Basic Principles: Are Cryptocurrencies a Fad?
(An Ongoing Cryptocurrency Series - July 2017)

Bitcoin is the first non-dilutable, fixed-supply currency in human history. The inherent demand for such a store of value must be at least as large – if one considers that for a moment – as the value of world-wide money supply and savings upon which the owners do not wish to earn a negative real return after the impact of the dilution of their money supply. In our era, such dilution, through the power to print money, has been a coordinated policy of the world's central banks for the past decade. The concept of such an instrument, a non-fiat, non-inflationary currency, is not new; it's just that there did not previously exist the technology to enable it.

The survival risk for any new financial instrument, particularly as radical a one as bitcoin, is obviously great, success requiring its acceptance broadly across the populations of individual buyers, private commercial interests and institutions, let alone by public institutions, regulatory bodies and sovereign authorities. That risk has diminished markedly in just the last several months and weeks.

As of July 1st, three months after declaring bitcoin to be legal tender, Japan removed the 8% consumption tax on cryptocurrencies – that is not merely allowance, it is encouragement.

On the same date, Australia recognized bitcoin as legal tender and removed the 10% consumption tax on such transactions.

The Japanese retailer, Meganesuper Co. Ltd. (3318 JP), which operates 334 stores, started accepting bitcoin for payment in July. Megane sells eyeglasses, sunglasses, contact lenses, and hearing aids. Other Japanese companies accepting bitcoin for payment include a mobile payment app called AirREGI, and a budget airline called Peach Aviation. The latter plans to install bitcoin teller machines in airports to facilitate exchanging yen for bitcoin, presumably so the customer can use the cryptocurrency to pay the airline. The three largest banks in Japan, MUFJ, Mizuho, and SMBC, are backing bitFlyer, an existing cryptocurrency exchange that is the largest one in Japan.

In February, in response to dramatically rising bitcoin use by its citizenry, the Philippine central bank issued a circular describing guidelines for virtual currency exchanges, including regulations governing registration, reporting requirements and annual fees. Mainstream adoption of bitcoin in the Philippines is occurring well in advance of developed markets, due to much more obvious practical needs (the term "adoption" does not apply to the U.S., since most people know nothing of it, and those who do have merely heard drastically conflicting headlines and rumors). The Philippines is the third largest remittance market in the world, at over $30 billion received per year, behind China and India. Much of the Philippine bitcoin volume is related to expatriate Filipino employees who use bitcoin to send earnings home, sidestepping the usurious, confiscatory fees charged by banks and wire transfer companies such as Western Union. Another major source of demand is from local employees, who settle utility bills and other common payments in bitcoin, escaping a notoriously inefficient banking system.

As of August 1st, Singapore's central bank issued its first regulatory memorandum for cryptocurrencies, which will begin under the auspices of its Securities and Futures Act. Regulation, though some view it through a negative or suppressive interpretation, is, in reality, tacit acceptance.

South Korea is considering the modification of its Electronic Financial Transactions Act to regulate bitcoin. It is asserted that 8% of the world's bitcoin now trades in South Korea on a daily basis.

These are large economies and major central banks. Moreover, these actions relate only to bitcoin or other cryptocurrencies in their use as a medium of exchange. Not mentioned here are as great a set of efforts being undertaken with respect to using the blockchain technology *(see further discussion below)* that underlies cryptocurrencies, to replace central bank money transfer systems and entire classes of securities and transactions recordkeeping – the province of the world's financial sector companies .

In the U.S., effective August 1, 2017, it will be legal in the State of Delaware to maintain corporate records on a blockchain. That is such a significant development that its implications can hardly be overstated. Since most U.S. corporations are chartered in Delaware, they can now have blockchain-based records. It is but one of the rapidly proliferating signs of how rapidly this technology is advancing.

We will discuss this further in future letters, but the seriousness of this effort is illustrated by the Bank of Japan's approving the development of plans to shift its money transfer system to the Ripple blockchain. As of March of this year, a consortium of 47 Japanese banks began to use the Ripple system following a multi-month pilot program. They are reported to account for 30% of Japan's banking system.

In March, Singapore's central bank, the Monetary Authority of Singapore, completed a proof-of-concept project to conduct domestic inter-bank payments using distributed ledger technology in partnership with a consortium of financial institutions. The consortium includes, among others, Bank of America Merrill Lynch, Credit Suisse, DBS Bank Ltd, The Hong Kong and Shanghai Banking Corporation, J.P. Morgan, and the Singapore Exchange. The next phases of the project will address instantaneous-settlement cross-border payments and securities trading and settlement.

