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Can stablecoins bring major disruption to the financial system?

Tristan PERRIER,
Global Views

More directly than other types of cryptocurrencies, the rapidly growing stablecoins may soon bring new opportunities and risks to payments and finance. Regulatory authorities are preparing to respond, yet the stakes are complex and not the same in all countries.

Stablecoins have been a rising topic in 2021

Stablecoins, referred here as those of the currently largely unregulated cryptocurrencies that, through various means[1], maintain a quasi fixed parity with a conventional currency[2] (most often the USD) have been attracting growing attention for several reasons:

Rapid growth

- **While the total market capitalisation of stablecoins remains moderate, at around USD 130bn in October 2021, it is increasing at a very rapid rate**. Their overall capitalisation was only 30bn in January 2021.
- **Stablecoins only represents roughly 6% of the total cryptocurrency market cap, yet account for a much larger share in terms of transaction volume**: Most cryptocurrency trades involve a stablecoin on one side, with Tether, the largest stablecoin, being also the most traded cryptocurrency (ahead of Bitcoin).

Signs that their use may soon extend to the broader economy

- **So far, the main role of stablecoins has been to facilitate cryptocurrency trading**, allowing market participants to stabilise the value of their investment in USD terms, without having to move funds out of the cryptocurrency ecosystem.
- **However, if used for other purposes, stablecoins can offer many practical advantages over bank deposits**: they are accessible via easily set-up digital wallets, are well adapted to peer-to-peer transactions, provide quasi-instantaneous 24/7 settlement and are well suited to interact with innovative fintech applications. While some stablecoin transactions may be difficult to trace by public authorities (although they do not offer absolute anonymity), their ease of use could also make them a tool for financial inclusion of currently unbanked population groups. Stablecoins, more than other fluctuating cryptocurrencies, may thus be seen, for better or worse, as the most imminent competitors to conventional money.
- **Against this backdrop, recent partnership announcements between stablecoin issuers and major players of other sectors** (notably Paxos with Paypal, or the inclusion of stablecoins issued by Paxos and Circle in the Novi digital wallet recently launched by Facebook[3]) hint at the possibility that stablecoins soon become mainstream instruments for money transfers and purchases of services, goods, and noncrypto assets.

Stablecoins can be very practical tools for many types of transactions

Potential new risks to the financial system

- **As competitors of bank deposits, stablecoins could, in theory, have an adverse effect on banks' credit distribution capacity**, although there are many, yet complex, ways such risks could be circumvented (for instance through changes in bank regulatory ratios, an adaptation of central bank financing or various forms of cooperation between stablecoins issuers and banks).
- **Yet it is also easy to think of circumstances where, if seen as relatively safe, stablecoins could act as magnets for destabilising money runs**, be it in a purely domestic crisis (if holding money in banks were seen as unsafe) or in one with cross border implications (if the citizens of a country with a fragile currency preferred to hold easily accessible foreign, presumably USD-pegged, stablecoins).
- **Conversely, the failure of a large stablecoin could generate a financial shock:** its sudden inability, for whatever reason, to maintain its targeted parity would cause large losses to its holders (until now, such

[1] *These means are usually either 1/(most often for large stablecoins) partial or total collateralization by assets such as cash, cash equivalents, commercial papers and government securities 2/(for many, although not all, minor stablecoins) a combination of overcollateralization by various assets (including other cryptocurrencies) and algorithmic mechanisms that adjust the stablecoins' supply and attempt to guide market participants' expectations.*

[2] *Other fixed parity digital assets are sometimes referred as stablecoins even though they are not usually considered cryptocurrencies: That can be the case, notably, for bank stablecoins, that are claims on the bank issuing them and, thus, digital equivalents of conventional bank deposits.*

[3] *Facebook has also been working on its own stablecoin project, which initially attracted a lot of attention. However, after several delays, its launch date remains unclear.*

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a situation has mainly been seen as a risk for the sole cryptocurrency market, but it could directly hit the broader financial system if many non-specialist participants held stablecoins). In this respect, note that a number of small stablecoins have already failed and that Tether's large holdings of commercial papers (with undisclosed details) recently raised questions over whether it had exposure to the troubled Chinese real estate giant Evergrande (which Tether has denied).

