

Lesson 18: Bitcoin Architecture

Module 2: Blockchain Fundamentals

Digital Finance

Bitcoin System Architecture



[SYNTHETIC DATA]

Core Components:

- **P2P Network:** Decentralized node communication
- **Blockchain:** Immutable ledger of transactions
- **UTXO Model:** Unspent transaction outputs (like digital cash)
- **Script System:** Programmable transaction validation

Bitcoin remains the largest cryptocurrency by market cap and network security.

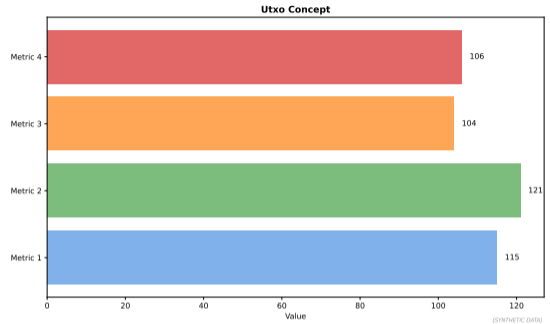
UTXO Model: Digital Cash Analogy

Physical Cash:

- Discrete bills and coins
- Cannot split a \$20 bill
- Give exact amount or get change
- Destroyed when spent

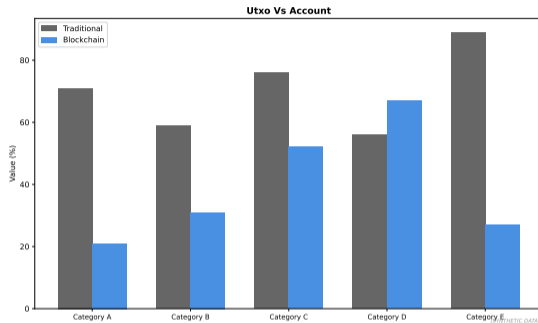
UTXO Model:

- Discrete chunks of bitcoin
- Cannot partially spend UTXO
- Consume entirely, create change UTXO
- Marked as spent, new UTXO created



Source: Protocol documentation and distributed systems research

UTXO vs Account Model



UTXO (Bitcoin):

- Stateless
- Better privacy (addresses change)
- Parallel transaction validation
- No account balances

Account (Ethereum):

- Stateful (balance stored)
- Simple mental model
- Sequential nonces
- Easier for smart contracts

Source: Protocol documentation and distributed systems research

Transaction Structure: Inputs and Outputs

Transaction Structure



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Components:

- **Inputs:** References to previous UTXOs (txid + output index) + signature
- **Outputs:** New UTXOs with amounts and locking scripts
- **Fee:** $\text{Sum}(\text{inputs}) - \text{Sum}(\text{outputs})$

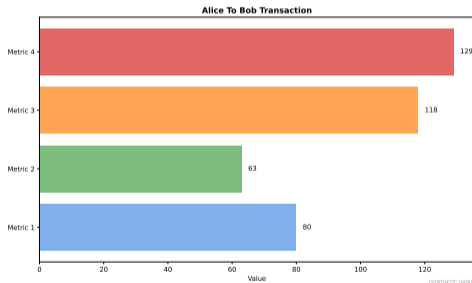
Source: Protocol documentation and distributed systems research

Example Transaction: Alice Pays Bob

Scenario: Alice has 0.5 BTC UTXO, wants to pay Bob 0.3 BTC

Transaction:

- **Input:** Alice's 0.5 BTC UTXO + Alice's signature
- **Output 1:** 0.3 BTC to Bob's address
- **Output 2:** 0.19 BTC change to Alice's new address
- **Fee:** 0.01 BTC ($0.5 - 0.3 - 0.19$)



UTXO model: Alice's UTXO consumed, new UTXOs created for Bob and change.

Transaction Chain



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Key Properties:

- Each transaction references previous outputs
- Creates directed acyclic graph (DAG)
- Double-spending prevented by UTXO tracking
- Validation traces back to coinbase transactions

AI and ML are transforming financial services through automation and prediction.

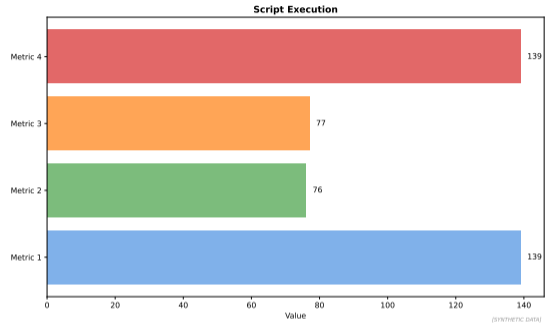
Bitcoin Script: Programmable Conditions

What is Script?

