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Only Time Will Tell if Bitcoin is a Financial One-night Stand

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Sir Isaac Newton's Law of Universal Gravity states that what goes up must come down. To date, traders, speculators and many average citizens are disregarding Sir Isaac's physics and going all in on bitcoin. Is bitcoin destined to be a bubble, like tulip-mania in 17th century Holland, or is it on a fast track to become a new, widespread, durable currency?

It is difficult to ignore the commotion led by bitcoin's meteoric ascent over the past year, especially the last few weeks, and although many financial assets have been rising in tandem, the cryptocurrency distinguishes itself not only by the degree that it has appreciated over a very short period of time but also the sheer volatility that its investors are exposed to. At present bitcoin is the 6th largest currency in the world with a total value of over $300 billion.

So, let's break down bitcoin to the basics. In essence it is a cryptocurrency--a digital asset designed to work as a medium of exchange that uses cryptography to secure its transaction. With bitcoin, there is no central regulating body nor is there a lender of last resort such as a central bank involved. The only reason that cryptocurrencies can exist is thanks to the blockchain, a sort of encrypted, peer-based digital ledger that was first released in distributed form almost a decade ago.

The main advantages of bitcoin and other cryptocurrences are that they are peer-based and therefore do not rely on central market makers, which means that transaction costs, at least theoretically, should be very low and it is impossible for authorities to disrupt transactions or place freezes on Bitcoin accounts. In digital form, they are easy to carry (you can carry a billion dollars' worth of bitcoins in a usb stick. They also provide a high degree of privacy, by being untraceable and therefore equivalent to cash only purchases. Bitcoin is also cheaper than currency, in a sense, since credit and debit cards and money transfers incur billions of dollars in fees that cover banks' costs and risks. Without intermediaries, the waiting period for transfers is also extremely short. Bitcoin also provides security and a hedge for emerging market consumers from nations with high inflation, freezing of foreign exchange transactions, and political upheaval. Venezuela is a prime example.

The main drawback of cryptocurrencies is that almost all the positive attributes of bitcoin are also what attracts criminal enterprises and terrorist organizations, which means that governments may eventually enforce regulation of its uses by, for example, curbing the current privacy advantages. Unlike traditional currencies, there is no mechanism to recover stolen or lost bitcoins, and cryptocurrencies have not been around long enough to ensure that there are no flaws in the system that could render it vulnerable to hacking. Additionally, not many businesses offer payment in cryptocurrencies which means its use for purchases is still very limited. Bitcoin is essentially an investment security. Lastly, as pointed out by

Lawrence Baxter, co-director of Duke University's Global Financial Markets Center, bitcoin uses enormous amounts of electricity for recording transactions, so it needs a huge number of server farms.

Is bitcoin akin to the dot-com bubble of 2000-2002, an updated manifestation of "irrational exuberance"? In the future we are likely to see a limited degree of regulation to enhance security and curb criminal activities which will certainly pave the way towards greater acceptance by businesses.

In the meantime, the last month has witnessed three events have impacted the landscape for bitcoin. First, in mid-December the world's largest exchange company, the Chicago Mercantile Exchange & Chicago Board of Trade, launched bitcoin futures. Funds such as Fortress Investment Group and Horizon Kinetics are looking to profit from bitcoin by buying it or betting against it. Presently, nearly two dozen funds managing over $2 billion in assets are trading cryptocurrencies, and some big Wall Street investment banks are starting to clear bitcoin futures transactions. Second, Bitcoin plunged 25% in one day, wiping away the market value it had accumulated. Losing $100 billion in one week, the loss is twice the market cap of Tesla. Third, a Senate bill that would include digital currency in an update of money-laundering laws, cracking down on potentially illicit transactions, will be taken up in the next Congress, shepherded with bi-partisan support by Senator Chuck Grassley, chairman of the Senate Finance Committee.

Are bitcoin and competing cryptocurrencies are here to stay? Only time will tell whether they are a financial one-night stand or a long-term marriage.

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