# The Bitcoin Money Myth

by Frank Shostak  April 17, 2013

Many economists and financial commentators believe that in the unregulated market of the internet economy, new forms of money can be created that bypass central-bank and government supervision. The latest development is the emergence of a new electronic means of exchange, Bitcoin (BTC). Bitcoin was launched on January 3 2009 by its inventor, a programmer called Satoshi Nakamote.

The basic idea behind Bitcoin is to create, by means of a mathematical algorithm, a digital good that is scarce and fungible.

Nakamote devised a software system that enabled people to obtain bitcoins as a reward for solving complex mathematical puzzles. The resulting coins are then used for online trading. Nakamote also arranged that the number of bitcoins can never exceed 21 million.

Some experts maintain that Bitcoin will displace the existent fiat money and will usher in a new era of free banking, which will finally put to rest the menace of inflation.

Unfortunately, this is a pipe dream. Electronic money will not replace fiat paper money. The belief that it can stems from a failure to understand the nature and function of money and how it emerges on the market.

To see where this view goes wrong, let's first see how money comes about. Money emerges out of barter conditions that permit more complex forms of trade and economic calculation. The distinguishing characteristic of money is that it is the general medium of exchange, evolved from private enterprise from the most marketable commodity. On this Mises wrote,

There would be an inevitable tendency for the less marketable of the series of goods used as media of exchange to be one by one rejected until at last only a single commodity remained, which was universally employed as a medium of exchange; in a word, money. (The Theory of Money and Credit, pp. 32-33)

In short, money is the thing for which all other goods and services are traded. Furthermore, money must emerge as a commodity. An object cannot be used as money unless it already possesses an exchange value based on some other use. The object must have a pre-existing price for it to be accepted as money.

Why? Demand for a good arises from its perceived benefit. For instance people demand food because of the nourishment it offers. With regard to money, people demand it not for direct use in consumption, but in order to exchange it for other goods and services. Money is not useful in itself, but because it has an exchange value, it is exchangeable in terms of other goods and services.

The benefit money offers is its purchasing power, i.e. its price in terms of goods and services. Consequently for something to be accepted as money, it must have a pre-existing purchasing power: a price. This price could have only emerged if it had an exchange value established in barter.

Once a thing becomes accepted as the medium of exchange, it will continue to be accepted even if its non-monetary usefulness disappears. The reason for this acceptance is that people now possess previous information about its purchasing power. This in turn enables them to form the demand for money.

In short the key to the acceptance is the knowledge of the previous purchasing power. It is this fact that made it possible for governments to abolish the convertibility of paper money into gold, thereby paving the way for the introduction of the paper standard. Again the crux here is that an object must have an established purchasing power for it to be accepted as general medium of exchange, i.e. money.

In today's monetary system, the core of the money supply is no longer gold, but coins and notes issued by governments and central banks. Consequently coins and notes constitute the standard money we know as cash that are employed in transactions. Notwithstanding this, it is the historical link to gold that makes paper money acceptable in exchange.

Observe that a bitcoin is not a thing; it is a unit of a non-material virtual currency. A bitcoin has no material shape; hence from this perspective the notion that it could somehow replace fiat money is not defendable.

Bitcoin can function only as long as individuals know that they can convert it into fiat money, i.e. cash on demand (see, e.g., Lawrence H. White "The Technology Revolution And Monetary Evolution," Cato Institute's 14th annual monetary conference, May 23, 1996).

Without a frame of reference or a yardstick, the introduction of new forms of settling transactions is not possible. On this Rothbard wrote,

Just as in nature there is a great variety of skills and resources, so there is a variety in the marketability of goods. Some goods are more widely demanded than others, some are more divisible into smaller units without loss of value, some more durable over long periods of time, some more transportable over large distances. All of these advantages make for greater marketability. It is clear that in every society, the most marketable goods will be gradually selected as the media for exchange. As they are more and more selected as media, the demand for them increases because of this use, and so they become even more marketable. The result is a reinforcing spiral: more marketability causes wider use as a medium which causes more marketability, etc. Eventually, one or two commodities are used as general media-in almost all exchanges-and these are called money. (Murray N. Rothbard, What Has Government Done to Our Money?)

It was through a prolonged process of selection that people had settled on gold as the most marketable commodity. Gold therefore had become the frame of reference for various forms of payments. Gold formed the basis for the value of today's fiat money.

Besides, Bitcoin is not a new form of money that replaces previous forms, but rather a new way of employing existent money in transactions. Because Bitcoin is not real money but merely a different way of employing existent fiat money, obviously it cannot replace it.

The fact that the price of bitcoins has jumped massively lately implies that people assign a high value to the services it offers in employing existent money. This is no different from the case when in a country which imposes restrictions on taking money out people will agree to pay a high price for various means to secure their money.

Summary and conclusion

Contrary to the recent hype, we hold that Bitcoin is not money but rather a new way of employing existent money in transactions. The fact that the price of bitcoins has jumped massively lately implies that people assign a high value for the services it offers and nothing more.