As well, the rise of bitcoin and other cryptocurrencies does not merely occur in isolation. In fact, it cannot occur in isolation; it will come at a cost, and in some areas, a terrible cost. It is a technological and disruptive threat to the profitability of the incumbent financial services sector. This means not only displacing the aforementioned wire transfer activity; it includes the disintermediation or cannibalization of custody services and fees, deposit balances, credit card fees and transaction volumes, and more. Financial services is the largest sector in most global indexes, although it is only 14% of the S&P 500.

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Bitcoin & the "Fork"

Bitcoin has been serially suspected of being on the verge of failure for any number of reasons. The most recent concern related to a fork from bitcoin known as bitcoin cash. Cryptocurrency itself is a new term, and the term "fork" as it relates to a cryptocurrency requires explanation. In order to understand a fork, one must first understand the concept of the distributed ledger or blockchain, upon which bitcoin and other cryptocurrencies are based. The blockchain contains all of the transactions that ever occurred with that particular cryptocurrency. A transaction can be only added to the chain with an encrypted digital signature.

The chain or distributed ledger exists in a multitude of copies, on thousands of servers around the world, unlike the more common central database used by a bank. Thus, not only would a criminal need the correct digital signature, also known as private keys, to corrupt the system, the criminal would also need to simultaneously attack and alter every copy of the blockchain or distributed ledger. This is why the blockchain is secure.

However, the system, being distributed, works on consensus. Everyone must use the same code. If someone changes the code without the consent of the other members, a transaction could be processed on one copy of the distributed ledger, which would not be represented on all of the other copies.

As an open source code protocol, bitcoin inherently adopted a decentralized system allowing users' economic interest, "the market", to govern the network. The fact that there are two proposals on the table is a reflection of the basis of why bitcoin was created at the first place, as an antithesis to the centralized governing regime. Contrast this to a traditional closed system. For example, Microsoft: when there is a new version, the user has no option but to adopt the new version, decided and issued only by the governing entity, i.e., Microsoft.

On August 1, 2017, bitcoin miners seemingly reached majority consensus to activate a fork. The dispute between two factions centered around the carrying capacity, or processing speed, of the system. Specifically, in this instance, the dispute was over the size of a block (the set of new transactions to be appended to the existing blockchain). From this point in time, the blockchain, or distributed ledger, becomes different. These are then said to have forked. In other words, there begins a deviation from what was heretofore a common history. There are now two currencies, known as bitcoin and bitcoin Cash.

Nevertheless, there is another way to view the matter. There are now two currencies in which the users agree on the monetary policy concept of fixed issuance to the level of 21 million currency units and no more issuance beyond that point. This implies an agreement that the central banks or governments will play no role in currency issuance. The basic point of cryptocurrency is that the power to debase a currency must be taken away from governments.

The issuance process is known as mining; whereby, the operator, or miner, attempts to guess a random number and, if successful, is granted the right to transmit the latest transactional information to all of the nodes in the blockchain. In other words, a miner is creating new currency and is, therefore, involved in seigniorage. Seigniorage is the economic profit that results from the issuance of money. Ordinarily, a government issues money and levies the seigniorage. For example, it does not cost the U.S. government $20 to mint a $20 bill. The difference between production cost and value is the seigniorage. In the current era, until the invention of cryptocurrency, this right belonged exclusively to the government, but in prior centuries, it was not uncommon to grant a license or a charter to a private institution for this service.

Cryptocurrency has changed this relationship, now that miners can earn the seigniorage profits. In fact, since cryptocurrency is decentralized and relies on the cooperation of many to give security to the blockchain, the only way to secure cooperation is to make seigniorage profits possible. People who wish to mine are making a business and return-on-capital decision. And since they must agree to immobilize capital in the form of servers for a very long time, a certain level of return is necessary. The miners are going to gravitate to (that is, are going to mine) whichever cryptocurrency offers the highest value.

It is very much the same as advocating democracy as opposed to monarchy. The various adherents of democracy may have radically different notions of how society ought to be governed. However, none advocate return to traditional monarchy. The point is not the success or failure of a given cryptocurrency. The point is that opposition to fiat currency debasement and negative real returns is growing.

If this view gains acceptance, there will be a noninflationary cryptocurrency of some type, although it might or might not be bitcoin. If that happens, a seminal event will have occurred in the world of investing: the power to avoid currency debasement. A new asset class will then have been created. Investors will not be able to ignore this asset class, since very few people will prefer debasement over retention of purchasing power.

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