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What Makes Bitcoin Special? An Economist Explains

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A top cryptocurrency expert and economist explains the bitcoin phenomenon.

Bitcoin and other cryptocurrencies are all the rage right now.

Of course, the rise of non-government, decentralized, encrypted electronic currencies like bitcoin has been going on for years. But in recent months it has surged to the forefront of the national conversation as major figures like Elon Musk have bought in and bitcoin has hit record valuation levels.

Many Americans may not have followed the trend closely, and are seeking to understand it. So, to help readers better understand the novel technological trend, FEE interviewed Will Luther, an economics professor, director of the American Institute for Economic Research's Sound Money Project, and an adjunct scholar with the Cato Institute's Center for Monetary and Financial Alternatives.

What Makes Bitcoin Different From the US Dollar?

One easy way to understand bitcoin is to compare it to the US dollar.

"Bitcoin is similar to the dollar in many respects," Luther explained. "Both are intrinsically worthless, meaning they have no use apart from their role as a medium of exchange. Both are irredeemable, meaning they are not backed by some underlying asset. And both are digital base monies. (Bitcoin is fully digital, while the dollar is only 99.96% digital—close enough.)"

However, the two differ in important ways.

For one, the US government has centralized control over the dollar and its supply. Bitcoin is decentralized, meaning there's no central authority controlling it.

"Bitcoin's supply is preprogrammed," Luther said. "There will never be more than 21 million bitcoin in circulation and the supply will follow a predetermined trajectory until it reaches the maximum. The supply of dollars, in contrast, depends on the discretion of the Federal Reserve."

One consequence of this difference is that the government can inflate the US dollar if it wishes, by printing money. No one can inflate bitcoin because the supply of the currency is not centrally controlled or subject to manipulation.

One other key difference, Luther says, is that "bitcoin tends to provide more financial privacy in digital transactions."

While exchanges using the dollar can be very private if done in-person with cash, digital exchanges using the dollar that are not done in person must involve a trusted third-party that records the transaction—like Venmo or your bank. (This opens up an opportunity for privacy violations).

However, "since bitcoin can be transferred without relying on a trusted third party, it tends to offer more financial privacy than traditional digital payment mechanisms," Luther explains.

Is Bitcoin a 'Currency' or an 'Asset'?

Much of the news around bitcoin involves people making (or losing) money by purchasing it and then selling it when its highly-volatile price shifts. At first glance, it seems more similar to an asset like a stock one buys on the stock market than a currency, defined as a medium of exchange.

But it's both, Luther explains.

"Bitcoin is, first and foremost, a currency (or, potential currency)," the economist says.

However, "all currencies are assets," Luther offers. "And some assets appreciate. For this reason, some people think of bitcoin as an investment. But that is secondary. Indeed, bitcoin's price will only rise if (1) it becomes more useful as a currency today or (2) is expected to be more widely used as a currency in the future. Hence, even those interested in bitcoin as an investment should understand its role as a currency."

Why Is Bitcoin's Price So Volatile?

Bitcoin is infamous for its volatility, meaning that its valuation, or price, often swings drastically up and down over relatively short periods of time. This is what makes it an attractive speculative asset for some, but also is a barrier to its adoption as a widespread currency used for exchange.

Why is it so volatile?

"Since bitcoin's supply is essentially fixed, its price fluctuates due to changes in demand," Luther says. "Bitcoin is more volatile than many other assets because it is a medium of exchange. It is more volatile than other media of exchange because it lacks a core, reliable source of demand."

"Media of exchange are subject to what economists call network effects," he explained. "No one wants to use a [form of] money that no one else is using. Everyone wants to use the same money that their trading partners are using."

"Therefore, my decision to accept bitcoin makes it more desirable to you, and vice versa," Luther continued. "The network effect means that small shocks to demand are amplified, since anything making bitcoin more attractive to me also makes it more attractive to you and everyone else by virtue of the fact that it is more attractive to me. The same process works in the opposite direction for anything making it less attractive to me."

Again, comparing bitcoin to the dollar can help us understand this phenomenon.

"With other monies, there is some core group of users that everyone can count on with near certainty to accept it," Luther said. "The U.S. government, for example, stands ready to accept dollars in payment of taxes and fees. It seems very, very unlikely that it will stop doing so. That core group of users provides a lower bound to the demand for dollars… as a result, demand tends to be fairly stable."

"That's not the case with bitcoin," the economist continued. "It's not unreasonable to think its demand could fall to zero. So we are constantly on guard against that prospect. Relatively small disturbances lead some to reevaluate their positions. And bitcoin's price fluctuates as a result."

Will Bitcoin Ever Catch on For Widespread Use in Everyday Exchange?

Whether bitcoin is just a fad or could catch on for widespread use in everyday exchanges is a subject of much debate. Luther, for his part, points out that it already *can* be used in many exchanges.

"You can buy a new couch on Overstock.com," he says. "You can pay your AT&T wireless bill. Tell me what you are looking for and there is a good chance someone is out there ready to sell it for bitcoin. That it is not more commonly used, despite many retailers willing to accept it, suggests that it is not well suited for many transactions."

"Bitcoin is very well suited for making cross-border payments," Luther continued. "It is well suited for making private transactions. But few of the transactions I make in the course of a month involve cross border payments or require more privacy than is afforded by my bank. So I don't spend bitcoin very often. I suspect other people make a similar calculation. That's not a knock on bitcoin. It is just to acknowledge that it tends to function as a niche money at present, and seems likely to do so into the foreseeable future."