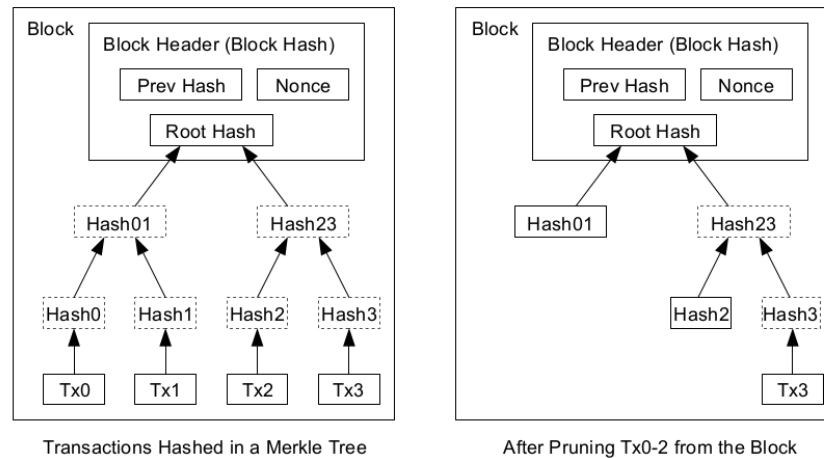

Figure 2.4: Transactions hashed in a Merkle Tree and pruning

A block header with no transactions would be about 80 bytes. If we suppose blocks are generated every 10 minutes, 80 bytes * 6 * 24 * 365 = 4.2MB per year. With computer systems typically selling with 2GB of RAM as of 2008, and Moore's Law predicting current growth of 1.2GB per year, storage should not be a problem even if the block headers must be kept in memory.

2.8   Simplified Payment Verification

It is possible to verify payments without running a full network node. A user only needs to keep a copy of the block headers of the longest proof-of-work chain, which he can get by querying network nodes until he's convinced he has the longest chain, and obtain the Merkle branch linking the transaction to the block it's timestamped in. He can't check the transaction for himself, but by linking it to a place in the chain, he can see that a network node has accepted it, and blocks added after it further confirm the network has accepted it.

As such, the verification is reliable as long as honest nodes control the network, but is more vulnerable if the network is overpowered by an attacker. While network nodes can verify transactions for themselves, the simplified method can be fooled by an attacker's fabricated transactions for as long as the attacker can continue to
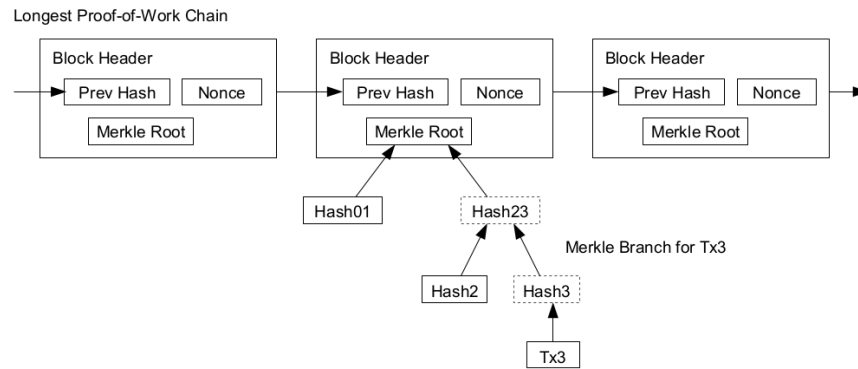
Figure 2.5: Proof-of-Work Chain

overpower the network. One strategy to protect against this would be to accept
alerts from network nodes when they detect an invalid block, prompting the user's
software to download the full block and alerted transactions to confirm the incon-
sistency. Businesses that receive frequent payments will probably still want to run
their own nodes for more independent security and quicker verification.

2.9 Combining and Splitting Value

Although it would be possible to handle coins individually, it would be unwieldy to
make a separate transaction for every cent in a transfer. To allow value to be split
and combined,transactions contain multiple inputs and outputs. Normally there
will be either a single input from a larger previous transaction or multiple inputs
combining smaller amounts, and at most two outputs: one for the payment, and
one returning the change, if any, back to the sender.

It should be noted that fan-out, where a transaction depends on several transac-
tions, and those transactions depend on many more, is not a problem here. There
is never the need to extract a complete standalone copy of a transaction's history.

2.10 Privacy

The traditional banking model achieves a level of privacy by limiting access to
information to the parties involved and the trusted third party. The necessity to
announce all transactions publicly precludes this method, but privacy can still be
maintained by breaking the flow of information in another place: by keeping public
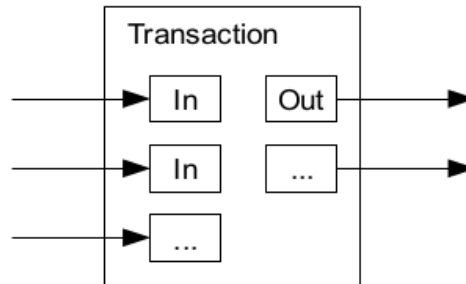
Figure 2.6: Inputs and Outputs in a transaction

keys anonymous. The public can see that someone is sending an amount to some-
one else, but without information linking the transaction to anyone. This is similar
to the level of information released by stock exchanges, where the time and size
of individual trades, the ẗape, is made public, but without telling who the parties
were.
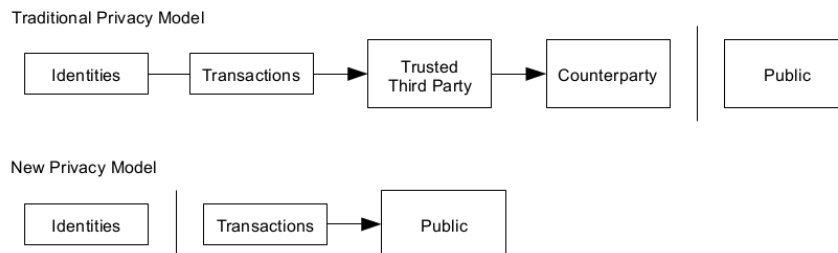
Figure 2.7: Privacy Models

