

Bitcoins

New Currency or Tulip Bubble 2.0?

Some people compare the current hype with the historical tulip bubble, some people talk about a new currency age – the topic is the virtual currency called Bitcoin. This article shows the advantages of Bitcoins, how they work and what perspective Bitcoins have in the future.

» Decentralised, Unregulated and Anonymous

The concept of Bitcoin was introduced publicly for the first time by Satoshi Nakamoto in 2008 – a time when the global financial world was on the edge. Since then our existing monetary system has been faced with a deepening crisis of confidence and therefore the call for an alternative has become louder.



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One alternative might be Bitcoins. But what are Bitcoins? It is a virtual currency that consists of cryptographically coded data that is forgery-proof. Bitcoins enable the direct transfer from one user to the other and render intermediates like commercial banks and central banks redundant. Instead of a central third party – the central bank or commercial bank – you have a global P2P (Peer-to-Peer) network, where every user takes care of the control of the currency system. The decentralised structure avoids having single powerful players using the system in their favour or manipulating it. A major advantage of Bitcoins in contrast to the current monetary system is anonymity and cheap transaction costs.

Money Creation in a Different Way

Bitcoins are not issued by a central institution but have to be created. All users within the network can take part.



If you want to use the virtual money for speculation instead of shopping you can already do so.



But it only makes sense if you have a high-performance computer because they earn Bitcoins for the resolution of a highly-complex arithmetic problem. The “Mining”, the money creation, is organised in a way that you need more performance power with time to create additional units of money – it is similar to the production of natural resources. The network creates about 25 new Bitcoins in ten minutes at the moment. In contrast to the current monetary system, where the big central banks try to out do each other by money printing, the Bitcoin money supply is limited from the beginning – to 21 million units which guarantees monetary stability Bitcoin supporters say.

How Does the Technical Handling Work?

Before you can use Bitcoins you need to install a so-called “Bitcoin-client” on your computer. This is an open source software which manages the reception and the transfer of Bitcoins. A digital wallet is also a part of this program – a wallet where you can store your virtual money. In this wallet there are a couple of public and private keys that serve as a signature for transactions, similar to a standard contract.

Bitcoins consist of data and therefore they can be copied as many times as desired – for example as a backup copy on a USB-stick – there is, though, the danger, that users spend their Bitcoins several times. All transactions within the network are saved, dated and published at the payer and the payee as well as on a decentralised list – the blockchain – that can be used by all system participants to avoid this “double spending”. It is accessible under www.blockchain.info. So if a user buys from a seller with a certain Bitcoin, all participants of the network are informed of this transaction – but without indicating the true identity of the parties involved. An attempt to use an already spent Bitcoin

again is recognised by the network and declared an error immediately.

Payment Method and Object of Speculation

The acceptance of Bitcoins in businesses and online-stores is increasing steadily. In the USA there are large online-shops offering electronic device for Bitcoins. And in Germany, especially in Berlin, fans of Bitcoins are becoming more numerous. But as long as volatility stays high and the virtual money has no legal status as a payment method it is very unlikely that you will buy your breakfast with Bitcoins in the near future.

But if you want to use the virtual money for speculation instead of shopping you can already do so. Dozens of market-places and swap-meets exist where you can buy and sell the virtual coins. Online-exchanges offer the easiest and fastest way. The largest provider in the world is Mt. Gox with its main office in Tokyo. On average more than 100,000 Bitcoins change hands per day. After registration users can pay a sum via bank transfer. This money will then be exchanged into US dollars and is then available for the purchase of Bitcoins. A few clicks later the buyer can buy his Bitcoins at the stock exchange and save it in his wallet. Selling works the same way. The proceeds are available in US dollars first and then can be changed into Euros and within one to three days you can transfer it back to your “standard” account at your bank. Another, but more expensive alternative to change

