

Thoughts on Bitcoin

Maybe bitcoin will be the world reserve currency, maybe it will totally fail, or maybe it will survive in some niche capacity. I don't know how to weight the probabilities (although I think in the immediate term it's likely to go down), but I do have a thought about the metric to watch: growth in legitimate transactions. A currency without the major use case being legitimate transactions is going to fail.

Right now, the dominant use case of bitcoin seems to be speculation, with a secondary use case for illegal transactions.

Legal transaction volume is still tiny, and many of those involve the seller immediately converting bitcoins to dollars, with the buyer not desiring to use bitcoin as a new currency but instead a version of either money laundering or tax avoidance. (For example, I have bitcoins that have appreciated a lot. If I sell them, I owe taxes on the gain. If I just buy a bunch of stuff, maybe I don't, or more precisely, maybe it's harder to prove. Or maybe it's just hard to cash out my bitcoins to dollars because the wait times at all the exchanges are really long, and I want to buy stuff anyway.)

The fact that the few merchants willing to accept bitcoin generally convert to dollars right away suggests an underlying lack of faith in bitcoin—or at least a problem with the volatility. It's also a reflection of the reality that a business still needs to deal in dollars with most of the world.

The estimates I've heard from smart people that really follow bitcoin are that legitimate transactions are up only about 2-3x from a year ago—wildly outpaced by growth in speculation. If bitcoin is going to work as a currency, at some point before the music stops, legitimate transaction growth needs to really pick up.

When friends ask me how to buy bitcoin, I always ask why they want to buy before I help. The main driver is the very human desire to get rich quickly without doing much work combined with a fervent belief that someone else will pay more for the coins later—the tulip strategy.

The second major reason is out of fear that there is a small chance bitcoin becomes the reserve currency. Even if the chance is tiny, maybe it makes sense to buy some as a hedge (this was why I bought the small amount that I have).

Neither of these can sustain bitcoin as a currency, nor can drugs and gambling (people that make their money in the underworld still need money that can buy regular things, and so whatever is used to track exchange still needs to be pegged to dollars or whatever). The tulip strategy is especially scary; an eventual crash could be so severe that it will shake even the truest believer's conviction. The price of tulip bulbs has yet to recover from its 1637 peak.

Some people claim that bitcoin is not really a currency but a store of value, like gold. Maybe. This would be a personal blindspot for me; I've never thought gold was the best place to put money. As I understand it, some people transact in gold, and it has at least some industrial and ornamental uses. It seems to me that the people that prepare for the end of the world—i.e. the people I know that really like gold—are likely to prefer something they can hold in their hands than something that requires the Internet to keep working.

Whether or not bitcoin should be compared to dollars or gold, there are a lot of other weird factors at play that make it hard to weight probabilities—for example, bitcoin provides a way to convert RMB into dollars. You can mine bitcoin with energy purchased in RMB and then later sell those reward

bitcoins for dollars! This is just one of many ways to use it for money laundering--there are lots more, and this alone may be enough to sustain it for awhile.

A second big issue until the US switches from USD to BTC, you're still going to owe taxes in dollars. The fact that you have to do things like pay taxes and buy oil in dollars seems to make it hard for bitcoin to become the reserve currency—people will still need dollars more than they need bitcoins.

(Patrick Collison says: "I personally think this is overestimated. Tax is a big deal, of course, but even nations can't always compete with the popular sentiment tidal forces enabled by the internet.")

A third issue is that although we have big strong guys holding guns to remind anyone that a dollar is worth a dollar, we do not have such an effective reminder that a bitcoin is worth a bitcoin. Currencies have traditionally needed a central actor to enforce them.

All of that said, there's clearly something very interesting going on. And the bull case is exciting—a world where we all transact in bitcoin would be much more transparent, and financial transparency is great. It's perhaps the thing that would most reduce corruption. (Of course, it's possible, even likely, that everyone just gets good at anonymizing bitcoin by passing around entire wallets or whatever.) Transparency is not the only benefit—for example, even if we don't get transparency, low transaction costs for worldwide commerce would still be great.

Just as it'd be stupid to convert all your dollars to bitcoin, it'd be stupid to not pay attention. Specifically, watch legitimate transaction volume--I'd suggest only buying if it shows signs of seriously ramping up.

Thanks to Patrick Collison and Lachy Groom for reading drafts of this.