As an additional firewall, a new key pair should be used for each transaction to
keep them from being linked to a common owner. Some linking is still unavoidable
with multi-input transactions, which necessarily reveal that their inputs were owned
by the same owner. The risk is that if the owner of a key is revealed, linking could
reveal other transactions that belonged to the same owner.

Chapter 3

Under the Hood of the Bitcoin System

Bitcoin is based on a peer-to-peer network layer that broadcasts data to all nodes on the network. There are two types of object that are broadcast: transactions and blocks. Both object types are addressed by a hash of the object data, and are broadcast through the network to all nodes. Transactions are the operations whereby money is combined, divided, and remitted. Blocks record the transactions vetted as valid.

Spending. Suppose that Alice wishes to remit 1 bitcoin to Bob and 2 to Carol. Alices coins reside in prior transactions that designate her public key as beneficiary. To spend coins, Alice creates a new transaction that endorses any such coins she has not spent yet, e.g., she can endorse, using a digital signature, 4 coins each received from Diane and Edgar as the inputs of her new transaction. As outputs she specifies 1 coin for Bob, 2 for Carol, and 4:99 of change back to herself. In this example, Alice chose to leave a residual of 0:01 coin, which can be claimed as a fee by whoever vets it first.

Vetting. In order for a transaction to be confirmed, its various components must be validated and checked against double spending. Once verified, transactions are incorporated in frequently issued official records called blocks. Anyone is allowed to create such blocks, and indeed two sorts of incentives are offered to attract verifiers to compete for block creation:

- the collection of fees; and

- the minting of new coins.

Minting. The bitcoin money supply expands as each block created may contain a special generation transaction (with no explicit input) that pays the block creator a

timedependent amount for the effort (50 coins today, rapidly decreasing). The rate of block, hence money, creation is limited by a proof of work of adaptive difficulty, that strives to maintain a creation rate of one block every 10 minutes across the whole network. Bitcoin transaction verification is thus a lucrative race open to all, but a computationally expensive one. Note: bad blocks will be rejected by peers, invalidating their rewards.

3.1   Transactions and Scripting: The Tools for Spending

One of the main powers of the Bitcoin system is that the input and output of transactions need not have a fixed format, but rather are constructed using a Forth-like stack-based flexible scripting language. The transaction principals are not named users but anonymous public keys, which users may freely create in any number they wish.

Transactions. Transaction encapsulate the movement of bitcoins by transferring the value received from its inputs to its outputs (exception: generation transactions have no explicit input at all). An input identifies a previous transaction output (as the hash of the earlier transaction and an index to an output within it), and claims its full value. An output specifies an amount; the outputs total must not exceed the inputs. Both also contain fragments of executable script, on the input side for redeeming inflows, and on the output side for designating payees.

Script fragments. The scripting language is a Forth-like stack-based language. Operators include cryptographic operations like SHA1 (which replaces the top item on the stack with its hash), and CHECKSIG (which pops an ECDSA public key and signature from the stack, verifies the signature for a message implicitly defined from the transaction data, and leaves the result as a true or false on the stack). For a transaction to be valid, its outputs must not exceed its inputs, and its issuer must show title to each input claimed. Title is tested by evaluating the input script fragment concatenated with the script fragment from the output (of an earlier transaction) that the input references.

Standard transfer. To illustrate how the stack-based scripting language can be used, among other things, to designate and enforce the recipient of a transfer, we study the example of the standard Bitcoin transaction used for transfer. To send coins to an address stated as the hash of a public key, the payer, Alice, creates a transaction output with the following associated script fragment (recall that since the amount is specified in a special record associated with the output; the script only needs to enforce the recipient):

DUP HASH160 ⟨recipient-address⟩ EQUALVERIFY CHECKSIG

The recipient, Bob, will notice the remittance (since it is broadcast to all),

and mark it for spending. Later on, to spend those received coins, he creates a transaction with an input that redeems them, and an output that spends them. The redeeming input script is:

⟨signature⟩ ⟨public-key⟩

Bob will have managed to spend coins received from Alice if his redemption is valid. This is checked by executing the concatenated script ,the input fragment pushes a signature and a key on the stack; the output fragment checks that the key hash matches the recipient, and checks the signature against transaction and key.

3.2   Blocks and Coin Creation: the Process of Verifying

Transactions become effective after they have been referenced in a block, which serve as the official record of executed transactions. Transactions may only be listed in a block if they satisfy such conditions as valid timestamping and absence of double spending.

