HORIZON KINETICS

Bitcoin & the "Fork" (July 2017)

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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