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Bitcoins, Dollars and Renminbi

Reports indicate strong Bitcoin interest in China. BTC, the China-based Bitcoin exchange accounts for trading a third of all Bitcoin transactions, while China may account to close to half of the daily turnover, according to some internet reports at an estimated 200k Bitcoins a day.

Registered participants on BTC are reportedly near 10k and rising quickly lately. China-based Baidu, one on the largest internet companies in the world, has begun integrating Bitcoins into their network.

On a recent trip to Asia and since, we found the Chinese media, in particular, had strong interest in Bitcoin angles and stories. That level of interest, however, did not appear reflected among the asset managers to whom we spoke.

There are two general explanations offered from the Chinese interest in Bitcoins. The first is that it is part of China's challenge to the US dollar. Some who are involved in the digital currency space, think that the Bitcoin could actually chip away at the US dollar's reserve currency status. This seems quite far fetched and a incredible claim (in the sense of lacking credibility), though it has not stopped reporters from repeating it. Yet, not to lose point, the idea is that digital currencies, of which the Bitcoin is the biggest and best known, is an alternative to fiat money.

The other explanation of the popularity of China's interest in Bitcoins is much less philosophical and normative and simply pragmatic and grounded into *real* needs. Simply put, in a country that continues to closely regulate capital flows, the Bitcoin gives Chinese savers a way to circumvent the government's strictures.

China has been in the process of financial liberalization for some time, albeit at varying speeds. It is expected to become gradually easier to invest overseas. **Often, when legitimate channels are developed, officials crack down harder on the shadier channels.** Back in 2009, Chinese officials did move against another digital currency (QQ). Some argue that it was the centralized form that Chinese officials thought challenging rather than digital currencies in theory.

Yet, there are few places in China to really spend Bitcoins and the issue seems to be how much are the Bitcoins, simply another speculative vehicle and how much is it a circumvention vehicle. Even if it is mostly a speculative vehicle, regulators may still take an interest. To be fair, the media coverage outstrips the actual number of people involved with Bitcoin trading in China.

In the US, Bitcoins have a different function. As seen with bluejeans and rock and roll music, the plasticity or flexibility of American culture and political institutions offer a different tact. In Senate hearings early this week, both the chairman of the Senate Committee on Homeland Security and Governmental Affairs and the Director of the Treasury Department's Financial Crimes Enforcement Network (FINCEN) suggested that digital currencies are comparable to the internet in its earliest days.

Treasury's Calvery was quoted saying, "So often, when there is a new type of financial service or a new players in the financial industry, the first reaction by those of us who are concerned about money laundering or terrorist finance is to think about the gaps and the vulnerabilities that it creates in the financial system. But it is also important that we step back and recognize that innovation is a very important part of our economy."

US officials seem to recognize the digital currencies can provide a legitimate financial service and have the same benefits and risks of online payment systems. Later today, the Federal Election Commission is to decide today whether digital currencies, such as Bitcoins, can be used as contributions to political campaigns.

For those devotees who embrace the Bitcoin in the US (and high income countries more generally) as an alternative store of value than fiat (paper) money, there seems to be a fundamental contradiction. If it is truly desired as an alternative store of value, then the exchange value is less important, but if it cannot be used, then it might not be considered money. It seems that such a holders of Bitcoins should only use them for transactions if they felt that value of Bitcoins was rich to paper money.

The critique of fiat money indicates that paper money will continue to depreciate against some external metric, like gold or a basket of goods. This view argues against using Bitcoins as medium for transactions. Economists often argue there are three functions of money, a medium of exchange, a store of value and a unit of account. Digital currencies, including the Bitcoin have not achieved the networking effect that is required for a unit of account. **We argue here that its function as a store of value works against it acting as a medium of exchange. Perhaps this is the trilemma facing digital alternatives to fiat money.**

Sovereigns traditionally have two monopolies: the power of coinage and the legitimate use of violence. There are numerous examples of the sovereign sharing its monopoly with others, but only in limited ways. Those who embrace digital currencies as an alternative to fiat money may always exist, but in relatively small numbers. Surely, the income and wealth divergence that transcends economic models, suggest that far too many people do not have sufficient fiat money to make ends meet and digital currencies are a luxury they cannot afford.

On the other hand, digital currencies to facilitate transactions may have a greater future, but then, they are will be ultimately predicated on fiat currencies.