The Stablecoin Paradox

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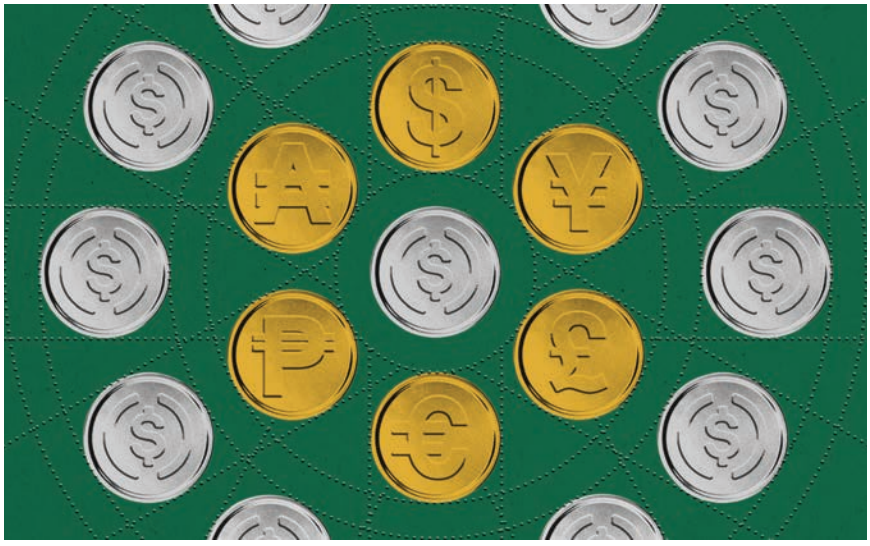
Stablecoins may concentrate financial power and reinforce the current structure of the international monetary system



Crypto's early revolutionaries intended to end the choke hold of central banks and large commercial lenders on financial intermediation. The great ambition of the original crypto asset, Bitcoin, and the blockchain technology that underpins it, was to cut out the middlemen and connect transacting parties directly.

The technology was meant to democratize finance by giving everyone, the poor as well as the rich, easy access to a broad range of banking and financial services. New insurgent providers would use the technology to offer competitive financial services—including bespoke products for managing savings, credit, and risk—without setting up expensive brick-and-mortar operations. All this was meant to sweep out the old financial institutions, which had forfeited people's trust during the global financial crisis, and build a new financial order in their place. Competition and innovation would flourish in this brave new world of decentralized finance. Consumers and businesses alike would benefit.

But the revolution was soon subverted. Decentralized crypto assets like Bitcoin, which are essentially created and managed by computer algorithms, proved untenable as mediums of exchange. Their volatile values and inability to process a large volume of transactions cheaply made them impractical for everyday use and led them to fail in their intended purpose. Instead, Bitcoin and the rest have become what they were never intended to be—speculative financial assets.

Stablecoins stepped in to fill the void by serving as more reliable mediums of exchange. They use the same blockchain technology as Bitcoin but maintain a stable value by being backed one-to-one with reserves of central bank currencies or with government bonds.

Stablecoins are facilitating decentralized finance, but they are the antithesis of decentralization. They don't rely on decentralized trust mediated by computer code but rather on trust in the institutions that issue them. Governance isn't decentralized, with users deciding the rules through public consensus, either. Instead, the firm that issues a stablecoin decides who can use it and how. Stablecoin transactions are posted to digital ledgers maintained on a decentralized network of computer nodes, the same as Bitcoin. But the stablecoin issuer, rather than a computer algorithm, validates these transactions.

Payment pathway

Perhaps the larger objectives are more important. Stablecoins could still serve as a pathway for people of all income levels to access digital payments and decentralized finance, undercut the privileges long enjoyed by stodgy commercial banks, and level some aspects of the playing field between richer and poorer nations. Even a small country could benefit from easier access to global finance through integration with payment systems with fewer frictions.

And stablecoins have indeed lowered costs and removed frictions in payments, particularly those that cross national borders. Economic migrants can send remittances to their home countries far more easily and cheaply than before. Importers and exporters can complete transactions with foreign counterparts

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Illustration by Chantal Jahchan

instantaneously rather than having to wait for days.