Blocks. A block consists of one coinbase minting transaction, zero or more regular spending transactions, a computational proof of work, and a reference to the chronologically prior block. Thus the blocks form a singly linked blockchain, rooted in Nakamotos genesis block whose hash is hardcoded in the software. The regular creation of new blocks serves the dual purpose of ensuring the timely vetting of new transactions, and the creation of new coins, all in a decentralized process driven by economic incentives (the minting of new coins and the collection of fees) balanced by computational costs. The difficulty of the required proof of work is adjusted by a feedback mechanism that ensures an average block creation interval of 10 minutes across the entire network.

Coinbase. Currently, each new block may contain a coinbase transaction with an implicit input value of 50 coins, with about 7M already minted as of this writing. The minting rate is slated to decrease shortly, eventually to reach zero when the total supply reaches about 21M bitcoins. The coinbase transaction also serves to claim all the fees in the transactions collected in the block. Both minting and fees motivate people to create blocks and hence keep the system alive.

3.3   Forking and Conflict Resolution

If two blocks are published nearly simultaneously, a fork in the chain can occur. Nodes are programmed to follow the blockchain whose total proof-of-work difficulty is the largest and discard blocks from other forks. Transactions on the discarded branch will eventually be collected into blocks on the prevailing branch. This mechanism ensures that one single ordering of transactions becomes apparent

and accepted by all (although it may take a few blocks time to become clear), and hence this solves the doublespending problem.

3.4 Theft or Loss of Bitcoins

As all bitcoins are public knowledge (in the form of unredeemed transaction outputs), what enables a user to spend a coin is possession of the associated private key. Theft or loss of private keys, or signature forgeries, thus equate to loss of money in this world.

3.4.1 Malware Attacks

Reported malware attacks on Bitcoin are on the rise resulting in the theft of private keys. The online wallet service mybitcoin.com recently lost $1:3 million worth of users coins due to malware. Several solutions can be envisaged Threshold cryptography. A natural countermeasure to malware is to split private keys into random shares, using standard threshold cryptography techniques and distribute them onto multiple locations, e.g., a users desktop computer, her smart phone, and an online service provider. In this way, only when a threshold number of these devices collaborate, can a user spend her coins. Of course, doing so can harm the usability of the system, since coins can no longer be spent without operating multiple devices (even though not all the devices but only a chosen number of them are needed at once). Super-wallets. To address the usability concern the simple idea of superwallet was purposed, i.e., a users personal bank where most of her coins are stored. The superwallet is split across multiple computing devices, using threshold techniques as above. In addition, the user carries a small sub-wallet with her on her smartphone. Pre-approved transactions are setup so that the user can withdraw money from her super-wallet onto her sub-wallet, periodically in small amounts (similar to how real banks let people withdraw cash from ATMs today). The user now only needs her smartphone to spend money in her wallet, and in case her smartphone is captured by an adversary, the user only loses the small amount of money that she has in her wallet, but not that in her personal bank. Large amounts can always be spent from the super-wallet using a threshold of devices. Both approaches can be implemented as backward-compatible and incrementally deployable wrappers, requiring changes in the signature generation but not verification.

3.4.2 Accidental Loss of Bitcoins

Apart from malware, system failures or human errors can cause the accidental loss of the wallet file (which stores the private keys needed to spend coins), which in

turn leads to the loss of coins (turning them into zombies). For example, bitomat, the third largest bitcoin exchange, recently lost about $200K worth of bitcoins (at the exchange rate at the time) due to the loss of its private wallet file the cause was later identified to be human error, as the developer hosted the wallet on non-persistent cloud storage.

Backups. Naturally, the universal answer against accidental loss or adversarial destruction of data, is to follow best-practice backup procedures. For backup purposes, the wallet file should be treated like any other private cryptographic asset meaning that backups are a non-trivial proposition, not because of volume, but because of secrecy. With Bitcoin, things are complicated by the incessant creation of keys. Pseudo-random keys. To avoid having to back up a constantly growing wallet file, a trivial solution is to generate all of ones private keys not at random, but pseudorandomly from a master secret that never changes, using a standard PRG. The problem then reduces to that of backing up the short and static PRG seed, e.g., in a bank vault. problem, of course, is that strong passwords are prone to memory loss and palimpsest.

Offline (single-)password-based encryption. One solution relies on the optimal password-based encryption system of, which offers optimal trade-offs between password strength (how tough it is to guess) and snappiness (how quickly it can be used, which is also kept a secret). Users can even set multiple passwords with varying tradeoffs for a common security goal: e.g., an everyday password, complex but snappy; and a backup password, simple but just as secure by virtue of being made sluggish. A pseudo-random wallet seed, encrypted la, would combine static portability with usable protection against both loss and theft, and is probably the best approach for an isolated user who trusts his mental possessions more than his physical ones.

Online (multi-)password-based encryption. Another approach is to combine the power of several memorable secrets into a single high-security vault, using the protocols of each member in some circle of friends holds a short totally private and long-term memorable phrase. One member is a distinguished leader. Without revealing their secrets, the members can perform private operations such as signing or decrypting a message on behalf of the leader. With this protocol, a group of users can cooperate to let the leader spend the coins from his wallet (kept as a public, static, accessible, encrypted file), by issuing signatures on messages created by the leader. This approach provides strong safety against loss, plus security against compromise of a subset of the group.

