Written by **Bob Adelmann** on November 29, 2013

As Bitcoin Prices Increase, So Do Concerns

With the price of a single Bitcoin exploding by 4000 percent just since January and by 400 percent in the last month, concerns are increasing about its legitimacy as a viable Internet money that could effectively serve as an alternative to central banks' currencies.

The Bitcoin morphed from an Internet algorithm to legitimacy beginning in August when a federal judge ruled that the digital currency serves as money just like the dollar, the yen, and the yuan. It gained further legitimacy when China's giant Internet provider Baidu announced in October that its website firewall division would begin accepting Bitcoins. The nearly 20 Bitcoin trading platforms located in China now handle more than half of the world's Bitcoin transactions.

The Bitcoin's credibility took another jump when a Senate committee gathered several government agencies together early in November to discuss how to regulate it, driving its price to a new high for the year during the day of that meeting. Another boost came from an unlikely place: the Federal Reserve. It issued a "Bitcoin Primer" which explained how the Bitcoin works, calling it "a remarkable conceptual and technical achievement…" As of Friday, the Bitcoin was trading at over $1,100 apiece. The price chart shows a nearly exponential explosion just since the first of November.

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This is making a number of respected commentators nervous, including *The Economist* magazine's technology department, which stated:

> All currencies involve some measure of consensual hallucination, but Bitcoin, a virtual monetary system, involves more than most.…
>
> Rather than relying on confidence in a central authority, it depends instead on a distributed system of trust.

With the explosive growth in the Bitcoin's credibility and price have come some serious problems, according to *The Economist*, including the fact that the system isn't nearly as secure or anonymous as has been touted, the amount of computing power that is required to create new Bitcoins has also grown exponentially, and its maintenance demands are threatening its continued viability.

In October a study by professors at the University of California, San Diego, and George Mason University revealed that they were able to hack into the Bitcoin software to track and follow financial transactions across the globe:

> The researchers exploited a current weakness in most Bitcoin personal and server software, which

> generates single-use addresses to store change from transactions. This allowed them to follow the movement of Bitcoins across hundreds of transactions from large sums accumulated at single addresses.

The computer power needed to "mine" new Bitcoins has gone nearly vertical as well, increasing 25-fold between July and November, according to *The Economist*. And that is making it nearly impossible for occasional "miners" to participate:

> Bitcoin's growing popularity is having other ripple effects. Every participant in the system must keep a copy of the [entire Bitcoin program], which now exceeds 11 gigabytes in size and continues to grow steadily. This alone deters casual use.

It's also in danger of imploding, says the magazine: "The [Bitcoin] protocol, like the currency, is a fiction they accept as real, because rejection by a large proportion of users — be they banks, exchanges, speculators or miners — could cause the whole system to collapse."

There are other challenges, too, like hackers who have managed to invade individual accounts through weaknesses in Bitcoin exchange software.

The Bitcoin is also a far cry from real money as defined by Carl Menger, the founder of the Austrian school of economics. He said that money is "the most marketable commodity" which arises out of innumerable market transactions. Over time gold and silver have proven to be the most able commodities to serve as mediums of exchange, moving a direct-exchange economy to one of indirect exchange. This has facilitated the division of labor, increasing an individual's productivity enormously.

As economist Gary North explained:

> The central benefit of money is its predictable purchasing power.… Money … must have continuity of value.…
>
> Money … is useful in the facilitation or exchange precisely because its market value varies little over time. It is the predictability of money's market exchange rate that makes it money.

The Bitcoin market, says North, is based instead on speculation that prices will continue to rise, not on its alleged exchange value: "People are not buying it to serve as money: they are buying it because they are in the midst of a mania, and they are gambling that the number of [new] buyers will continue onward upward forever." This, according to North, is the classic mark of Ponzi scheme psychology:

> People do not buy [Bitcoins] for the benefits that the investment provides as an investment.… They buy it only because it has gone up in price.…
>
> The mania has destroyed Bitcoins' use as money. Bitcoins are too volatile in price … to serve as money.…
>
> It is a mania going up. It [will be] a mania coming down.

There is another challenge the Bitcoin faces that few commentators have mentioned: It is dependent upon the Internet, which itself is dependent upon the electric grid. If the grid goes down (read *One Second After* by William Forstchen), so does the Bitcoin. As one blogger noted at RT.com,

> We [may] use it for instant international value transfers without government tracking or snooping. It's really great for stuff that the Powers That Be don't want us and others of like-minded purpose to do.

> But you gotta be just plain nuts to think of using it as a medium or long-term store of value….
>
> When the grid and the ‘net go down, it’s gold coins and 7.62 ammo that will be real money, not inaccessible Bitcoins!

A graduate of Cornell University and a former investment advisor, Bob is a regular contributor to The New American *magazine and blogs frequently at www.LightFromTheRight.com, primarily on economics and politics. He can be reached at badelmann@thenewamerican.com*