As Bitcoin virtual currency soars, bubble fears do too

April 7 2013, by Thomas Watkins

Some call it the most famous pizza purchase in history: In May 2010, a programmer called Laszlo asked an online forum if anyone would buy him a couple of pies in exchange for 10,000 Bitcoins, an experimental online currency launched in 2009. As of Friday, a single Bitcoin traded at around $135, amid fears that a new online bubble might soon burst.

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programmer called Laszlo asked an online forum if anyone would buy him a couple of pies in exchange for 10,000 Bitcoins, an experimental online currency launched in 2009.

"No weird fish topping or anything like that," he wrote.

With each Bitcoin fetching less than a cent at the time, the order was worth about $41. Today, it would be valued at about $1.4 million (1.08 million euros).

As of Friday, a single Bitcoin traded at around $135, with the currency nearing $147 earlier in the week—up from about $20 at the start of February. It's a stratospheric jump some claim has been fuelled by Cypriots and Russians seeking to invest their euros elsewhere during Cyprus's banking crisis, stoking fears that a new online bubble might soon burst.

"It's completely irrational," said Yannick Naud, a portfolio manager at the London-based Glendevon King Asset Management firm, who has seen an increase in client queries about Bitcoins. "As an investor you can't put any underlying value on the Bitcoin itself."

Bitcoins were launched in 2009 in the wake of the global financial crisis by an anonymous programmer who wanted to create a currency independent of any central bank or financial institution. A form of "e-money", it is made of strings of dazzlingly complex code created by raw computing power—a process called "mining" that can in theory be carried out by anyone with a computer.

The software is written in such a way that it becomes increasingly difficult to generate new Bitcoins, with the number in circulation designed to eventually top out at 21 million.

Once mined, Bitcoins are stored on a user's hard drive in a virtual wallet, and can be sent directly to another person. Such peer-to-peer sharing bypasses the banks so is largely anonymous. But this brings its own risks—in June 2011, hackers targeted virtual wallets and wiped some people's accounts clean.

At first a coder's curio, Bitcoins quickly found a home in the "deep web", the shadier part of the Internet that is largely anonymous and requires some good technical understanding to access. It was used to fuel illicit drug buys and pay for other illegal services on specialist sites.

But computer aficionados and tech-savvy libertarians embraced the currency too, and in recent months a flurry of legit businesses have started accepting Bitcoins.

A cottage industry of stores buying and reselling goods online for Bitcoins has emerged, and some high-profile transactions have helped push the currency into mainstream consciousness. One Canadian man reportedly hoped to sell his house for Bitcoins, and a US man claimed to have traded his 2007 Porsche for 300 Bitcoins.

Robert Walker, a digital designer from London, said he bought about 200 Bitcoins over a six-month period starting at the end of 2011. He spends much of his time online and was excited by the idea of the Internet minting its own currency, and an investment not beholden to any central authority.

His purchase set him back about $900, but today would net some $27,000. But despite this week's new price highs, he's going to keep his virtual stash—for now at least.

"It's not a life changing amount of money, but it could be if I sat on it for five years," Walker said.

But for Naud, the asset manager, Bitcoin is reaching unsustainable levels. On paper at least, the value of Bitcoins in circulation now tops $1 billion, and a continued increase in price will require a lot of new investors.

"The bubble will burst when there will be less people willing to enter (the Bitcoin market) than people willing to leave it," he said. "It's hard to pinpoint, but it probably won't last another month at this price."

Experts said Bitcoins are especially vulnerable to rapid deflation. Governments trying to regulate them, for example, could spook investors and cause them to lose confidence. Already in the US, regulators have taken note of the currency and moved to make firms report transactions worth $10,000 or more, according to the Wall Street Journal.

"If it gets very popular, I can see the government clamping down," said Alistair Cotton, a senior analyst with Currencies Direct. "I think it would lead to a massive drop off in the number of users."

The Cyprus banking crisis - which saw the tiny nation agree a bailout deal with the International Monetary Fund, European Commission and European Central Bank that will shrink the banking sector and lead to losses on deposits of more than 100,000 euros - also coincided with a run-up in Bitcoin valuation.

Cotton sees similarities between Bitcoin and Napster, an early online file-sharing service that ran into legal difficulties and was eventually closed, though it was soon replaced by numerous other file-sharing services. Even if Bitcoin doesn't last, other virtual currencies will surely rise in its place, he said.

"If you look back in history in terms of financial bubbles, they always end," he said. "It's going to be a very rough ride for guys that invest in Bitcoin for speculative purposes."

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