Bitcoins: Wave of the Future, or Laurel and Hardy Start a Currency System?

By David M. Reeder

Laurel and Hardy, for the uninitiated, were a 1920s comedy duo whose claim to fame was that everything they undertook fell flat. But it fell flat hilariously.

So it may be with bitcoins. One of the more interesting financial developments in recent years has been the rise and at least partial fall of the bitcoin enterprise. In short, bitcoins are a "peer to peer" payment system, digital currency, and substitute for conventional money in on-line transactions.

Bitcoins have been on the scene since 2009, and are widely promoted due to their anonymity and relative freedom from regulation. Also, the prices of bitcoins have fluctuated widely. A recent report in the Wall Street Journal stated that the commercial use of bitcoins has been dwarfed by the speculative use.

One of the biggest problems with bitcoins is that, although the story is that they are a currency substitute custom made for e-commerce, in this incarnation they have been marketed as an investment. Speculation has driven the bitcoin bubble, which now may have possibly burst (again) with the bankruptcy of bitcoin exchange Mt. Gox.

Creating a brand new currency system is heady stuff. In a recent article in the New York Times entitled In Search of a Stable Electronic Currency, Robert J. Shiller, senior professor of economics at Yale, stated that no system of exchange whose main focus is speculation can long survive. Further, good old fashioned money does a pretty good job at what it is supposed to do, denominate and measure transactions. If we scratch very deeply we find that the rise of bitcoins was based on wide swings in value, leading to large speculative gains, and losses. Schiller went on to say that "The central problem with Bitcoin in its present form, though, is that it doesn't really solve any sensible economic problem. Nor should it substitute for banks and the governmental institutions that regulate them. They are reasonably effective institutions, despite their flaws, and should not just be scrapped and replaced by a novel electronic system."

One of the weaknesses of bitcoins is that they can be lost and stolen in ways that almost defy logic. Bitcoin "wallets" are the motherload for hackers, who have had more than their fair share of success mining other's bitcoins.

On the loss front, a bitcoin investor reported that he had lost, that's right, lost, 7,500 bitcoins, worth about $7.5 m, when he discarded a hard drive containing his "private key" to his bitcoin wallet. In bitcoin language, it is not as if he can push a button saying forgot your password? and fix everything. It is more like the entire wallet, and its contents, were gone with the hard drive. ("Ollie, I lost all the bitcoins." "You what?! What a fine mess you've gotten us into.")

A similar lost, but then found, story came out of the Mt. Gox debacle, where, at the time that the company filed its bankruptcy case in Japan, it reported it had lost bitcoin wallets containing 200,000 bitcoins. At a value of $490 per bitcoin, down from the high of $980, the loss was in the staggering amount of $98,000,000. Not to worry though, shortly after the company filed its U.S. bankruptcy case in Dallas seeking protection under the cross-border provisions of chapter 15, Mt. Gox found the bitcoins that had gone missing. They were in some old bitcoin wallets. A company spokesman compared it to looking in a different pair of pants for your lost wallet.

More optimistic players believe that the Mt. Gox debacle signals the end of the "hobby bitcoin operations," and the entry of "robust, enterprise grade operations." Well-written and heartfelt articles and publications touting bitcoin as the biggest financial development of the last several millennia abound. The problem is that they nearly all have a pronounced entrepreneurial bent. Since when is floating a currency an entrepreneurial activity in itself, as compared to a way of promoting and fostering the underlying commerce?

Whether the bitcoin enterprise will take on a serious commercial component and stabilize, as compared to being a roll of the virtual dice, remains to be seen. Will it be a viable new currency, or just more Laurel and Hardy moments? Stay tuned.

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