

Forbes

Bitcoin Is A Bad Currency But It Might Be A Good Platform For Financial Innovation

By: Timothy B. Lee – April 1, 2013

Tim Worstall is skeptical about the recent boom in Bitcoin prices, which soared above \$100 on Monday. Worstall is “reasonably certain that it will all turn out to be a bust in the end”:

Look around at the currency stocks in other currencies. Then have a look at the economic activity that they support. The US money supply supports the \$15 trillion of the US GDP for example. And that GDP is a significant multiple of the monetary base of \$600 billion or so. The same holds true of other currencies around the world (well, obviously not Zimbabwe). With Bitcoin it is very different indeed. Transaction value (which is not at all the same as GDP, transaction value will be vastly larger than GDP) is much lower for Bitcoin than the outstanding value of the currency is. That might make it a great speculative toy but it's most certainly not making it a useful currency.

The obvious problem with this argument is that the “Bitcoin economy” has a lot more potential for growth than a conventional national economy. The real GDP of the United States is guaranteed to grow relatively slowly—three or four percent a year at most. In contrast, it's entirely possible that the volume of Bitcoin commerce could be 10 or even 100 times larger than its current size a decade from now. And since there will never be more than 21 million Bitcoins in the world, the only way the Bitcoin network could accommodate a higher transaction volume would be for each Bitcoin to be worth a lot of money.

A more fundamental problem with Worstall's argument is that he's comparing treating Bitcoins as a direct competitor to conventional currencies. Some people think Bitcoin will eventually replace conventional currencies, but I think that's crazy. The dollar is working fine, and there's no reason to think people want to switch to an exotic digital currency.

Rather, the future demand for Bitcoins will largely come from applications where conventional currencies *don't* perform that well. Bitcoins have some unique properties that no other financial instrument has. They combine the irreversibility of cash transactions with the convenience of electronic transactions. And, the lack of middlemen and regulations greatly reduces the barrier to entry. You don't need to get permission from big banks or financial regulators to create a Bitcoin-based financial service. All of this means it makes sense to think of Bitcoin less as an alternative currency than as a new platform for financial innovation.

So far, Bitcoin innovation has largely focused on legally dubious activities like gambling and drug sales. Bitcoin is ideal for this because its lack of intermediaries makes it hard to

regulate. In the long run, Bitcoin may become the new Swiss bank accounts, letting people park wealth offshore where the authorities can't get their hands on it. But while legally questionable activities are the lowest-hanging fruit for Bitcoin, there's no reason to think those are the only possible applications. I've pointed to international money transfers as one promising application for the technology. There are doubtless others I haven't thought of.

It's never easy to predict in advance how a disruptive technology will be used. But by lowering barriers to entry, disruptive technologies create expanded opportunities for experimentation and innovation. Usually, someone eventually discovers a "killer app" that dramatically expands demand for the underlying technology.

There's no guarantee that this will happen with Bitcoin; maybe we'll look back at today's highs as the peak of an unsustainable bubble. But personally, I'm planning to hold onto most of my Bitcoins to see how the market develops. Bitcoin is such a unique technology that it would be a surprising if no one was able to find commercially significant applications for it.

Disclosure: I own some Bitcoins.