Yet beyond payments, decentralized finance has become an arena for financial engineering that has spawned complex products of dubious value for anything other than speculation. Decentralized finance activities have hardly improved the lot of indigent households and could even hurt less sophisticated retail investors who get duped by the prospect of outsize returns and don't appreciate the risks.

Shift in regulation

Will recent US legislation that permits a broad range of corporations to issue their own stablecoins promote competition and check less savory issuers? In 2019, Meta tried to create its own stablecoin, called Libra (later renamed Diem). But the project was halted in the face of fierce opposition from financial regulators, who feared that such a stablecoin could undermine central bank money.

A shift in the regulatory climate in Washington, with a new crypto-friendly administration, has now opened the door wide for private stablecoin issuers. Stablecoins issued by large US corporations, such as Amazon and Meta, backed by their sizable balance sheets, could sweep away other issuers. Minting stablecoins would ramp up the power of these corporations. It would lead to more concentration not more competition.

Large commercial banks are also adopting some aspects of the new technologies to make their operations more efficient but also to extend their reach. Turning bank deposits into digital tokens allows them to be transacted on blockchains, for instance. It's conceivable that large banks could one day start issuing their own stablecoins. All of this would undercut the advantages of smaller banks, such as regional and community lenders, and entrench the power of the big players.

International dominance

Stablecoins are also likely to reinforce the current structure of the international monetary system. Dollar-backed stablecoins are in the greatest demand and most widely used around the world. They could end up indirectly boosting dollar dominance of the global payment system and weakening potential rivals. For instance, Circle, a company that issues the second most popular stablecoin, USDC, has seen little demand for its other stablecoins, whose values are pegged to other major currencies such as the euro and the yen.

Even major central banks are rattled. Concerns that dollar-backed stablecoins could be used for cross-border payments is pushing the European Central Bank to issue a digital version of the euro. The euro area's payment system within its own perimeter is still fragmented. It's possible to move money from a Greek to a German bank, but making a payment in one euro area country using money from a bank account in another is still not seamless.

Stablecoins pose an existential threat to the currencies of smaller economies. People in some corners of the developing world are likely to trust stablecoins issued by well-known companies such as Amazon and Meta more than local currencies that have suffered from high inflation and have volatile exchange rates. Even people in a well-managed economy with a trusted central bank might find it difficult to resist the temptation of using stablecoins that are convenient for both domestic and international payments and whose value is pegged to the dominant global currency.

Many inefficiencies

Why have stablecoins gained so much traction so quickly? One reason is that high costs, slow processing times, complicated processes, and other inefficiencies still bedevil international and even domestic payments in many countries. Some countries are contemplating issuing their own stablecoins to prevent their domestic currencies from being sidelined by dollar-backed stablecoins. This approach is unlikely to succeed. They would be better off fixing problems in domestic payment systems and working with other countries to remove frictions in international payments.

Stablecoins appear safe but pose a variety of risks. One is the possibility that they could lubricate illicit financial activities, making it harder to police money laundering and terrorism financing. Another is that they threaten the integrity of payment systems by creating a disparate set of systems managed by private corporations.

Fixing the problems

The solution seems obvious: effective regulation that tamps down the risks, leaves space for financial innovation, and ensures fair competition by curbing excessive concentration of economic power in the hands of a few companies. The internet knows no borders, so regulating stablecoins at the national level won't work as well as a cooperative approach that involves all countries.

Alas, this is an unlikely outcome at a time when international cooperation is in short supply, with each country aggressively protecting and promoting its own interests. Even major economic powers such as the US and euro area are going their own way on crypto regulation. Even with a more coordinated approach, smaller economies are unlikely to have a seat at the table. These countries, with weaker financial systems, limited regulatory capacity, and a lot more riding on sound regulation, could be hit with rules that pay little attention to their concerns, foisted on them by the larger powers.

Stablecoins are serving a useful purpose by shining a light on the inefficiencies that pervade existing financial systems and showing how innovative technologies can fix these problems. Yet stablecoins might well lead to a world where power is more concentrated. And that might foster a new financial order—not of flourishing innovation and competition and a fairer distribution of financial power as crypto's pioneers intended, but of even greater instability. F&D

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