Bitcoin – Huge opportunity or massive bubble?

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Discussions on the topic of Bitcoin – or crypto-"currencies" in general – are usually plagued by strong emotions. That fact alone is enough to make me skeptical. When it comes to investing, strong emotions are almost always detrimental. And with Bitcoin, it's more than just emotions. You sometimes get the feeling that arguments are being made with an almost religious fervor. There seems to be little room for nuance and sober analysis. Nevertheless, let me try.

Proponents of Bitcoin are often highly critical of today's prevailing monetary system, which they refer to as "paper money" or "fiat money." When they talk about fiat money, they are talking about a medium of exchange (a currency) that does not have intrinsic value and is not pegged to the price of a commodity, such as a precious metal. That the criticism of fiat money has even become an issue today is due to the policies pursued by state-sponsored central banks around the world, who have become increasingly reckless, especially since the financial crisis. The money supply has been massively expanded since 2009 as larger and larger quantities of money have been printed. Many government bonds – for example those issued by the German government – have negative interest rates, which means that investors, rather than earning money when they lend to the state, are actually paying for the privilege when they buy bonds. Critics fear that this will fuel inflation or even hyperinflation. Although inflation has risen slightly in recent months, the high inflation that critics have been warning of since 2008 has failed to materialize. Instead, the prices of all asset classes have risen, especially those of government bonds and real estate, but also securities. Critics of expansionary central bank policy rightly fear that this is never going to end well. Some have therefore turned to gold as a hedge in the event of another financial crash.

But what, you might ask, does all of this have to do with Bitcoin and other crypto-“currencies”? The criticism of fiat money is nothing new. Almost half a century ago, the economist and Nobel laureate Friedrich August von Hayek criticized the paper money system and, in his 1975 lecture “Choice in Currency”, called for the abolition of the government monopoly on money. He argued that everyone should have the freedom to offer goods that others might want to demand as money. It should no longer be the sole preserve of the state to create money, he reasoned, but everyone should be allowed to offer their own form of money. And, by the natural process of competition, as is usual in a free market economy, he was convinced that the best currency would prevail.

Proponents see Bitcoin and other crypto-“currencies” as the practical implementation of Hayek’s concepts of private money. But is Bitcoin really a “currency”? Money and individual currencies serve a variety of functions, primarily as a store of value and as a means of payment. Bitcoin is not suitable for either. Given the massive fluctuations in the value of Bitcoin, it is completely unsuitable as a store of value. And it is only in very rare circumstances that Bitcoin is accepted as a means of payment. It may play a role in the field of organized crime, but not in normal transactions. Recently, Elon Musk announced that he would accept Bitcoin payments for Tesla cars, but it remains to be seen whether this will ever actually happen. The term “crypto-currency” is therefore technically wrong and should appear in inverted commas because it is not actually a currency.

To most crypto-“currency” investors, crypto-“currencies” are nothing more than an object of speculation. They buy a crypto-”currency” because they hope prices will rise and they will make a healthy profit, which was indeed possible in the past. Investors who got in at the right time earned many times their original stakes. However, the possibility of making a massive profit does not, in and of itself, qualify a crypto-“currency” as an “investment.” It is also possible to rake it in at a casino, and yet no one would ever describe a bet in a casino as an “investment.”

Critics of Bitcoin point to the fact that the last few centuries are full of speculative bubbles – and they all burst in the end. They recall the Dutch “tulip mania” of the 1630s, during which the bulbs of certain types of tulip became objects of speculation. In some cases, the prices of single bulbs rivalled the prices paid for the most expensive houses in Amsterdam. As with all bubbles, the tulip bubble eventually burst – and this is precisely what Bitcoin critics are now worried about.

However, it must be said that even traditionally stable or well-established investment assets, such as securities or real estate, can become objects of speculation. I’m sure we all remember the skyrocketing prices being paid for houses in the U.S. and some cities and regions of Europe in the early 2000s – until the bubble burst. The stock market Dotcom Bubble in the mid- to late-1990s is another recent example. The mere fact that a bubble develops around a certain asset does not, however, necessarily mean that there is a fundamental problem with the asset itself.

Nevertheless, I am always suspicious when something becomes “fashionable” and, all of a sudden and all around you, people are telling you that you need to invest in it without delay. That really sets my alarm bells ringing. I didn’t get rich by doing anything that was “fashionable” – I have always invested in assets that left others shaking their heads. Later, when it became fashionable to invest in these assets – for example, real estate in my hometown of Berlin – I sold.

As far as crypto-“currencies” are concerned, the German financial market expert Gerd Kommer makes a very good point: “Lots of private investors have failed to understand that crypto-currencies can be either an object of speculation or a means of payment, but not both at the same time. If crypto-currencies do become what they are designed to be but are not, namely real currencies that serve as a means of payment for more than a handful of transactions, rather than an object of speculation and gambling, as they have been up to now, then their expected inflation-adjusted return would drop to near zero, as is the case for all currencies.”

Bitcoin does not yield any income, unlike stocks and real estate that typically generate dividends or rental yields. It is therefore impossible to calculate the intrinsic value of Bitcoin with any degree of accuracy. Advocates of Bitcoin object to this argument, pointing out that this is a characteristic Bitcoin shares with gold, which also does not yield any income. This is true, but the comparison is flawed: Bitcoin has been around for 12 years, while the first evidence of gold being used as a means of payment is found on the tablets containing the Babylonian king Hammurabi’s code of laws, 1,870 years before the birth of Christ. In China, gold was being used as money 1,100 years before the birth of Christ, in the form of small cubes.

And such traditions carry weight: One of the most important insights provided by the aforementioned economist von Hayek is the realization that the origin of well-functioning institutions is to be found "not in contrivance or design, but in the survival of the successful", with the selection process operating "by imitation of successful institutions and habits". Gold has been passing this test for thousands of years. Whether any of the current crypto-"currencies" will ever survive and thrive by this process of "imitation" remains to be seen.

I have saved perhaps my most important piece of advice for last: whenever you are weighing up an investment, you should strip yourself of your ideological convictions, just as you would strip yourself of your coat before you hand it in at a cloakroom. I have personally been interested in politics all my life and hold very strong political opinions. For example, I am sympathetic to numerous libertarian positions – but I forget these sympathies whenever I am considering the pros and cons of a given investment. Nevertheless, I often have discussions with people whose political beliefs are similar to my own and who base their investment strategies on their political beliefs. They raise a number of very correct arguments against paper money (fiat money) and then conclude that you should invest your money in crypto-"currencies." Most people who think this way have strong political opinions but have never actually made much money as investors. Political convictions are usually closely linked to strong emotions – and it is precisely these strong emotions that have no place in the world of investing.

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