Growing regulatory push

Public authorities have therefore well identified the regulation of stablecoins as one of the most pressing tasks within their ongoing broader cryptocurrency regulation efforts.

A large stablecoin failing to maintain its peg could cause a financial shock

- **The ECB issued a report on the topic in September 2020** (when stablecoins were much smaller than they are today), **but concerns accelerated in the US at the end of summer 2021** with both Treasury Secretary J. Yellen and Fed Chairman J. Powell calling for swift action on stablecoin regulation[4].
- **The IMF, which devoted a section of its last Global Financial Stability Report to cryptocurrencies, stressed the risk that a troubled stablecoin could conduct a fire sale of its assets,** bringing contagion to other markets (notably commercial paper).
- **Stablecoins have also been mentioned by central bankers as a major reason to develop their own digital currencies (CBDCs)[5]** (which, depending on their architectural choices, could offer some of the same advantages as stablecoins, but without credit risk).

Regulation will mitigate some of the risk, but the stakes are complex

In most cases, authorities are much more likely to regulate stablecoins than ban them as they cannot ignore the fact that, despite the risks, stablecoins offer many practical advantages and can support financial innovation, generally seen as promising in terms of income, development of new skills and jobs. Yet, how exactly they will be regulated is still unclear.

Stablecoins may be vectors of dollarisation

- **A focus will most certainly be on imposing KYC (*Know-Your-Customer*) procedures and transparency on the assets held by stablecoins issuers to maintain the pegs.** Further steps will likely involve more alignment of stablecoins and their issuers' obligations and rights with those of money market funds, banks and bank deposits.
- **However, the large dominance of USD-pegged stablecoins also means that the stakes are not exactly the same in the United States and in other countries.** From the US perspective, while stablecoins do raise domestic challenges, they may also be vectors to consolidate the global influence of the USD. Moreover, with little foreign threat to the status of the USD on their domestic territory, US authorities feel less pressure than others to quickly develop a CBDC[6]. They may then well find strong arguments in favour of letting stablecoins grow: valuable insight into people's attitude towards digital money can thus be acquired, while private sector stablecoin technology can be experimented with a view to subsequent application to a CBDC. This, however, would only apply to stablecoins that would be well regulated and cooperative with US authorities, leading some observers to hint that US authorities may currently have more a Tether problem (Tether being issued by a Hong Kong based company and subject in 2021 to fines by several US authorities for lack of transparency) than a lasting problem with all stablecoins issuers.
- **In the case of other countries, however (although to very varying extents), USD stablecoins do bring with them, among other challenges, some risk of dollarisation.** Local authorities are therefore likely to face more pressing decisions than their US counterparts. These choices can be either tight regulation, active fostering of stablecoins pegged to local currencies, acceleration of CBDC programmes or acknowledgement that at least a limited dollarisation in niche sectors need be accepted so as to reap the practical benefits of stablecoins and the innovation they bring.

All in all, given the complexity of the assessment, by public authorities, of the balance between the many threats and opportunities presented by stablecoins, it is unlikely that their current development will soon be brought to a sudden stop. The most likely outcome is that stablecoins will continue to grow and find new uses, both as an asset class and means of payment, with regulation making progress yet nonetheless struggling to keep pace with the rapid changes brought by these newcomers to the financial system.

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[4] *At the time of writing the press was reporting that the US Treasury and other agencies would soon publish a report on stablecoins and their necessary regulation.*

[5] *Fed Governor Lael Brainard notably made this point several times this year.*

[6] *On 14 Jan 2021, J. Powell mentioned that the Federal Reserve felt no "need or urge to be first" in developing a CBDC. Among the justifications he provided for this patient approach was the first mover advantage given by the US dollar reserve currency status.*

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