Overview of stablecoins

Cryptocurrencies present life-changing opportunities to investors, but are subject to volatility. On the other hand, stablecoins, as the name suggests, provide a degree of measurable stability in uncertain economic times. In this piece, we'll explore the different ways in which stablecoins seek to achieve a fixed price and look at the potential that they offer to the savvy trader.

Defining stablecoins

Anyone with a basic working knowledge of cryptocurrency will be familiar with the market fluctuations and roadblocks associated with this technology. However, what sets stablecoins apart from other digital currencies is that they are designed to be used as a unit of account and even as a store of value. These digital tokens are pegged to another stable asset, like gold or the US dollar.

Stablecoins: A blueprint for the future?

To fully understand the potential that this digital currency holds, we first have to understand the capabilities of blockchain technology and the promise that it holds.

Many of the financial services we rely upon are controlled by centralized institutions that also yield a great deal of control over the economy. Blockchain is a distributed technology that is independent of any party and provides a truly secure, transparent and stable platform. Cryptocurrencies are the digital tokens that are based upon the digital ledger that is the blockchain, but they are far from foolproof, and have been subject to frequent spikes, crashes and coin splits.

This could potentially hinder the widespread adoption of systems that are built upon cryptocurrency protocols. If businesses are unable to use it for everyday transactions or capitalise on market trends because the underlying cryptocurrency deviates significantly in a short period of time, then it will always be viewed as a speculative investment. For example, few people would buy their groceries with a Bitcoin if they believed the Bitcoin would drastically increase in value in just a few months.

For some, stablecoins represent a new ray of hope in a world where many believe that there is no such thing as stable money.

These trustless, global tokens have low volatility against the world's most important national currencies and are therefore a far more attractive prospect to investors that could potentially pave the way for mass adoption. However, there are several different types of stablecoin and not all of them offer the same measure of stability. We explore these in more detail below.

Non-Collateralized

Non-collateralized stablecoins as the name suggests, are stablecoins that are not backed by any fiat currencies or commodities. Instead they are sustained by the expectation they will maintain a certain value. They require continual network growth in the form of new investors who can provide capital in the event that the currency value depreciates. The seigniorage shares method is one of the most common types of stablecoin that falls under this category. It is algorithmically governed by smart contracts that expand and contract the supply of the non-collateralized stablecoin in very much the same way that banks do. Central banks regulate traditional currencies in a similar fashion, but stablecoins, for the most part, do this in a decentralized way.

Here are some of the stablecoins that fall under this category:

Basis

Basis is a stablecoin with an algorithmic central bank. It works by adjusting supply depending on market demands. When the demand rises, more Basis is created on the blockchain, which brings the price of it back down. However the blockchain buys back more Basis when demand falls. If coins are traded for less than $1, coin holders can buy bonds and the coins used to buy those bonds are destroyed. Supply decreases and the price increases.

The advantage of Basis is that no collateral is needed to invest in this stablecoin, and it can be used as a medium of exchange to anyone with an internet connection. However, this is also its weakness. The stablecoin is not backed by any other asset, so much of its stability is dependent upon faith in the protocol.

Fragments

Fragments is an algorithmic reserve and monetary supply policy for creating low volatility Ethereum standard tokens. It stabilizes its purchasing power by increasing and decreasing the supply of its USD Fragments token in response to demand. When demand increases, it capitalizes a reserve and then splits and distributes those tokens into wallets. When demand falls, the reserve automatically purchases tokens and removes them from the supply in exchange for bonds.

The stability of this token is managed autonomously and this provides the advantage of quick adaptability. However, one of its major pitfalls is that token holders get very little say in the decision-making process when there is a significant price drop. This means that the success of the token is dependent upon people holding onto their tokens in the long-term.

Crypto-collateralized

Crypto-collateralized stablecoins are backed by cryptocurrency reserves. It takes a much more decentralized approach than fiat collateralized tokens. Users deposit crypto assets into a smart contract and then receive a certain amount of stablecoins. Instead of backing units

of a stablecoin 1:1 with fiat, crypto-collateralized stablecoins hold a ratio greater than 1:1 of a cryptocurrency (or a basket of cryptocurrencies). These types of stablecoins issue units of a stablecoin supported by the cryptocurrency held.

MakerDAO

Dai is the decentralized token that MakerDAO uses and it is backed by Ethereum's Ether. It uses a system of smart contracts and price oracles built on the Ethereum platform to regulate the price of Dai creation and therefore the value of Dai. When the price of Dai is too low, the base price increases. It decreases when the price of Dai is too high. The system regulates the cost of creating more Dai relative to demand in an attempt to balance its price.

When the price of Ethereum decreases, MakerDAO liquidates ETH collateral in anticipation so the value of Ether backing Dai doesn't drop below 1:1.

It was one of the first stablecoins in the blockchain space, which means it is well-established and this gives it a first mover advantage. However, its complex protocol and slow-moving system means that investors will need to be highly knowledgeable and experienced with stablecoins in order to benefit from it.

