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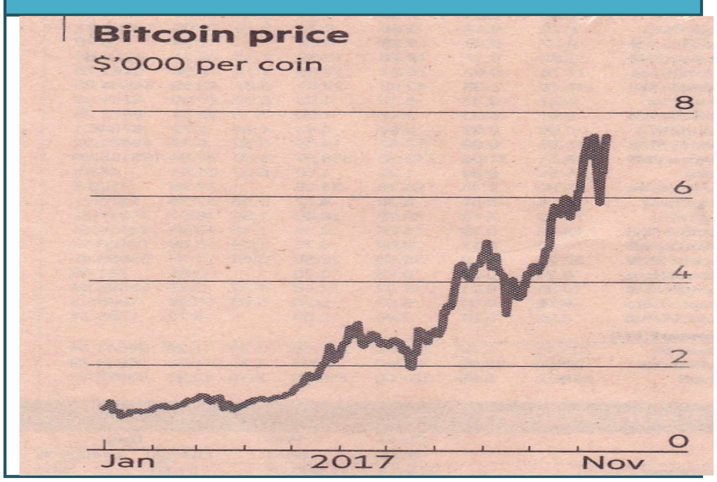
ECONOTE No. 66: "Bitcoins": From abject ignorance to disaster and back again 23/11/2017

Summary	Investment Conclusions
The title of this Econote should give the game away. One of the reasons claimed why Bitcoin, and later on its 1100 odd "cryptocurrency" imitators, was created was to replace central and commercial bank money which was " backed by nothing". This claim betrays a profound ignorance of double entry bookkeeping, let alone the fundamentals of banking. On that basis, anyone who continues to promote cryptocurrencies should be mistrusted not on the basis of honesty, but on the basis of ignorance. Same goes for Initial Coin Offers (ICO) which take the level of ignorance a stage further, not so much by claiming that they are going to substitute money but that they will be used to buy some unspecified asset.	Bitcoins and imitators and most ICOs should be treated, at their worst, equal to the tulip mania in Amsterdam in 1637 or the South Sea bubble in London in 1720, that is utterly speculative assets with virtually nothing "backing them", and having no claim on anything of value. At best, they can be treated as assets that have value because other people believe they have. At that level they resemble gold, which has no intrinsic value whatsoever, except its minor industrial uses, but it is desirable because other people (including central banks!) believe that it is desirable. My deep mistrust towards "bitcoins" is based on as simple a reason as this one.

Central banking 101 versus bitcoiners

Bitcoin is a computer generated unit of nothing. Let us repeat this, there is nothing backing the Bitcoin, no gold, bricks and mortar or paper assets. The first block of 50 Bitcoins was created in January 2009 through the computing efforts of an unknown group of software engineers who designed the program, later called blockchain, which created it. Bitcoins can be used, if enough people accept them, for any transaction. They can be traded in some exchanges and their price is determined by supply and demand. The price of the Bitcoin can be extremely volatile and hence it is a very risky asset. (Figs.1 and 2). Same goes for the generation of other digital currencies which followed the creation of Bitcoin. The Bitcoin is created by a process called "mining " which involves anyone (repeat **anyone**), with a PC and the related software, compiling recent Bitcoin transactions into blocks and then solving a mathematical puzzle. The one who solves the puzzle first gets a reward in newly created Bitcoins. The Bitcoin "mother program" is designed to produce no more than 21 million coins by 2140, and if too many puzzles are solved easily, it makes the puzzles harder. To repeat: Bitcoins liberate us from the slavery of the central and commercial banks, as the coins are self –generated. More transactions will lead to more compiled blocks by geeks seeking to solve the puzzle and win the fluffy toy. The reasoning behind using Bitcoins, and their process of creation, defies belief in its naiveté, nay, near idiocy, whereby a program designed by unknowns, produces money out of nothing and limits its amount by an arbitrarily set level. Back to the key issue however. Central banks do not create money out of nothing. All properly run central banks issue notes or expand their balance sheets by fully backing them with government or high quality bonds.So central bank money is backed by something, unlike the Bitcoin which is not.Suggesting to replace the, admitedly fallible, central bank system by a software program beggars belief.