Trusted paths. Any of the above approaches can be combined with trusted-path devices, which are dedicated hardware devices that let humans input and read out (tiny amounts of) cryptographic data out of the reach of any malware. European banks use the DigiPass, for example. Alas, while trusted-path protocols are well

known and very safe when it can be assumed that the remote server is uncorrupted (e.g., when talking to a bank), in the Bitcoin case the server is the users own PC, possibly infected. It is an interesting open problem to devise trusted-path protocols that are secure in this model, when the trusted-path data is too tiny to provide cryptographic strength by itself.

3.5 Scalability

The smooth operation of Bitcoin relies on the timely broadcast of transactions and blocks. A preprint suggests that verifiers competing for the same reward have an incentive to withhold the information needed to do so. However, since transactors have an incentive to disseminate their data as quickly and widely as possible, not only is retention futile, but economic forces will counter it by fostering circumvention services.

3.5.1 Linear Transaction History

The Bitcoin wallet software fetches the entire Bitcoin blockchain at installation, and all new transactions and blocks are (supposedly) broadcast to all nodes. The Bitcoin nodes cryptographically verify the authenticity of all blocks and transactions as they receive them. Clearly, this approach introduces a scalability issue in the longer term, in terms of both network bandwidth, and computational overhead associated with cryptographic transaction verification. The scalability issue can be worrying for smart phones with limited bandwidth, computational power, and battery supply. The scalability issue can be addressed with a subscription-based filtering service. Recall that Bitcoin nodes can be divided into broadly two classes, verifiers and clients. Verifiers create new blocks and hence mint new coins. Verifiers are mostly nodes with ample computational and bandwidth resources, typically desktop computers. By contrast, clients are Bitcoin nodes that are not actively minting new coins, such as smart phones. While verifiers have incentives to receive all transactions (to earn transaction fees), clients may not care. In particular, all that is needed for clients to spend their coins is that they receive transactions payable to their public key(s).

Bitcoin filtering service. Filtering service is a third-party cloud service provider which filters Bitcoin transactions, and sends only relevant transactions to nodes that have registered for the service. A Bitcoin client (e.g., a users smartphone) can send a cryptographic capability to the filtering service, which allows the filtering service to determine whether a transaction is payable to one or more of its public keys.

Identified the following desirable security and usability requirements are:

- **Unlinkability without the capability.** While a user may allow the filtering service to determine which transactions are payable to itself, no other party should be able to link a users multiple public keys better than they can today (i.e., without the filtering service).

- **Forward security.** The filtering service should be able to update its capability periodically, such that in the case of compromise or a subpoena, the revealed capability can allow one to identify new transactions targeted to a specific user, but cannot be used to link the users transactions in the past.

- **Reasonable false positives and low false negatives.** A false positive is when the filtering service mistakenly sends a user a non-relevant transaction. False positives wastes a users bandwidth and computational power, but a user can locally detect such false positives after receiving the transactions. A false negative is when the filtering service fails to send a user a relevant transaction. The false negative rate should ideally be 0.

Chapter 4

Bitcoin mining the hard way: The algorithms and protocols

4.1   The purpose of mining

Bitcoin mining is often thought of as the way to create new Bitcoins. But that's really just a secondary purpose. The primary importance of mining is to ensure that all participants have a consistent view of the Bitcoin data. Because Bitcoin is a distributed peer-to-peer system, there is no central database that keeps track of who owns Bitcoin. Instead, the log of all transactions is distributed across the network. The main problem with a distributed transaction log is how to avoid inconsistencies that could allow someone to spend the same Bitcoins twice. The solution in Bitcoin is to mine the outstanding transactions into a block of transactions approximately every 10 minutes, which makes them official. Conflicting or invalid transactions aren't allowed into a block, so the double spend problem is avoided. Although mining transactions into blocks avoid double-spending, it raises new problems: What stops people from randomly mining blocks? How do you decide who gets to mine a block? How does the network agree on which blocks are valid? Solving those problems is the key innovation of Bitcoin: mining is made very, very difficult, a technique called proof-of-work. It takes an insanely huge amount of computational effort to mine a block, but it is easy for peers on the network to verify that a block has been successfully mined. Each mined block references the previous block, forming an unbroken chain back to the first Bitcoin block. This block chain ensures that everyone agrees on the transaction record. It also ensures that nobody can tamper with blocks in the chain since re-mining all the following blocks would be computationally infeasible. As long as nobody has more than half the computational resources, mining remains competitive and

nobody can control the block chain. As a side-effect, mining adds new Bitcoin to the system. For each block mined, miners currently get 25 new Bitcoin (currently worth about $15,000), which encourages miners to do the hard work of mining blocks. With the possibility of receiving $15,000 every 10 minutes, there is a lot of money in mining.

4.2 How mining works

Mining requires a task that is very difficult to perform, but easy to verify. Bitcoin mining uses cryptography, with a hash function called double SHA-256. A hash takes a chunk of data as input and shrinks it down into a smaller hash value (in this case 256 bits). With a cryptographic hash, there's no way to get a hash value you want without trying a whole lot of inputs. But once you find an input that gives the value you want, it's easy for anyone to verify the hash. Thus, cryptographic hashing becomes a good way to implement the Bitcoin "proof-of-work". In more detail, to mine a block, you first collect the new transactions into a block. Then you hash the block to form a 256-bit block hash value. If the hash starts with enough zeros, the block has been successfully mined and is sent into the Bitcoin network and the hash becomes the identifier for the block. Most of the time the hash isn't successful, so you modify the block slightly and try again, over and over billions of times. About every 10 minutes someone will successfully mine a block, and the process starts over.

