Bitcoin Isn't Money

Description

Lately, there has been a lot of talk about Bitcoin and its role in the financial system. Over the past 10 years, its value has skyrocketed, leading to massive interest in BTC and other cryptos. Despite its many ups and downs, Bitcoin has been one of the best-performing assets over the last 10 years.

But despite all of the gains it has made, there is one thing Bitcoin is not: *money*.

In a short *New York Times* piece, Nobel Prize Winning economist Paul Krugman outlined a persuasive case that the "world's biggest cryptocurrency" isn't a currency at all. Instead, he argued, it is a vehicle for speculation that buyers buy just to see the price go up. The argument made a lot of people in crypto-land unhappy. But, in fact, it made a lot of sense. In this article, I'll explore Krugman's case against money in detail and examine whether Bitcoin might have any alternative uses that justify its price.

Characteristics of money

In economics, money is thought to have three purposes:

1. It serves as a medium of exchange.
2. It serves a unit of account.
3. It serves as a store of value.

Bitcoin runs into serious problems with the first two of these characteristics. It only partially serves as a medium of exchange. You can use it as a currency, but mainly only on black markets. Very few legal marketplaces accept it. It does not serve as a unit of account in any way — its price is far too volatile, making it practically useless for quoting values of other things.

The one characteristic of money Bitcoin *does* possess is that of a store of value. Unquestionably, Bitcoin is a valuable asset. A single BTC is worth tens of thousands of dollars, and over the long run its price has been rising. Bitcoin first started trading in 2009 for pennies, today a single Bitcoin is worth $43,000. This is the one purpose of money that Bitcoin has served so far. But it's just one out of three.

An idea for investors

If you're interested in Bitcoin but aren't certain whether it's "legitimate" enough to invest in, here's an idea: hold Bitcoin as a *smaller* position in a large, diversified portfolio made up of assets at with different risk characteristics.

Let's say your portfolio looked like this:

- 55%: equity funds like **iShares S&P/TSX 60 Index Fund** (TSX:XIU).
- 35%: bond funds like**BMO Mid-Term U.S. Investment Grade Corporate Bond ETF**.
- 10%: Bitcoin.

A serious case could be made that this is, *overall,* a fairly sensible portfolio. Yes, Bitcoin is an ultra-risky asset whose persistent high price is somewhat of a mystery. But it's not unheard of for portfolio managers to include a very small allocation in such assets — say, 5-10%. Portfolios are usually sorted into different assets with different levels of risk. If you have the stomach to include an "ultra-high-risk" category in your portfolio, there's no reason for Bitcoin not to be part of it — as long as your portfolio is diversified.

With a portfolio like the one above, you'll have XIU doing most of the heavy lifting for you. It's an equity fund, so there's some risk, but with 60 stocks worth of diversification and a large-cap focus, it's relatively tame. To reduce the risk even further, you include a bond fund. Finally, you include a bit of Bitcoin as a "Hail Mary" play that you buy fully recognizing that you could lose it all. Such a portfolio would have a higher *maximum* return than just holding XIU alone. And even if the 10% in Bitcoin went to zero, you could get to a positive return from the two ETFs after just a few years.

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2025/08/23
Date Created
2021/06/07
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