Fig.1 Bitcoin price in USD



Source: FT

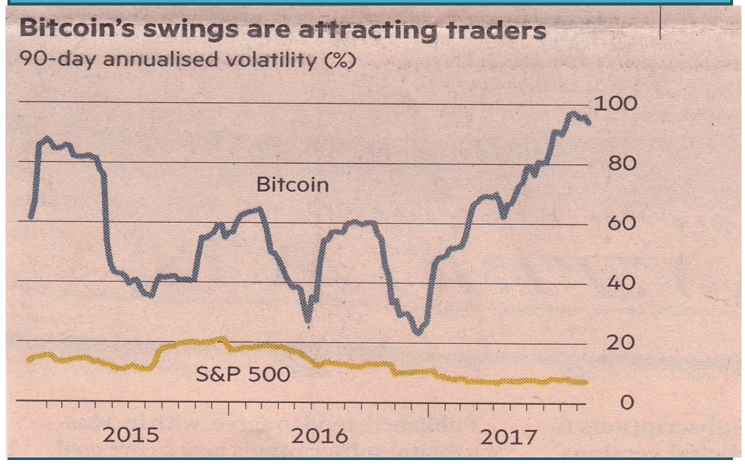
Blockchains: The village idiot's view

I make no claim of any high expertise on the program and programming of blockchains.However I do make a claim on clear thinking, and believe strongly that anyone who does not explain well something, is mostly because he or she does not understand it.Hence my claim of being the village idiot- but only to the extent that I think that the following simple explanations are right ! Blockchain (in a moment will define it) ran the risk of being thrown out ,like the proverbial baby, with the Bitcoin bathwater, because blockchain was used to launch, trade and "mine" Bitcoins.Blockchain is a family of computer programs which allow the management of files (could be files relating to buying and selling, keeping ledger accounts etc) in such a way that: (a) any transactions using the resident files are interlinked, meaning that all transactions are open to inspection and are transparent (b) all the files reside in the PC or desktop computers of the people using this particular program and not in a cloud or some "mother computer memory".In other words the archived files are decentralised (c) the risk of hacking, stealing, erasing etc of files is quite small.Blockchain is not a kind of internet, it is simply a data handling program.It has , however, aquired magical properties in the eyes of the media as, we are told, it will run everything and will usher a new IT era.Oh, and it cannot be hacked.Tell that to the CIA, Google,Uber, and all others who have suffered from "unbreakable" systems.Anything which can be stolen, it will, and as the blockchain programs involve money and Bitcoins, there will be a way to steal from, and trick the people who use these programs.

Fact Box: Please Sir! Where can I buy a blockchain ?

The explantions of what blockchain is and what it does,at least in the popular press and internet is pathetically short of clear explanations and extremely long on obfuscation,technobable and a lot of unclear blah blah.As a test, Google "how can I use blockchain" and most likely will be told to create a Bitcoin wallet and then a Bitcoin account by a company which trades bitcoins.It gets even better if you try to find where you can buy a blockchain program and run it for your own business.Not clear or easy although Ethereum is addressing this issue but only for creating coins.Yet another little detail: if all the files of a particular application, not just the parts one personally uses but all are on the hard disk of my PC or laptop, will it not run out of memory ? It normally won't but I will not explain here !

Fig.2: Bitcoin volatility



Source: FT

In a word: keep out of "Bitcoins" and ICOs

The surreal absurdity of the Bitcoin, and the fact that it never substituted any form of other "money", and indeed it trades for USD rather than the other way around, cannot obscure the fact that thousands if not millions of people, buy, sell it and try to use it and other cryptocurencies. Mercifully more regulatory authorities forbid or restrict the use and trade of cryptocurrencies all of them using blockchain for their transactions.Worse was to come, **and we will deal with this in more detail in the next issue of the Econotes,** as digital coins are issued and used to raise funding for projects.The lethally dangerous detail in this development was that a lot of these ICOs sold coins for USDs, with the proceeds of the coins sold destined to fund some vaguely defined project.The poor punters could hang on to these coins till the project materialised and then swap them for shares, or, in-between, find some other suckers to sell their coins to.Regulatory controls descended on this scam-like process and China and S.Korea for example, have completely prohibited ICOs.The promoters of ICO dress them up as peoples' power funding as it bypasses the banks and all pre-IPO compliances.It is a sobering thought that people carry on buying meaningless units of nothing on the expectation that other people will buy them in the future, but at a higher price.Investment in bitcoins, unless linked to a well-defined specific project are inherently risky and in a major crash will have no support by anything or anybody as they are totally unregulated.Trading them simply trades on the belief that other people will trade them.Caveat emptor!

Andrew Freris (writing completed 23 November 2019)