The diagram below shows the structure of a specific block, and how it is hashed. The yellow part is the block header, and it is followed by the transactions that go into the block. The first transaction is the special coinbase transaction that grants the mining reward to the miner. The remaining transactions are standard Bitcoin transactions moving bitcoins around. If the hash of the header starts with enough zeros the block is successfully mined. For the block below, the hash is successful:0000000000000000e067a478024addfecdc93628978aa52d91fabd4292982a50 and the block became block #286819 in the block chain.

The block header contains a handful of fields that describe the block. The first field in the block is the protocol version. It is followed by the hash of the previous block in the block chain, which ensures all the blocks form an unbroken sequence in the block chain. (Inconveniently, the hash is reversed in the header.) The next field is the Merkle root a special hash of all the transactions in the block. This is also a key part of Bitcoin security, since it ensures that transactions cannot be changed once they are part of a block. Next is a (moderately accurate) timestamp of the block, followed by the mining difficulty value bits. Finally, the nonce is an arbitrary value that is incremented on each hash attempt to provide a new hash
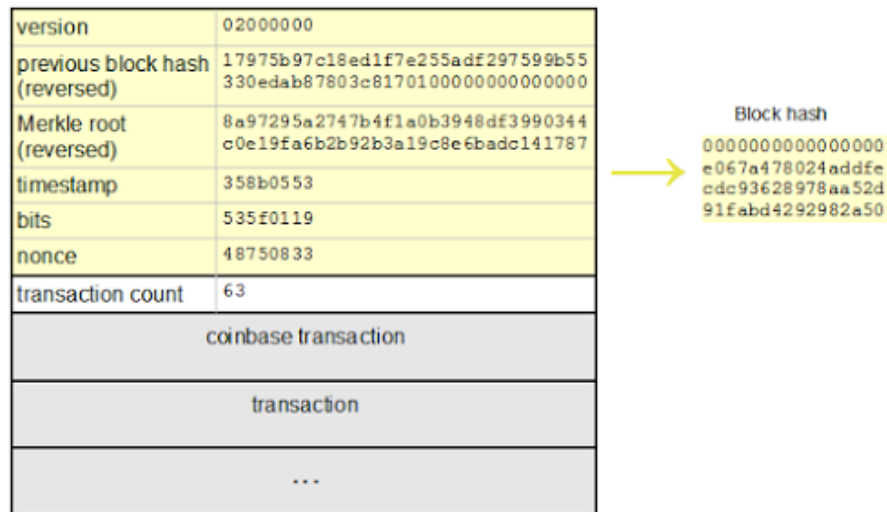
version	02000000
previous block hash (reversed)	17975b97c18ed1f7e255adf297599b55 330edab87803c8170100000000000000
Merkle root (reversed)	8a97295a2747b4f1a0b3948df3990344 c0e19fa6b2b92b3a19c8e6badc141787
timestamp	358b0553
bits	535f0119
nonce	48750833
transaction count	63

Block hash

0000000000000000
e067a478024addfe
cdc93628978aa52d
91fabd4292982a50

coinbase transaction

transaction

. . .

Figure 4.1: Structure of a Bitcoin

value. The tricky part of mining is finding a nonce that works.

4.3   Mining is very hard

The difficulty of mining a block is astounding. At the current difficulty, the chance of a hash succeeding is a bit less than one in 1019. Finding a successful hash is harder than finding a particular grain of sand from all the grains of sand on Earth. To find a hash every ten minutes, the Bitcoin hash rate needs to be insanely large. Currently, the miners on the Bitcoin network are doing about 25 million gig hashes per second. That is, every second about 25,000,000,000,000,000 blocks gets hashed. I estimate (very roughly) that the total hardware used for Bitcoin mining cost tens of millions of dollars and uses as much power as the country of Cambodia.

Note that finding a successful hash is an entirely arbitrary task that doesn't accomplish anything useful in itself. The only purpose of finding a small hash is to make mining difficult, which is fundamental to Bitcoin security. It seems to me that the effort put into Bitcoin mining has gone off the rails recently.

Mining is funded mostly by the 25 Bitcoin reward per block, and slightly by the transaction fees (about 0.1 Bitcoin per block). Since the mining reward currently works out to about $15,000 per block, that pays for a lot of hardware. Per transaction, miners are getting about $34 in mining reward and $0.10 in fees.

4.4 Mining with a pool

Since mining is so difficult, it is typically done in mining pools, where a bunch of miners share the work and share the rewards. If you mine by yourself, you might successfully mine a block and get 25 Bitcoin every few years. By mining as part of a pool, you could get a fraction of a Bitcoin every day instead, which for most people is preferable.

Mining pools use an interesting technique to see how much work miners are doing. They send out a block to be mined, and get updates from a miner whenever a miner gets a partial solution. Each partial solution proves the miner is working hard on the problem and gives the miner a share in the final reward when someone succeeds in mining the block. For instance, if Bitcoin mining requires a hash starting with 15 zeroes, the mining pool can ask for hashes starting with 10 zeroes, which is a million times easier. Depending on the power of their hardware, a miner might find such a solution every few seconds or a few times an hour. Eventually one of these solutions will start with not just 10 zeroes but 15 zeroes, successfully mining the block and winning the reward for the pool. The reward is then split based on each miner's count of shares as a fraction of the total, and the pool operator takes a small percentage for overhead.