Collateralized by fiat

Fiat stablecoins are backed by a regular currency such as the US dollar or Euro.
Reserves are held by a central entity and deposits are taken in US dollars or another viable currency by that third party. A stablecoin is issued for every dollar deposited.

Some of the best known fiat-backed stablecoins include Tether and TrustToken.

Tether

Tether is one of the 10th largest cryptocurrencies, it reflects the value of the US dollar and it was designed to be used in the same way as US dollars. It converts cash into digital currency, to anchor or "tether" the value of the coin to the price of the national currency. Its token is known as USDT and for every USDT there is one US dollar stored as a reserve in Tether's bank account.

As a well integrated and established stablecoin, traders can benefit from the stability of investing in a cryptocurrency that comes close to a 1:1 exchange from fiat to crypto. The major drawback of Tether however is that it is highly centralized, it is not trustless and has in the past refused audits, which has created a fair bit of controversy in the past.

TrustToken

TrustToken is a platform for creating stablecoins or cryptocurrencies pegged to tokenized assets. It launched an ERC20 token in March 2018 called TrueUSD. On this platform, US dollars are held in the bank accounts and fiduciary institutions of multiple trust companies

that have signed escrow agreements, rather than in a bank account controlled by a single company.

Its aims are to make it quick and easy for users to redeem their trust tokens and the equivalent amount of US dollars are sent directly to the user's bank account. It is also audited on a regular basis, which helps to provide a degree of stability for users.

However, the audits are not fully presented and it is highly centralized as it relies upon banks to act as an intermediary. This contradicts the principle of a fully free and decentralized currency. Moreover, all of these factors could potentially pave the way for legal claims from centralized authorities in the future.

Commodity-collateralized

These types of stablecoins are backed by physical assets such as gold and even oil or other commodities. They make it possible to purchase these commodities by providing a digitized version of those assets so that the investor does not have to physically own or store it.

DigixDAO

An example of a commodity-collateralized stablecoin is DigixDAO. It has two cryptocurrencies, Digix Gold (DGX) and DigixDAO (DGD). The stablecoins are backed by bars of gold. Although DGX can be redeemed for gold, this is not the case with DGD. Instead, DGD allows users to vote for proposals submitted that will grow the Digix ecosystem.

The DGX tokens comes with two sets of fees associated with storing and securing gold. There's a demurrage fee that comes out to be 0.60% annually and also a 0.13% transaction fee when transferring DGX with an Ethereum wallet.

One of the main advantages of DGX is that its price will not move unless the price of gold does. However, the gold is stored in third-party vaults Singapore, which could potentially create a security risk, because it does not have the same lengthy history of democracy and neutrality compared to many Western political systems. This means that the stability of assets stored in Singapore may not always be as secure. DGX tokens are within the Ethereum EIP20 format. Transactions are made with Ethereum, which are subject to the same volatility as traditional cryptocurrencies.

Collateralized by gold

USDV stablecoin

This type of stablecoin is backed by USD Vault (USDV), a gold-backed ERC-20 stablecoin that is pegged 1:1 to the US dollar. The tokens are fully backed by gold bullion stored in Swiss vaults. Unlike stablecoins that are backed by commodities, investors are able to buy into USDV tokens instead of volatile coins like Bitcoin or Ethereum.

One of the major advantages of the USDV stablecoin is that it allows investors to store funds during periods of instability. The fact that it is backed by gold gives it an additional measure of security against volatility.

Conclusion

Stablecoins represent the next evolution of digital currency. Regardless of which category they fall into, it is clear that they provide a much greater degree of stability than traditional cryptocurrencies, which are subject to significant fluctuations and volatility.

However, not all stablecoins are created equal. For example, some stablecoins are not backed by anything, so their value is based purely upon perceived value. As such it has the highest vulnerability to cryptocurrency market crashes. In the event of a crash, liquidation would be impossible. The same is true for stablecoins that are backed purely by other cryptocurrencies. They are also less stable in comparison to asset-backed stablecoins and their longevity is dependant upon the performance of the cryptocurrencies they are based on.

By far, the greatest promise is from stablecoins that are backed by commodities such as gold. However, only the discerning investor can yield any benefits from these types of stablecoins in the long-term. This is because while stablecoins such as the DGX are backed by valuable assets such as gold, they require a trusted custodian to keep those reserves secure. Moreover, if those stablecoins are partially backed by Ethereum, then once again, the investor is exposed to a greater level of risk.

It is clear therefore that gold-backed stablecoins such as USDV, which are pegged to the US dollar offer the greatest measure of security. In effect you've got the best of both worlds: you have a cryptocurrency that is backed by one of the most secure currencies and the most valuable commodities in the world. The US dollar is the world's standard exchange currency for the majority of the worlds transactions, while gold has always maintained its value over the long-term.

If that gold is then stored in secure, physical vaults in a country such as Switzerland, which has a history of neutrality, then the risks are minimal in comparison to the potential returns. This makes it possible for investors to benefit from the stability of the dollar while still holding a cryptoasset that can be instantly traded for an alternative token. It also opens a door for those who can't access fiat currency due to the political climate. So for any trader wishing to invest in stablecoins, then USDV is the best place to start.