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Digital Currencies: the Tradeoff between Efficiency and Trust

Minimizing volatility in their exchange rates, new forms of digital currencies become viable alternatives to traditional currencies for payments. We develop a model to capture incentives and preferences behind the use of different payment methods in over-the-counter market transactions. Our model features the fundamental tradeoff between (i) welfare gains from lower transaction costs and (ii) costs of setting up the digital technology and trust concerns when using digital currencies. While participants in the digital currency benefit from welfare gains, people lacking trust in the digital currency suffer from fewer trading opportunities and decreased welfare when digital currencies become widely used. The talk is based on joint work with Qianhong Huang (University of Alberta).