Most of the time someone outside the pool, will mine a block first. In that case, the pool operator sends out new data and the miners just start mining the new block. People in a pool can get edgy if a long time goes without a payout because of bad luck in mining.

Chapter 5

Challenges and Benefits

5.1 Challenges

Despite the benefits that it presents, Bitcoin has some downsides for potential users to consider. It has exhibited considerable price volatility throughout its existence. New users are at risk of improperly securing or even accidentally deleting their bitcoins if they are not cautious. Additionally, there are concerns about whether hacking could compromise the bitcoin economy.

5.1.1 Volatility

Bitcoin has weathered at least five significant price adjustments since 2011.These adjustments resemble traditional speculative bubbles: overoptimistic media coverage of Bitcoin prompts waves of novice investors to pump up Bitcoin prices. The exuberance reaches a tipping point, and the value eventually plummets. Newcomer investors eager to participate run the risk of overvaluing the currency and losing their money in a crash. Bitcoins fluctuating value makes many observers skeptical of the currencys future.

Does this volatility foretell the end of Bitcoin? Some commentators believe so. Others suggest that these fluctuations are stress-testing the currency and might eventually decrease in frequency as mechanisms develop to counteract volatility If bitcoins were only used as stores of value or units of account, the currencys volatility could indeed endanger its future. It does not make sense to manage business finances or keep savings in bitcoins if the market price swings wildly and unpredictably.

When Bitcoin is used as a medium of exchange, however, vola - tility is less of a problem Merchants can price their wares in terms of a traditional currency and accept the equivalent number of bitcoins. Customers who purchase bitcoins to

make a one-time purchase dont care about what the exchange rate will look like tomorrow; they simply care that Bitcoin can lower transaction costs in the present. Bitcoins usefulness as a medium of exchange might explain why the currency has grown more popular among merchants in spite of its price volatility.It is also possible that the value of bitcoins will become less volatile as more people become familiar with the Bitcoin technology and develop realistic expectations about its future.

5.1.2 Security Breaches

As a digital currency, Bitcoin presents some specific security challenges. If people are not careful, they can inadvertently delete or misplace their bitcoins. Once the digital file is lost, the money is lost, just as with paper cash. If people do not protect their private Bitcoin addresses, they can leave themselves open to theft.

Bitcoin wallets can now be protected by encryption, but users must choose to activate the encryption. If a user does not encrypt his or her wallet, bitcoins could be stolen through malware Bitcoin exchanges, too, have at times struggled with security; hackers successfully stole 24,000 BTC ($250,000) from a bitcoin exchange called Bitfloor in 2012 and mounted a massive series of distributed denial-of-service (DDoS) attacks against the most popular bitcoin exchange, Mt.Gox, in 2013. (Bitfloor eventually repaid the stolen funds to its customers, and Mt.Gox ultimately recovered from the DDoS attacks.) Of course, many of the security risks facing Bitcoin are similar to those facing traditional currencies. Dollar bills can be destroyed or lost, personal financial information can be stolen and used by criminals, and banks can be robbed or targeted by DDoS attacks.

Bitcoin users should take care to learn about and prepare for security concerns just as they currently do for other financial activities

5.1.3 Criminal Uses

There are also reasons for policymakers to be apprehensive about some of Bitcoins exaptations. Because Bitcoin is pseudonymous, policymakers and journalists have questioned whether criminals can use it to launder money and accept payment for illicit goods and services. Indeed, like cash, it can be used for ill as well as for good.

For one example, we can look at the FBI taken down infamous Deep Web black-market site known as Silk Road. Silk Road took advantage of the anonymizing network Tor and the pseudonymous nature of Bitcoin to make available a vast digital marketplace where one can mail-order drugs and other licit and illicit wares. Although Silk Road administrators never allowed the exchange of any goods that

resulted from fraud or harm, like stolen credit card information or photographs of child exploitation, it did allowed merchants to sell illegal products like forged identity documents and illicit drugs. The pseudonymous nature of Bitcoin allows buyers to purchase illegal goods online in the same way that cash has been traditionally used to facilitate illicit purchases in person. One study estimated the total monthly Silk Road transactions amounted to be approximately $1.2 million.

Bitcoins association with Silk Road has tarnished its reputation. Following the publication of an article on Silk Road in 2011, senators Charles Schumer and Joe Manchin sent a letter to Attorney General Eric Holder and the Drug Enforcement Administrations administrator Michele Leonhart calling for a crackdown on Silk Road, the anonymizing software Tor, and Bitcoin

Another concern is that Bitcoin can be used to launder money for financing terrorism and trafficking in illegal goods. Although these worries are currently more theoretical than evidential, Bitcoin could indeed be an option for those who wish to discreetly move ill-gotten money. Concerns about Bitcoins potential to facilitate money laundering were stoked after Liberty Reserve, a private, centralized digital-currency service based in Costa Rica, was shut down by authorities on charges of money laundering. While Liberty Reserve and Bitcoin appear similar because they both provide digital currencies, there are important differences between the two. Liberty Reserve was a centralized currency service created and owned by a private company, allegedly for the express purpose of facilitating money laundering. Bitcoin is not. The transactions within the Liberty Reserve economy were not transparent. Indeed, Liberty Reserve promised its customers anonymity. Bitcoin, on the other hand, is a decentralized open currency that provides a public record of all transactions. Money launderers may attempt to protect their Bitcoin addresses and identities, but their transaction records will always be public and accessible at any time by law enforcement. Laundering money through Bitcoin, then, can be seen as a much riskier undertaking than using a centralized system like Liberty Reserve. Additionally, several bitcoin exchanges have taken steps to comply with anti money laundering record-keeping and reporting requirements. The combination of a public ledger system and the cooperation of bitcoin exchanges in collecting information on their customers will likely make Bitcoin less attractive to launderers relative to private anonymous virtual currencies.

