

# How Much Bitcoin Would That Be, Sir?

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## WisdomTree

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*We previously explored corporations' bitcoin purchases and the investment management industry's participation as two sources of bitcoin's growing institutional demand driving the past rally.*

*Here, we consider the third aspect of demand – the public's increasing acceptance of bitcoin as payment.*

Invented as a peer-to-peer electronic cash transfer system, bitcoin aims to function as a global decentralized digital currency. It envisioned an efficient and transparent financial system without centralised parties and entitling power directly to participants.

In the current stage of bitcoin's development, some doubt whether it's a mature system to facilitate transactions given its high volatility, scalability issues, as well as regulatory uncertainties, tax complications, and environmental concerns.

But potential developments could help move progress forward.

Companies' growing acceptance of bitcoin for payment could bring wider adoption, and the consequent increase of demands could dampen volatility. Technological advancement such as the lightning network could also improve the system.

## Current Challenges

**Money** is a social construct to conveniently exchange goods. Throughout history, it evolved from shells to fiat currency<sup>1</sup> backed by governments.

The commonality of these forms consists of three aspects: store of value, medium of exchange, and unit of account.

Examining bitcoin's current stage from those three angles raises some doubts if bitcoin can be counted as money:

- **Store of value:** Bitcoin's price fluctuates widely
- **Medium of exchange:** Bitcoin is not yet accepted in many places
- **Unit of Account:** Bitcoin is not a good vehicle to denominate goods given its volatility

The major challenge is volatility, which dictates that it is not a good store of value nor a unit of account. Bitcoin has an annualised volatility of approximately 80%<sup>2</sup> in the past five years. Its drawdowns during sell-offs could also be intimidating.

Regulatory uncertainties and crypto influencers' change of attitude could feed this volatility. Recently, we've seen bitcoin drop drops 40%<sup>3</sup> partly due to Elon Musk suddenly reversing his previous decision to accept bitcoin as payment, citing environmental concerns.

The Internal Revenue Service (IRS)'s current tax guidance also hinders its adoption. Bitcoin is treated as a property rather than a currency, which implies that users need to pay capital gains taxes or recognize tax losses when transacting. This could lead to high tax payments when bitcoin's price is soaring.

From a technical aspect, the system's design poses a challenge to its scalability. Due to bitcoin's inherent block time and proof-of-work mechanism, it could only process up to seven transactions per second, vs. Visa's 65,000. These limitations prevent the network from handling large numbers of transactions, which can result in delays in processing times and increasing transaction fees, making it inefficient and expensive.

All of that holds bitcoin back from being a "digital payment."

Investors have recently focused more on the "digital gold" narrative, treating it as an asset class that could provide inflation protection and portfolio diversification.

Yet, the narrative could shift in the future as the network develops and its adoption accelerates.

### **Payment Platforms' Participation**

Payment platforms such as Square, PayPal, Visa, and Mastercard are expanding their cryptocurrency businesses as bitcoin becomes mainstream. By participating in the crypto space, they hope to grow their revenue and leverage their existing infrastructure to form an integrative crypto ecosystem.

With these companies' participation making access easier, bitcoin could draw more usage from the public. The increase of usage could potentially support bitcoin's substantiation as a currency and lead to the stabilisation of its price.

Payment platforms engage with cryptocurrencies in two major ways: providing cryptocurrency trading services, and facilitating payment with cryptocurrencies. The latter is worth particular attention as it enables cryptocurrencies to function as money.<sup>5</sup>

Square – a payment service that allows users to transfer money to one another (like Venmo) – expanded its Cash App to include bitcoin in 2018.

The success of Cash App indicates the service's high demand. In Q1 2021, Cash App generated a revenue of \$3.5 billion related to its bitcoin services, or 11x growth YoY.<sup>6</sup>

Source: <https://www.theblockcrypto.com/post/104136/square-reports-3-51-billion-in-bitcoin-revenue-via-its-cash-app-for-first-quarter-of-2021>.

**Historical performance is not an indication of future performance and any investments may go down in value.**

In November 2020, PayPal established its crypto selling and buying services. In March 2021, it started letting users pay with selected cryptocurrencies via its “Checkout with Crypto” service, seamlessly like using a credit card or debit card.

### **Visa and Mastercard**

Visa and Mastercard partnered with various digital platforms to roll out debit and prepaid cards, which allow customers to pay with selected cryptocurrencies. These partners help convert cryptocurrencies to fiat when processing the payment. Going forward, Visa and Mastercard will focus on allowing direct settlement of stablecoins and Central Bank Digital Currencies (CBDC).<sup>8</sup>

### **The Lightning Network**

Bitcoin developers are working on a solution to solve its scalability problem – adding a second layer protocol on top of bitcoin called the lightning network. It carries transactions off-chain, allowing users to send instant payments and conduct micropayments (i.e. payment in small amount).

The lightning network was introduced in 2017 and it has been adopted by major crypto exchanges such as Kraken and OKEx. It now has 10,000 active nodes<sup>9</sup> and holds around \$69M in value.<sup>10</sup> If widely supported, it could scale the transaction process, making it faster and cheaper.

### **The Beginning of a New Trend**

The idea of a decentralized currency is an exciting one, and bitcoin’s invention gives possibilities to a more efficient and transparent financial system.

Right now, we are at the early stage and the system is being put to the test. More participants are riding this trend: Microsoft, Yum Brands (KFC in Venezuela accepts bitcoin), Landry’s restaurants (including Mastro’s)...

As PayPal’s CEO Dan Schulman mentioned, we are at “a transitional point where cryptocurrencies move from being predominantly an asset class that you buy, hold and or sell to now becoming a legitimate funding source to make transactions in the real world at millions of merchants.”<sup>11</sup>

<sup>1</sup> A fiat currency is a national currency that is not pegged to the price of a commodity such as gold or silver. The value of fiat money is largely based on the public’s faith in the currency’s issuer, which is normally that country’s government or central bank.

2 Glassnode.

3 WisdomTree, Glassnode.

4 <https://www.comp.nus.edu.sg/~prateeks/papers/Bitcoin-scaling.pdf>,  
<https://usa.visa.com/dam/VCOM/global/about-visa/documents/visa-fact-sheet-july-2019.pdf>

5 However, most of the payment options offered now do not allow direct settlement. Instead, cryptocurrencies need to be converted to fiat currency to be used.

6 <https://www.sec.gov/Archives/edgar/data/1512673/000119312521153261/d180447dex991.htm>

7 [https://s27.q4cdn.com/311240100/files/doc\\_financials/2020/q4/Square\\_4Q20-Earnings-Shareholder-Letter.pdf](https://s27.q4cdn.com/311240100/files/doc_financials/2020/q4/Square_4Q20-Earnings-Shareholder-Letter.pdf)

8

<https://usa.visa.com/visa-everywhere/blog/bdp/2021/03/26/digital-currency-comes-1616782388876.html>

<https://www.mastercard.com/news/perspectives/2021/why-mastercard-is-bringing-crypto-onto-our-network/>

9 A computer which hosts and synchronises a copy of the entire Bitcoin blockchain.

10 <https://www.coindesk.com/bitcoin-lightning-network-10k-active-nodes>

11 <https://www.reuters.com/article/us-crypto-currency-paypal-exclusive/exclusive-paypal-launches-crypto-checkout-service-idUSKBN2BM10N>

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