Stablecoin Destabilization – why should we care?

Cryptoassets like Bitcoin and Ethereum have gained mainstream attention and are now commonly found in investment portfolios. However, the original vision of a decentralized financial system enabling global, anonymous payments with low transaction fees is fading.

Today, the crypto world is highly centralized, with new financial intermediaries in place. Despite this, cryptoassets continue to push financial technology innovation, leading to regulatory sandboxes being established to nurture crypto businesses.

Two recent financial innovations, stablecoins and Decentralized Finance (DeFi) services, have emerged and are highly intertwined. Stablecoins like Tether or USDC promise to peg to real-world assets like the US dollar or Euro; DeFi leverages cryptoassets to the next level and offers financial functions like exchanging assets, taking loans, or betting on future prices. However, these services are complex and have associated risks that most users and regulators do not fully understand.

But why should we care if the capitalization of the crypto markets is still relatively low, and services are running in a closed sandbox? First, because DeFi introduces leverage to cryptoassets, increasing financial risks. Second, stablecoins are directly tied to traditional currencies, representing an interface between the crypto and the conventional financial system.

Recent events have shown that the impossible is possible: stablecoins can lose their peg, and the collapse of Silicon Valley Bank (SVB) has highlighted the risks associated with these financial instruments. Suppose the Federal Deposit Insurance Corporation (FDIC) had not intervened to provide a safety net for the stablecoin deposits – in that case, the companies behind stablecoins may not have managed to close the missing money gap, which could have caused a crypto-induced bank run.

As the interface between the crypto and traditional financial systems becomes more intertwined, careful monitoring is required to ensure that risks and damages remain within the cryptoasset space and do not affect users in the traditional financial system. A better understanding of stablecoins and the complexity of emerging financial services would be a good starting point for informed decisions and policy-making.

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