It is also important to note that many of the potential down - sides of Bitcoin are the same as those facing traditional cash. Cash has historically been the vehicle of choice for drug traffickers and money launderers, but policymakers would never seriously consider banning cash. As regulators begin to contemplate Bitcoin, they should be wary of the perils of overregulation. In the worst-case scenario, regulators could prevent legitimate businesses from benefitting from the Bitcoin network without preventing money launderers and drug traffickers from using bitcoins. If

bitcoin exchanges are overburdened by regulation and shut down, for instance, money launderers and drug traffickers could still put money into the network by paying a person in cash to transfer his or her bitcoins into their virtual wallets. In this scenario, beneficial transactions are prevented by over - regulation while the targeted activities are still able to occur. The challenge for policymakers and regulators is how to develop a system of oversight that assuages their twin concerns about money laundering and illicit purchases without smothering the benefits that Bitcoin is poised to provide to legitimate users in their everyday lives.

5.2   Benefits

The first question that many people have when they learn about Bitcoin is, Why would I want to use bitcoins when I can use dollars? Bitcoin is still a new and fluctuating currency that is not accepted by many merchants, so the uses for Bitcoin may seem mostly experimental. To better understand why people might want to use Bitcoin, it helps to think of it, not necessarily as a replacement for traditional currencies, but rather as a new payments system.

5.2.1   Lower Transaction Costs

Because there is no third-party intermediary, Bitcoin transactions are substantially cheaper and quicker than traditional payment networks. And because transactions are cheaper, Bitcoin makes micropayments and other innovations possible. Additionally, Bitcoin holds much promise as a way to lower transaction costs for small businesses and global remittances, alleviate global poverty by improving access to capital, protect individuals against capital controls and censorship, ensure financial privacy for oppressed groups, and spur innovation (within and on top of the Bitcoin protocol). On the other hand, Bitcoins decentralized nature also presents opportunities for crime. The challenge, then, is to develop processes that diminish the opportunities for criminality while maintaining the benefits that Bitcoin can provide.

First, Bitcoin is attractive to cost-conscious small businesses looking for ways to lower the transaction costs of doing business. Credit cards have greatly expanded the ease of transacting, but their use comes with considerable costs to merchants. Businesses that wish to offer the option of credit card payments to their customers must first pay for a merchant account with each credit card company. Depending on the terms of agreement with each credit card company, businesses must then pay a variety of authorization fees, transaction fees, statement fees, interchange fees, and customer-service fees, among other charges. These fees quickly add up and

significantly increase the cost of doing business. However, if a merchant neglects to accept credit card payments to save on fees, he or she could lose a considerable amount of business from customers who enjoy the ease of credit cards. Since Bitcoin facilitates direct transactions without a third party, it removes costly charges that accompany credit card transactions. The Founders Fund, the venture capital fund headed by Peter Thiel of PayPal and Facebook fame, recently invested $3 million in the payment-processing company BitPay because of the services ability to lower the costs of doing online commerce across borders.19 In fact, small businesses have already started to accept bitcoins as a way to avoid the costs of doing business with credit card companies.20 Others have adopted the currency for its speed and efficiency in facilitating transactions.21 Bitcoin will likely continue to lower transaction costs for businesses that accept it as more people adopt the currency.

Accepting credit card payments also puts businesses on the hook for charge-back fraud. Merchants have long been plagued by fraudulent charge-backs, or consumer-initiated payment reversals based on a false claim that a product has not been delivered. Merchants therefore can lose the payment for the item and the item itself, and also have to pay a fee for the charge-back. As a nonreversible payment system, Bitcoin eliminates the friendly fraud wrought by the misuse of consumer charge-backs. This can be very important for small businesses.

Consumers like charge-backs, however, because that system protects them from unscrupulous merchants or merchant errors. Consumers may also enjoy other benefits that merchant-account fees help fund. Indeed, many consumers and merchants will probably stick to traditional credit card services even if Bitcoin payments become available. Still, the expanded choices in payment options would benefit people of all preferences. Those who want the protection and perks of using a credit card can continue to do so, even if they pay a little more. Those who are more price- or privacy-conscious can use bitcoins instead. Not having to pay merchant fees means that merchants who accept Bitcoin have the option to pass the savings on to consumers. That is the business model of the Bitcoin Store,23 which sells thousands of consumer electronics at discounted prices and only accepts bitcoins. The same Samsung Galaxy Note tablet that sells on Amazon for $779 plus shipping24 sells at the Bitcoin Store for a mere $480.25 In this way, Bitcoin provides more low-cost options to bargain hunters and small businesses without detracting from the traditional credit card services that some consumers prefer.

