

Bitcoin: A Wildly Speculative Play

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IF YOU WATCH THE BUSINESS TELEVISION CHANNEL CNBC, you've undoubtedly seen the insert tracking the rises and falls of the wildly speculative bitcoin currency play. Cryptocurrency technology is interesting, but until bitcoin is used in transactions more commonly, it is difficult to determine its fair value. Its "value" is what the last buyer and seller were able to agree upon in that trade, based on supply and demand.

Ultimately, currencies are a store of value. They are also a means of executing transactions. Currently, cryptocurrencies are not effective for either of these purposes. Because the U.S. government currently recognizes cryptocurrencies as property not currency, this means that buys and sells are taxable if there is a gain, making cryptocurrencies even more inefficient if used in transactions.

GOVERNMENT BACKING AND VALUE

Widely used currencies are issued by governments. When we provide a service in the United States, we are paid in dollars. We "trust" that we can trade those dollars for another good or service. The U.S. dollar has been the world's reserve currency; it is the most-used currency in transactions and is therefore less speculative. Its value can rise and fall versus other currencies, but those moves are small and subtle, especially compared to a cryptocurrency. The dollar's allure as a currency resides in the fact that we are comfortable being paid in dollars because we are confident that we can turn around and spend those dollars on other goods and services without losing significant value in the interim. Its purchasing power largely remains the same, especially in the short term. But a government-issued currency's purchasing power can wither over long periods of time due to inflation. It should be noted that this is a much slower process.

Bitcoin or other crypto currencies are much more volatile. For example, if you were paid your Social Security payment in bitcoin, you could wake up one morning to find you've lost 10 to 20 percent of your "money" in real value. Of course, you might also find your money is worth 20 percent more in purchasing power. In some weeks, bitcoin has moved as much as 30 or 40 percent in market value.

A close-up photograph of several silver-colored Bitcoin coins. The coins are stacked and slightly out of focus, with the top one being the most prominent. The background is dark and blurry.

Until bitcoin is used more commonly in transactions, it will be difficult to determine its fair value,

Bitcoin may track similar to gold, if, as its proponents suggest, it will hold its value against other currencies.

According to Thomas J. Cunningham, PhD., a retired Federal Reserve System economist, in his upcoming book titled *Understanding Economic Equilibrium*:

“Cryptocurrencies’ are not always welcomed by sovereign governments. Most governments want to be able to track transactions as they can usually do with transactions conducted in their own currencies. Because cryptocurrencies facilitate transactions outside the regulatory purview of sovereign states, they face regulatory restrictions in many countries where their ease of transaction is cause for suspicion.

“Cryptocurrencies have yet to gain traction in large international business deals. Because they have no affiliation with any sovereign currency, they have no standing in any sovereign court and are treated as foreign currencies or commodities. The world’s courts and arbitration systems are set up to resolve disputes in domestic currencies, not in cryptocurrencies. Given the global legal environment, cryptocurrencies are not likely to improve their share of use in large, international transactions any time soon.”

In addition, Treasury Secretary Janet Yellen noted on CNBC on February 24, “To the extent it [cryptocurrency] is used, I fear it’s often for illicit finance. It’s an extremely inefficient way of conducting transactions, and the amount of energy that’s consumed in processing those transactions is staggering.”*

BITCOIN AS HEDGE

Bitcoin may track similar to gold, if, as its proponents suggest, it will hold its value against other currencies. Following the Great Recession of 2008, gold prices rose in light of concerns in the global financial system about governments potentially defaulting on national debt. Once those fears subsided, gold prices fell, until they began rising again recently with the volatility associated with the COVID-19 pandemic.

Longer term it is possible that cryptocurrencies will gain traction, although selecting the one that will be used most prevalently could prove difficult. As for bitcoin, it’s currently hard to tell how much of its price is based on speculation or actual demand. Investors are not buying bitcoin as a store of value; they are trading it, speculating on price appreciation. There is not a lot of transactional value. This could change in the future, but there is no substantive indication to date that bitcoin will be widely used and accepted. As well, governments around the world are considering adopting their own forms of cryptocurrency, which could reduce demand for bitcoin. Yellen noted in her CNBC interview that the Federal Reserve, where she once served as chair, has discussed the possibility of a new digital currency along with a payments system it expects to roll out over the next several years.

If bitcoin is ultimately a store of value, then potentially it could appreciate against the U.S. dollar — if the U.S. dollar was being devalued. If it is adopted by a government, the demand would float based on the financial security of the government issuing the currency. A cryptocurrency created by a government would have the backing of that country, its taxing power and trust factor, which bitcoin does not currently have. If countries start creating their own cryptocurrencies, bitcoin could cease to exist.

As a hedge, it is difficult to assign a value to a cryptocurrency at this point, hard to discern what is speculation and what is true demand for an alternate currency. The overview of cryptocurrencies as investments is that they are experimental. It is an extremely speculative investment, a hedge, but an extremely volatile one. Any investment in bitcoin or another cryptocurrency should be dollars you are willing to commit to a speculative investment.

**The mining process for bitcoin consumes massive amounts of power. The BBC recently covered this in a February 2021 article on the bitcoin mining technology.*

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