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Internet Currencies and National Security

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An established financial system is critical to states and their citizens in all areas of life, and it is one of the characteristics of sovereignty. The development of means of payment and financial systems outside the control of states arouses much interest, including with reference to national security, in both the narrow and broader senses of this term. The issues include funding terrorist activity, raising capital by organizations committing terror and sabotage, bypassing sanctions, making secret payments for sensitive and prohibited materials and technologies (nonconventional WMD, surface to surface missiles, cyber capabilities), undermining established financial systems, interfering with tax collection, committing cyber and ransom crimes, laundering money, paying bribes, and damaging public funds. This article deals with this aspect of the phenomenon of virtual decentralized currencies, such as Bitcoin, Atrium, and others (hereafter: "internet currencies").

Internet currencies are based on an advanced technology – "blockchain" - which enables them to exist on a secure internet network, in encrypted form, with no supervision by governments or central banks. Supporters of internet currencies point to their basic advantages compared to national currencies: they can be used for fast, reliable, and continuous money transfers at any time, without the intervention of a central entity. Proponents are encouraged by the growth of bitcoin usage in several countries, representing the breakthrough of virtual decentralized currencies. For example, since April 2016 Japan has recognized bitcoin as an official means of payment, and in December 2017, Chicago launched a "futures" market in Bitcoin. At the same time, senior economists around the world and heads of financial systems generally believe that investing in Bitcoin (and similar currencies) is a speculative gamble and that their rise in value relative to state currencies is simply a bubble.

There are several parameters regarding virtual currencies: the various types of decentralized virtual currencies (internet currencies), the phenomenon of internet currencies itself, virtual currencies in general (not only decentralized), and the new technology. There is broad consensus regarding the innovation represented by the blockchain technology, its value, and its potential future implementations, including within established financial systems and other areas.

Internet currencies can be used to pay for goods and services, conversion to other currencies, and investment. However, public access to and involvement in internet currencies is still low, their status is at this stage unclear, and they are subject to speculative investment. The sharp fluctuation in their exchange rates (against state currencies) makes it hard to see them as useful for commerce. All these factors work to restrain their wider use in business. Some of these features, such as high volatility, could also make it more difficult for hostile elements to exploit them (as described below), although the actual situation in this area is unknown and these features could change in the future. The big test for decentralized virtual currencies, as negotiable currency and as financial instruments, will come when there is regulation in this field, and if and when the behavior of these "currencies" is suitable in terms of stability, accessibility, the quantity of "money," and so on. The question of user confidence is central, and therefore these currencies are very sensitive to risks, such as technical hitches, manipulations, fraud, insider trading, and cyber attacks, which could undermine this trust.

True, internet currencies do not claim to replace state currencies, but even if the phenomenon is realized only partially, it is hard to dismiss the idea that it could deprive states and financial establishments that control the global financial system of their exclusive hold over means of payment, just as the internet deprives states and the media of their exclusive control of information. With the existing systems, it is hard for the state to track "new money" and its usage, so the main risk posed to states by these currencies is the fact of financial activity moving beyond the state's knowledge or reach. This includes the financial activity of terrorist and criminal organizations, which can use virtual currencies to pay their activists, acquire weapons on the black market, buy forbidden substances, launder money, and move money from country to country with no supervision. In the future, this currency system could also be used to bypass sanctions imposed on countries and hostile elements, including the purchase of banned substances and technologies, since it is a separate global financial system that is not controlled by states or banks.

In the long term, if this phenomenon spreads and is not regulated, it could also have implications for internal stability. These extra-state systems could enable private and business elements to operate outside the reach of state institutions within their own countries, or even without their knowledge, to avoid paying taxes, to take money out of bank accounts, and so on. These actions could also be done by individuals seeking to maintain the value of their money in countries where the local currency is subject to decline, where there are severe restrictions on foreign currency transactions, or where there is internal instability. Countries that feel threatened could take various defensive actions, such as banning the use of internet currencies and blocking access to trading sites and "digital wallets."

At present, regulatory bodies such as central banks in the West as well as in Israel appear fairly indifferent to these currencies and their impact on various fields of activity, because they are not a familiar official currency, security, or asset. This phenomenon has apparently exposed a gap in the state regulatory system. Some regulators are not yet worried due to the limited scope of the phenomenon, relative to the vast global extent of commercial markets, capital, and supervised money, and because the internet currency system is separate from the established financial system. For example, on December 13, 2017, US Federal Reserve Chair Janet Yellen said that bitcoin is “a highly speculative asset” and “not a stable store of value,” is solely intended for speculation, accounts for a very marginal part of the payments system, and poses no risks for market stability. In other words, it does not replace the state currency, and if the “bubble” should burst soon, the resulting shockwaves will not be very strong. Nevertheless, it is clear that if the “bubble” continues to inflate, the extent of the damage will rise accordingly. China is following developments closely; in early December, Pan Gongsheng, a deputy governor of the People’s Bank of China, warned investors, saying: “There is only one thing we can do: sit by the river bank and one day we will see bitcoin’s body pass by.” Concern for the implications of bitcoin for the general public has also been expressed in South Korea, where the government is introducing regulation.

Israel is still formulating its position, although it has been aware of the phenomenon for several years. In an open letter of February 2014, the Bank of Israel warned the public about the dangers of using decentralized virtual currencies, and stressed that they were not legal tender, even though they were called “currencies.” The Bank said that “this is an activity with a high-risk factor with regard to money laundering and funding of terror,” since it facilitates anonymous financial transactions that bypass regulated systems. The position of the income tax authorities in Israel is that virtual currencies are not currencies or securities under the laws of the state, and therefore the sale of a virtual currency will be taxed like the sale of an asset, and the profit will be subject to capital gains tax. Shmuel Hauser, head of the Israel Securities Authority, characterized the recent rise in bitcoin rates as a “bubble” and brought up the need for a regulatory position on stock exchange companies dealing with these currencies.

Israel would do well to accelerate the process of deciding on its approach, with an integrated examination of the subject by all the regulatory bodies involved, including cyber teams, and in collaboration with other elements worldwide. At this stage, since the world has not yet reached firm decisions about internet currencies, state authorities should adopt a conservative approach. If the dangers embodied by internet currencies become clear, legislative and enforcement steps at the state level could indeed be an important part of the response. A fundamental solution will require international

consensus. If extensive fraud is discovered, the system will collapse in any case. Yet even now it is important to promote, as much as possible, the formulation of responses to the various risks, including the prevention of "crime and terror funds." It is also advised to make the most of the opportunity provided by the innovative technological aspects of these systems, as this could also make a contribution to established systems.

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