As an inexpensive funds-transfer system, Bitcoin also holds promise for the future of low-cost remittances. In 2012, immigrants to developed countries sent at least $401 billion in remittances back to relatives living in developing countries. The amount of remittances is projected to increase to $515 billion by 2015.27 Most of these remittances are sent using traditional brick-and-mortar wire services such

as Western Union and MoneyGram, which charge steep fees for the service and can take several business days to transfer the funds.28 In the first quarter of 2013, the global average fee for sending remittances was 9.05 percent. 29 In contrast, transaction fees on the Bitcoin network tend to be less than 0.0005 BTC,30 or 1 percent of the transaction. This entrepreneurial opportunity to improve money transfers has attracted investments from big-name venture capitalists. Even MoneyGram and Western Union are contemplating whether to integrate Bitcoin into their business models. Bitcoin allows for instantaneous, inexpensive remittances, and the reduction in the cost of global remittances for consumers could be considerable.

5.2.2   Potential to Combat Poverty and Oppression

Bitcoin also has the potential to improve the quality of life for the worlds poorest. Improving access to basic financial services is a promising antipoverty technique. According to one estimate, 64 percent of people living in developing countries lack access to these services, perhaps because it is too costly for traditional financial institutions to serve poor, rural areas Because of the impediments to developing traditional branch banking in poor areas, people in developing countries have turned to mobile banking services for their financial needs. The closed-system mobile payment service M-Pesa has been particularly successful in countries such as Kenya, Tanzania, and Afghanistan. Entrepreneurs are already moving to this model; the Bitcoin wallet service Kipochi recently developed a product that allows M-Pesa users to exchange bitcoins. Mobile banking services in developing countries can be further augmented by the adoption of Bitcoin. As an open-system payment service, Bitcoin can provide people in developing countries with inexpensive access to financial services on a global scale. Bitcoin might also provide relief to people living in countries with strict capital controls. The total number of bitcoins that can be mined is capped and cannot be manipulated. There is no central authority that can reverse transactions or prevent the exchange of bitcoins between countries. Bitcoin therefore provides an escape hatch for people who desire an alternative to their countrys devalued currencies or frozen capital markets. We have already seen examples of people turning to Bitcoin to evade the harmful effects of capital controls and central-bank mismanagement. Some Argentines, for instance, have adopted Bitcoin in response to the countrys dual burdens of a 25 percent inflation rate and strict capital controls. Demand for bitcoins is so strong in Argentina that one popular bitcoin exchange is planning to open an Argentine office. Argentine Bitcoin use continues to surge in the face of Argentinas capital mismanagement.

Individuals in oppressive or emergency situations might also benefit from the financial privacy that Bitcoin can provide. There are many legitimate reasons why people seek privacy in their financial transactions. Spouses fleeing abusive partners

need some way to discreetly spend money without being tracked. People seeking controversial health services desire financial privacy from family members, employers, and others who might judge their decisions. Recent experiences with despotic governments suggest that oppressed citizens would benefit greatly from the ability to make private transactions free from the grabbing hands of tyrants. Bitcoin provides some of the privacy that has traditionally been afforded through cashwith the added convenience of digital transfer.

5.2.3 Stimulus for Financial Innovation

One of the most promising applications of Bitcoin is as a platform for financial innovation. The Bitcoin protocol contains the digital blueprints for a number of useful financial and legal services that programmers can easily develop. Since bitcoins are, at their core, simply packets of data, they can be used to transfer, not only currencies, but also stocks, bets, and sensitive information. Some of the features that are built into the Bitcoin protocol include micropayments, dispute mediations, assurance contracts, and smart property. These features would allow for the easy development of Internet translation services, instantaneous processing for small transactions (like automatically metering Wi-Fi access), and Kickstarter-like crowdfunding services. Additionally, programmers can develop alternative protocols on top of the Bitcoin protocol in the same way that the Web and email are run on top of the Internets TCP/IP protocol. One programmer has already proposed a new protocol layer to add on top of the Bitcoin protocol that can improve the networks stability and security. Another programmer created a digital notary service to anonymously and securely store a proof of existence for private documents on top of the Bitcoin protocol. Other programmers have adopted the Bitcoin model as a way to encrypt email communications. Another group of developers has outlined an add-on protocol that will improve the privacy of the network. Bitcoin is thus the foundation upon which other layers of functionality can be built. The Bitcoin project can be best thought of as a process of financial and communicative experimentation. Policymakers should take care that their directives do not quash the promising innovations developing within and on top of this fledgling protocol.

Chapter 6

Conclusion

Bitcoin is an exciting innovation that has the potential to greatly improve human welfare and jump-start beneficial and potentially revolutionary developments in payments, communications, and business. Bitcoins clever use of public-key encryption and peer-to-peer networking solves the double-spending problem that had previously made decentralized digital currencies impossible. These properties combine to create a payment system that could lower transactions costs in business and remittances, alleviate poverty, provide an escape from capital controls and monetary mismanagement, allow for legitimate financial privacy online, and spur new financial innovations. On the other hand, as digital cash, Bitcoin can be used for money laundering and illicit trade. Banning Bitcoin is not the solution to ending money laundering and illicit trade, just as banning cash is not a solution to these same ills.

Bitcoin could ultimately fail as an experimental digital currency and payment system. An unanticipated problem could arise and undermine the bitcoin economy. A superior cryptocurrency could outcompete and replace Bitcoin. It could simply fizzle out as a fad. The possibilities for failure are endless, but one reason for failure should not be that policymakers did not understand its workings and potential. We are ultimately advocating not for Bitcoin, but for innovation. It is important that policymakers allow this experimentation to continue. Policymakers should work to clarify how Bitcoin is regulated and to normalize its regulation so that we have the opportunity to learn just how innovative Bitcoin can be.

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