- Stack-based language
- Turing-incomplete (no loops)
- Defines spending conditions
- Executed by all nodes

Script Types:

- Pay-to-Public-Key-Hash (P2PKH)
- Pay-to-Script-Hash (P2SH)
- Pay-to-Witness-Public-Key-Hash (P2WPKH)
- Multisig



Bitcoin remains the largest cryptocurrency by market cap and network security.

Locking Script (scriptPubKey):

```
OP_DUP OP_HASH160 <PubKeyHash> OP_EQUALVERIFY OP_CHECKSIG
```

Unlocking Script (scriptSig):

```
<Signature> <PublicKey>
```

Execution:

- 1 Push signature and public key to stack
- 2 Duplicate public key
- 3 Hash duplicated public key
- 4 Compare hash to stored hash (EQUALVERIFY)
- 5 Verify signature with public key (CHECKSIG)
- 6 Success if top of stack is TRUE

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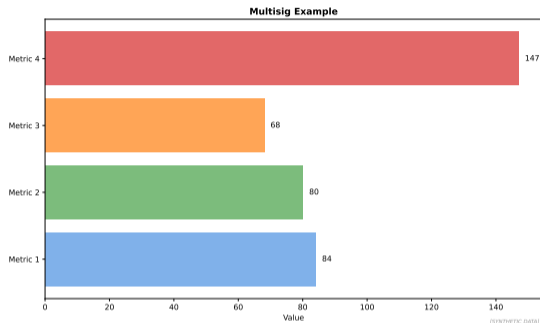
Multisig: M-of-N Signatures

Use Case:

- Shared custody
- Corporate accounts
- Escrow services
- Enhanced security

Example (2-of-3):

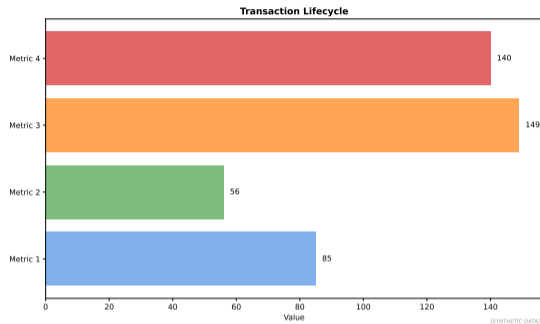
- 3 public keys
- Require any 2 signatures
- Escrow: buyer, seller, arbiter



Script: `OP_2 <PubKey1> <PubKey2> <PubKey3> OP_3 OP_CHECKMULTISIG`

Source: Protocol documentation and distributed systems research

Transaction Lifecycle



Stages:

- 1 **Creation:** User signs transaction
- 2 **Broadcast:** Sent to P2P network
- 3 **Mempool:** Unconfirmed transactions pool
- 4 **Mining:** Miner includes in block
- 5 **Confirmation:** Block added to chain
- 6 **Finality:** 6+ confirmations (~1 hour)

Technology adoption follows predictable patterns—timing matters for investment decisions.

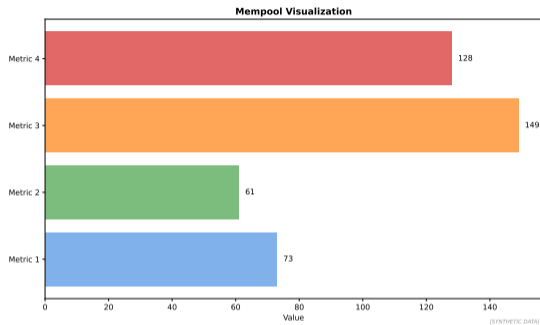
Mempool: Waiting Room for Transactions

Properties:

- Unconfirmed transactions
- Not consensus-critical (each node maintains own)
- Size varies by network congestion
- Transactions ranked by fee rate

Fee Market:

- Higher fee = faster inclusion
- Fee rate: satoshis per byte (sat/vB)
- Dynamic pricing based on demand



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Transaction Fees: Mechanics

Fee Calculation:

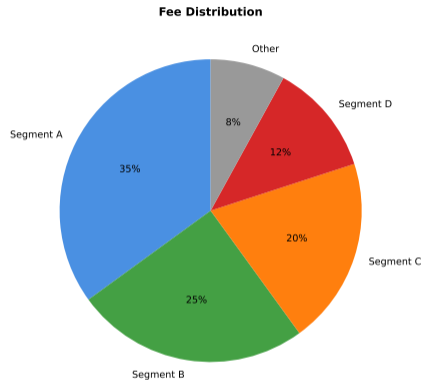
$$\text{Fee} = \sum \text{Inputs} - \sum \text{Outputs}$$

Fee Rate:

$$\text{Fee Rate} = \frac{\text{Fee}}{\text{Transaction Size (vB)}}$$

Example:

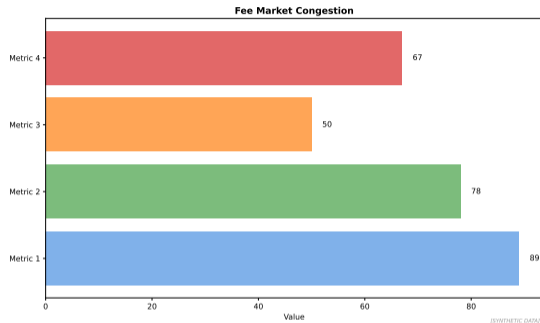
- Transaction size: 250 vB
- Target: 50 sat/vB
- Fee: $250 \times 50 = 12,500 \text{ sat} = 0.000125 \text{ BTC}$



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Source: Protocol documentation and distributed systems research

Fee Dynamics During Congestion



High Demand Periods:

- 2017 Bull Run: Fees $>$ \$50 per transaction
- 2021 NFT Craze: Ordinals inscriptions clog network
- 2024: Runes protocol launch, fees spike to $>$ 1000 sat/vB
- Replace-By-Fee (RBF) and Child-Pays-For-Parent (CPFP) for fee bumping

Source: Protocol documentation and distributed systems research

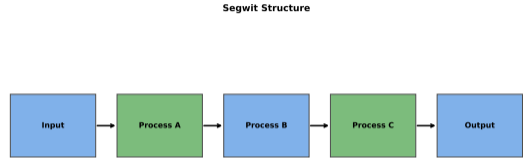
SegWit: Segregated Witness (2017)

Problem:

- Block size limit: 1 MB
- Signature data takes 60–70% of transaction
- Scalability bottleneck
- Transaction malleability

Solution:

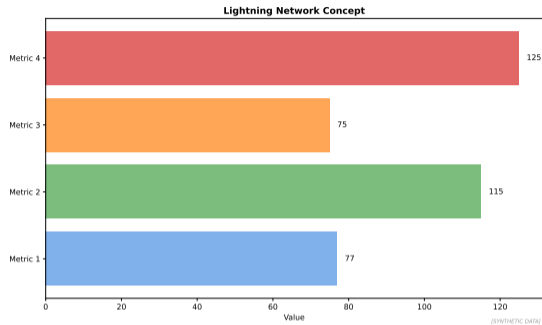
- Separate signature data (witness)
- Witness data not counted toward 1 MB limit
- Effective block size: $\sim 2\text{--}2.5$ MB
- Fixes malleability



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Source: Protocol documentation and distributed systems research

Lightning Network: Layer 2 Scaling



Problem: Bitcoin throughput ~ 7 tx/s, expensive fees, slow confirmations

Solution: Off-chain payment channels, only settle on-chain when closing

Network metrics provide objective measures of adoption and ecosystem health.

Lightning Payment Channel Mechanics

Opening Channel:

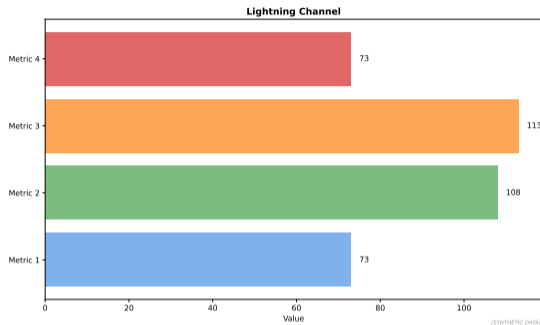
- 1 Alice and Bob create 2-of-2 multisig
- 2 Deposit funds (funding transaction)
- 3 On-chain confirmation

