Bitcoin can be priced, but not valued

When economic historians and financial market experts discuss asset price bubbles, market instability, or irrational exuberance, one example that often crops up is what is famously referred to as "tulipmania"—a speculative price bubble in tulip bulbs that gripped Holland in the mid-1630s. At its peak, the rage for trading tulips was so high that one Viceroy tulip bulb sold for as much as $51,945 in 2017 US dollars. Understandably, back in the mid-1630s, the Dutch buyers had to trade fortunes for one tulip.

As happens with most price bubbles, however, the tulip bubble burst and prices collapsed to a negligible fraction of their peak levels as buyers began to withdraw from the market. It should come as no surprise, therefore, when analogies are drawn between the tulipmania of the 17th century and the dynamics surrounding cryptocurrencies, especially bitcoin. The former president of the Dutch central bank, Nout Wellink, for instance, called the hype surrounding bitcoin worse than tulipmania. "At least then," he said, "you got tulips in the end, now you get nothing." The chief executive officer of JPMorgan Chase & Co., Jamie Dimon, seconded that view at an investor conference a month ago.

To be sure, the comparison between bitcoins and tulips may seem far-fetched, even unfair. Blockchain, the technology underpinning bitcoin, promises to revolutionize the traditional way of maintaining records—thereby helping facilitate secure land transfers, ensure efficient delivery of public services, or reduce transaction costs for businesses.

But do cryptocurrencies merit a position as an asset class in an investor's portfolio? That question requires us go back to the first principles of investing and draw a distinction between value and price.

As New York University professor and valuation expert Aswath Damodaran explains in his recent **blog**, value is essentially derived from the fundamentals of an asset—its present or expected cash flows, growth prospects, competition scenario, market structure, and so forth. Making investment decisions require us to assess this value and compare it to the current market price. If the fundamental value is higher than current market price of that asset, then the asset merits a position in the portfolio because the market price is expected to eventually converge to its fundamental value.

In contrast, pricing requires us to make a judgement about the future market price of an asset, mainly based on the market mood and momentum. It ignores the fundamentals because the objective is to profit from short-term movements in prices irrespective of the underlying value. This raises the question: Can bitcoin be valued, or priced? Or both?

As bitcoin does not generate cash flows, it is not possible to value it as an asset. Like any fiat currency, it must be priced relative to other currencies. But unlike fiat currencies, bitcoin is neither a relatively stable store of value nor a widely accepted medium of exchange. Its prices are highly volatile, swinging wildly in response to new information. It is, therefore, neither as safe as gold nor as trusted as fiat currencies. High price volatility makes it impossible for businesses to price their goods or services in bitcoin.

In their 2008 **white paper**, the bitcoin creators had proposed the new system chiefly as a means to enable electronic transactions in a more robust manner than the existing technologies, including those that involve digital signatures. But the trajectory of the bitcoin market has hardly echoed that intention. This is reflected in the fact that since the beginning of 2013, while the price of bitcoin has risen by as much as 456 times, the number of daily transactions has risen only by about eight times. For bitcoin to be viewed as a credible currency, it must gather steam as a medium of exchange than merely being a speculative bet.

One of the cardinal reasons why bitcoins, or for that matter any other cryptocurrencies, are not trusted enough for actual transactions is their lack of legal tender and the absence of regulations. But this may change soon. The Securities and Exchange Board of India, for instance, is working on a framework to regulate bitcoins. Kenneth Rogoff, professor of economics and public policy at Harvard University, views regulatory pressure from governments as a major reason for the prices of bitcoins to **collapse** in the long run. Monetary authorities do not tend to view competing currencies on favourable terms. Anonymous transactions in bitcoins not only encourage tax evasion and capital flight but also aid criminal activities because both the source and end usage are unknown.

In 1936, British economist John Maynard Keynes, in his magnum opus *The General Theory Of Employment, Interest And Money*, proposed that stock prices are based not on their fundamental values but on people's perception of what others would pay for it. In other words, equity prices were influenced more by crowd psychology than intrinsic value. Keynes illustrated this through the example of a beauty contest, where participants are asked to rate the most beautiful faces from a hundred options. Those who voted for the most popular option, not necessarily the most beautiful, would win. The best strategy in this case, Keynes noted, would be to choose the face that you believe others would find beautiful. This would ensure that you ended up choosing the most popular face.

Bitcoin must be viewed in a similar context. Like any fiat currency, its success hinges on the trust it may or may not eventually build among its intended users—merchants and consumers. Devoid of that trust, however, bitcoin will continue to be a speculative bet driven by market momentum until its prices eventually collapse under its own weight.

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