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Bitcoin Doesn't Have a Deflation Problem

By: Timothy B. Lee – April 11, 2013

A number of smart people have made arguments like this one from Matt Yglesias:

If over time more and more people want to use Bitcoins to conduct transactions of various kinds, then the price of bitcoins is going to have to rise and rise. The problem is that if the price of a bitcoin is on a steady upward trajectory, then nobody's actually going to want to spend a Bitcoin on anything. And if everyone's hoarding their Bitcoins, then the network is actually useless. Then, since it turns out to be useless, you get a crash.

I criticized a version of this argument last week, but it doesn't seem to have persuaded people. So here's another way of thinking about it.

Suppose God came down from heaven and declared that the price of Bitcoin on April 11, 2018 would be \$1000. And since God is omniscient, everyone believed him. As I understand Matt's argument, this would be a disaster for Bitcoin. Market participants who might otherwise have bought drugs on Silk Road at today's price of \$75 per Bitcoin would decide that it would make more sense to hold onto their Bitcoins until the price rose. So they'd buy their drugs with dollars instead. The volume of Bitcoin-denominated commerce would plummet, destroying its value as a currency.

But that's not what would happen. Instead, the price of a bitcoin would immediately rise to around \$950 (specifically, \$1000 discounted by the current yield on 5-year Treasury bonds). Because most American Bitcoin vendors automatically adjust their prices to the current dollar-Bitcoin exchange rate, Bitcoin-denominated prices would quickly fall to reflect the new, higher Bitcoin price. And then normal market activity would resume, with Bitcoin-denominated prices gently falling by a small fraction of a percentage point each month between now and April 2018.

Removing the gimmicky God hypothetical doesn't change the basic insight: if market participants become convinced that "the price of a bitcoin is on a steady upward trajectory," they're not going to hoard their Bitcoins for weeks or months waiting for the price to rise. They'll bid the price up right away. And that means there will never be a significant period of time where people generally are hoarding their Bitcoins in anticipation of future price rises. In equilibrium everyone who thinks Bitcoin is undervalued already has all the bitcoins he or she is willing to pay for.

Now the fact that Bitcoin prices are volatile *is* a serious problem for Bitcoin. But that volatility has nothing in particular to do with Bitcoin's deflationary "monetary policy." Rather, it has to do with the fact that there's a great deal of uncertainty about the currency's long-term value. That uncertainty would exist regardless of whether the

supply of Bitcoins was projected to rise quickly or slowly. I'll have more to say about this in a future post.

Disclosure: I own some bitcoins.