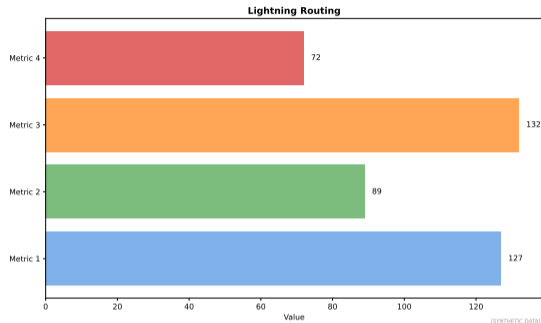
Off-Chain Payments:

- Exchange signed commitment transactions
- Update balances instantly
- No on-chain transactions
- Unlimited throughput

Closing Channel: Broadcast final state to blockchain

Payment systems are critical infrastructure for economic activity.





Multi-Hop Payments:

- Alice wants to pay Dave, no direct channel
- Route: Alice → Bob → Carol → Dave
- Hash Time-Locked Contracts (HTLCs) ensure atomicity
- Routing fees: ~ 1 satoshi per hop

Network metrics provide objective measures of adoption and ecosystem health.

Lightning vs On-Chain Comparison

Aspect	On-Chain (Layer 1)	Lightning (Layer 2)
Speed	10 min average	Instant (milliseconds)
Throughput	~7 tx/s	Millions of tx/s
Fees	\$1-\$50 (variable)	<\$0.01
Finality	6 confirmations (1 hour)	Instant (with channel counterparty)
Trust	Fully trustless	Counterparty risk (can close unilaterally)
Use Case	Large settlements, savings	Micropayments, retail

Source: Protocol documentation and distributed systems research

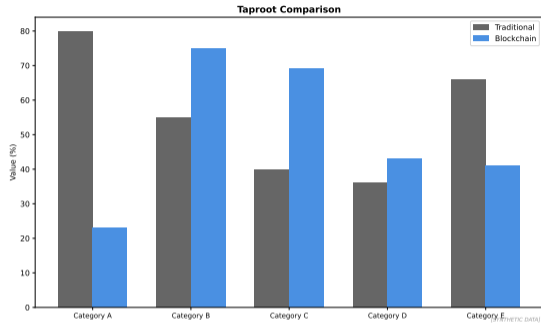
Taproot Upgrade (2021)

Improvements:

- Schnorr signatures (batch verification)
- MAST (Merkalized Alternative Script Trees)
- Enhanced privacy (multisig looks like single-sig)
- More efficient smart contracts

Benefits:

- Lower fees for complex scripts
- Better privacy
- Enables new use cases (DLCs, multi-party protocols)



Source: Protocol documentation and distributed systems research

Bitcoin Full Node

Responsibilities:

- Download entire blockchain
- Validate all transactions
- Relay transactions and blocks
- Enforce consensus rules

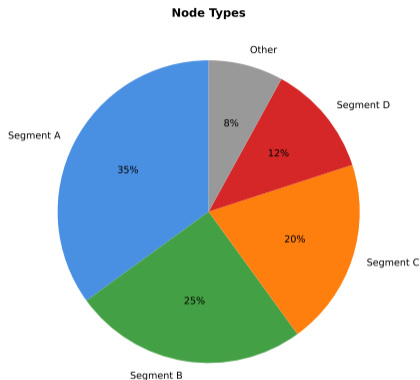
Requirements (2024):

~650-700 GB (Dec 2025)^a

- Bandwidth: ~500 GB/month
- RAM: 4+ GB
- CPU: Modest (validation not mining)

^aSource:

<https://www.blockchain.com/explorer/charts/blocks-size>



[SYNTHETIC DATA]

Bitcoin remains the largest cryptocurrency by market cap and network security. [Source: Blockchain.com, CoinMetrics 2024]

Bitcoin Architecture: Key Takeaways

- **UTXO Model:** Discrete outputs, like digital cash, stateless validation
- **Transactions:** Inputs (previous UTXOs) + Outputs (new UTXOs) + Fee
- **Script:** Stack-based language defines spending conditions (P2PKH, multisig)
- **Mempool:** Unconfirmed transactions, fee market determines priority
- **SegWit:** Separated witness data, increased capacity, fixed malleability
- **Lightning:** Layer 2, instant payments, millions tx/s, minimal fees

Next Lesson: Ethereum and Smart Contracts – from currency to computation

Technical proficiency in defi enables practical application.