Virtual currencies: house of cards or mass market trend?

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Edith Rigler, 22 November 2014

News about virtual currencies, and especially about Bitcoin, continue to appear in the media with unabated speed. The supply side seems to be outpacing the demand side, and it is interesting to review both sides of the market.

Many suppliers are ready to meet the demand

On the *supply side*, the infrastructure needed to support a currency is building rapidly. New suppliers appear on the market nearly on a daily basis: they range from providing trading and brokerage platforms, processing services, software products and mining services to information and marketing services, virtual currency apps and digital wallets. Earlier this year a Nordic venture capital company created a "Bitcoin Database" tracking the number of new start-ups connected with virtual currencies. If one believes their data, the numbers of new startups is growing swiftly. A whole new industry is being created in response to virtual currencies.

Each day additional merchants, large retailers, e-commerce companies, airlines, hotels and others announce that they are willing to accept Bitcoin. *CoinDesk*, an online publication that tracks digital currencies, estimates that by the end of this year 100,000 companies will accept bitcoins. Finally, exchanges keep adding to the range of "real" currencies, that one can use to buy or sell Bitcoins. US Dollars, Sterling, Euro, Polish Zloty, Renminbi, Mexican Pesos – the list goes on and keeps getting longer.

But demand is still limited

What about the *demand side*? Does anyone actually use Bitcoin? Although the number of Bitcoin wallets (an indication of how many users have bought Bitcoin) is increasing - *Coindesk* estimates that by year-end 2014 there will be eight million bitcoin wallets globally – this is by no means a large number: less than 2 % of just the EU population for example. Human interest stories about supposedly very happy users who tout the benefits of Bitcoin abound. But in its July 2014 "Opinion on virtual currencies" the *European Banking Authority* pointed out that "using a generous interpretation, the number of global virtual currency transactions has never exceeded 100,000 per day across the globe, compared to approximately 295 million conventional payment and terminal transactions per day in Europe alone (i.e. credit transfers, direct debits, e-money transfers, cheques, etc.).[1]

If people aren't using Bitcoin to transact, are they using it to invest? Between 55% and 73 % of Bitcoins are not in circulation, but are simply "hoarded", i.e. they are held in accounts rather than being traded or spent. One suspects that this has to do with Bitcoins price volatility: if you have bought Bitcoins with the fond hope that the investment might make you rich, but the Bitcoin price falls, you are probably trying to sit out the volatility cycle and will only sell or purchase goods once the price increases again. Another finding is that a majority of Bitcoin users have very few Bitcoins, and only very few users have large amounts of Bitcoins.

[1] European Banking Authority, „EBA Opinion on `virtual currencies´", July 2014.

So the demand is not (yet?) keeping up with the supply side. Will that change in the future, and how soon?

Much will depend on regulation. As pointed out in an earlier article, virtual currencies are not legal tender in any country of the globe right now, and in many countries restrictions around dealing and trading with Bitcoins exist. In others, regulators are grappling with arriving at an exact definition of virtual currencies. After all, you can only regulate something if you are clear about what it is.

The changing sociology of the Bitcoin user

Analysing who it is that uses Bitcoins is quite interesting. The early adopters were typically technology (and math?) enthusiasts ready to try something new. They were soon joined by people who either lacked confidence in the traditional banking system or wanted to find a way to escape what they saw as the capitalist oppression by banks and dominance of governments – and teach them a lesson. And criminals are said to have discovered that Bitcoin could be a conduit for money laundering, drug trafficking and computer hacking.

Now we see that in contrast to the earlier Bitcoin years, the sociology of the Bitcoin user – and potential user – is changing. We find a broad spectrum of people of all ages using Bitcoin.

An opportunity for financial inclusion and international remittances?

Another user segment of virtual currencies is foreign workers sending remittances to their families and relatives in their home countries, i.e. cross-border. This is an already huge market and growing rapidly. The World Bank estimates global remittances to developing countries at $436 billion in 2014, and accelerating to $516 billion in 2016. [2] Trading platforms and exchanges have already reacted to the need of foreign workers. For example, in the United States, an exchange like *meXBT* enables remittances from the US to Mexico, which according to the World Bank is the fourth-largest destination country for remittances. Not surprisingly, meXBT plans to include sending remittances to other countries in Latin America in the form of Bitcoins soon.

Whether virtual currencies will become a permanent fixture in the economy will also depend on governments´ views. Some have started to look at virtual currencies as a way of increasing financial inclusion. Yet globally, more than 2.5 billion adults do not have a bank account and are thus financially excluded. This means that they must rely on their own (extremely limited) informal and semiformal savings and borrowing to finance education, businesses and investments. Financial exclusion makes it hard to alleviate income inequality and spur broad-based economic growth. Thus in its August 2014 report on digital currencies, the *World Bank* called on governments to establish an environment that fosters low-cost innovative inclusive solutions, using digital currencies.[3]

Note that the World Bank spoke of digital currencies. These need not be virtual. They can be real currencies in digital form. Is that the future, and will Bitcoin go down in history, not as a new currency, but as the catalyst that compelled real currencies to go digital?

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[2] The World Bank, „Migration and Development Brief #22“, April 2014.
[3] The World Bank, „ The Opportunities of Digitizing Payments“, August 2014.