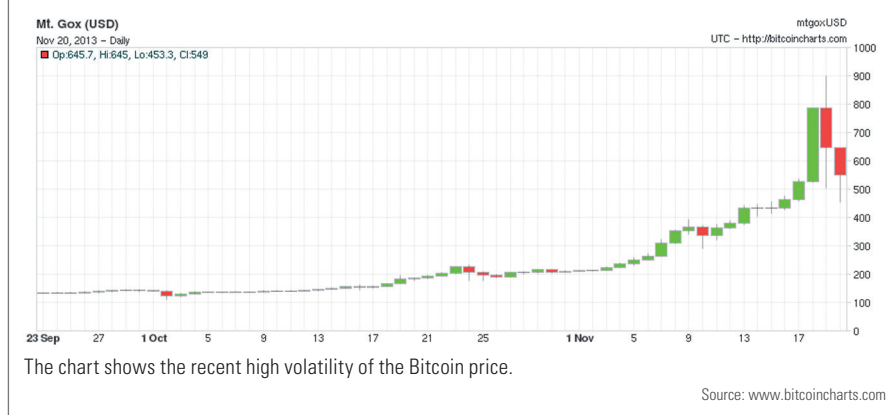
T1) Currency Types

legal status	not regulated	certain forms of local currencies	virtual currencies
	regulated	Bills and coins	E-Money Customer deposits at banks
		physical	digital
Type of money			

Bitcoins are a sort of virtual currency. They are not legally regulated and exist in digital form only.

Source: European Central Bank

F1) Price Development of Bitcoins in USD



currencies into Bitcoins is at specialised exchange offices. Furthermore you have the possibility to trade directly with other private persons – like on ebay.

It's Not for the Faint-Hearted

The charm of using Bitcoins as a trading instrument can be explained with a quick glance at the phenomenal price increases in the past years. The price of Bitcoin soared against the US dollar or euro in this year alone. It comes as no surprise that such a narrow market comes with extremely high volatility. The price of Bitcoins crashed from about 32 dollars to 0.01 within a few months because of a hacker attack against a Japanese wallet-provider in 2011. Shortly afterwards the price recovered to 14 dollars. In the recent run of the Bitcoin valuations soared to a high of about 900 US dollars. The price then dropped from that intraday high to about 450 USD, about 50 per cent in one day. As you can see, volatility is insane.

It is also possible that there are so-called “DDoS-attacks” – where hackers try to flood Bitcoin trading infrastructure with loads of server inquiries to buy cheaper after the price drop or simply a classic selling panic after a parabolic increase is known. But it is known

that the small and intransparent Bitcoin market offers opportunities but risks as well that could mean total loss. But Bitcoins are not yet a serious trading instrument – they cannot compete with stock exchanges because of ambiguous conditions and low liquidity.

What's Next?

The Bitcoin concept is an experiment and its outcome is completely unsure. The Bitcoin community is growing daily and is becoming more euphoric and

awaits the victory of the virtual coins, but it should be clear that there are still many legal, political and technical uncertainties for the future. We do not know yet how regulatory authorities will react. But one thing is for sure: The biggest advantage of the Bitcoin system – the anonymous and decentralised structure – will annoy governments and central banks. Because this system is unregulated as yet it might become a tool for money laundering or tax evasion. Recent events in the USA confirm this: In March regulators acted against Bitcoin providers under money laundering regulations. At the beginning of May the next sensation followed: Two accounts of the US-payment-service Dwolla were frozen because the Department of Homeland Security stated that there were unlicensed transfers. A Reuters report said that those accounts had belonged to the Bitcoin-exchange Mt. Gox and its US subsidiary Mutum Sigillum. A little later online-payment-service Liberty Reserve was busted and therefore exchange-provider Mt. Gox announced that user-accounts had to be verified from May 2013 on.

At the same time Bitcoins have to be safe on the technical side before they are suitable for the masses. Especially the question of if users can lose their Bitcoins in a potential hacker attack should be cleared. Because in this case the affected people cannot count on legal help. A software error in the Bitcoin protocol cannot be ruled out either and there are other dangers as well. The central idea behind every currency is its acceptance within the community. And that acceptance is based only on trust – just as with our current paper money system. To place trust in paper money, precious metals or Bitcoins – is a decision everybody has to take for themselves. «

Additional Links

- www.bitcoin.org
- www.mtgox.com
- www.bitcoin.clarkmoody.com
- www.bitcoin.de
- www.bitcointalk.org
- www.bitcoinfoundation.org
- www.bitcoincharts.com