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Bitcoins: Investment or Bust?

Bitcoins are a relatively new type of alternative digital currency. The actual coins are, of course, not coins at all; they are essentially records in a digital archive stored on servers throughout the web, in the form of digital signatures, timestamps, wallets and public keys, all created in open-source computer code in a way that is designed to foil hackers. Because a Bitcoin transaction doesn't involve banking or transaction fees, some economists think that they represent an early version of what all currencies will look like in the future.

Libertarians and drug dealers like bitcoins because they allow you to buy and sell (with those few business who will accept them in payment) without the government being able to assess taxes or track your activities. People who are suspicious of central bank policies like them because bitcoins are not tied to any traditional banking system. The total number of bitcoins that will ever be in circulation is fixed at 21 million (estimated to happen in the year 2140), and no government can print more of them and debase the currency. Hackers are also fond of bitcoins. If they can manage to steal bitcoins out of your electronic wallet, there is no way to recover your losses or trace the thieves.

When they were introduced in 2009, bitcoins were often given away as cheap curiosities, but the conversion price to dollars has risen above $1,000 this year. So are bitcoins a good potential alternative investment?

The answer is almost certainly no, for a variety of reasons. First, there is the volatility. Earlier this month, bitcoins suddenly lost more than half their value, dropping from $1,200 per "coin" to less than $600, on news that the Chinese central bank would not allow Chinese citizens to use them as legal tender. A graph of bitcoin values looks like the roller coaster of death, with prices soaring and plunging in ways that would give a hardened options trader a case of vertigo.

Second, what can you buy with bitcoins? Mainstream businesses will not accept bitcoins. Try holiday shopping with bitcoins, online or elsewhere, and you'll quickly discover that your options are limited--unless your holiday spirit involves porn, narcotics or gambling stakes.

But most importantly, many economists believe that it is inevitable that bitcoins will eventually wind up worthless. Why? First of all, there is nothing backing the bitcoins in your digital wallet. Unlike dollars, pesos, euros or yen, no government guarantees that bitcoins will have value in the marketplace. For bitcoins to become a stable reservoir of value, they would have to be accepted by the mainstream business community--which, in turn, would have to have confidence that the currency they receive will have value in the future.

Bitcoins have a built-in recipe for severe deflation. Since the global supply can never exceed 21 million, each bitcoin would have to dramatically rise in value to “lubricate” the U.S. and global economies. That means as the price of bitcoins increase the cost of your iPhone decreases from 1 bitcoin to one-half a bitcoin, to a quarter bitcoin. Just like consumers during the Great

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Depression, you (and millions of other bitcoin holders) would have little or no incentive to actually do any transactions with your bitcoins.

Currencies are not supposed to be terrific investments, and bitcoins are no exception. You want them circulating into the economy, rather than hiding in the mattress or an encrypted digital wallet. Those who invest thousands of dollars in bitcoins will likely get two rewards: a lot of heartburn as bitcoin values bounce around like a kangaroo on steroids, and then heartbreak when the music stops and their investment isn't worth the pixels and bytes they're printed on.