Stablecoins - strong and stable?

Cryptosceptics often point towards the wild price fluctuations of the likes of bitcoin as a reason why crypto assets cannot perform money-like functions: the store of value, a means of payment and a unit of account. However, the increasing popularity of stablecoins could quell these concerns.

What are stablecoins?

A recent ECB occasional paper defined stablecoins as: 'digital units of value that are not a form of any specific currency (or basket thereof) but rely on a set of stabilisation tools which are supposed to minimise fluctuations of their price in such currency(ies)'. Having minimised price fluctuations, there is a strong argument that stablecoins can indeed be a store of value, means of payment and a unit of account.

Why are they important?

Stablecoins were originally introduced to protect cryptoassets from volatility. However, there has also been a more recent trend of using stablecoins to protect against foreign exchange risk as well as providing opportunities to 'bank the unbanked'

According to an ECB occasional paper titled 'In search for stability in crypto-assets: are stablecoins the solution', published in August 2019, there are over 54 stable coin initiatives in existence. At present there is a market capitalisation of operation activities of €4.3 billion, which is almost three times its level in January 2018.

It is safe to say that there is certainly a growing demand for stablecoins.

Is it going anywhere?

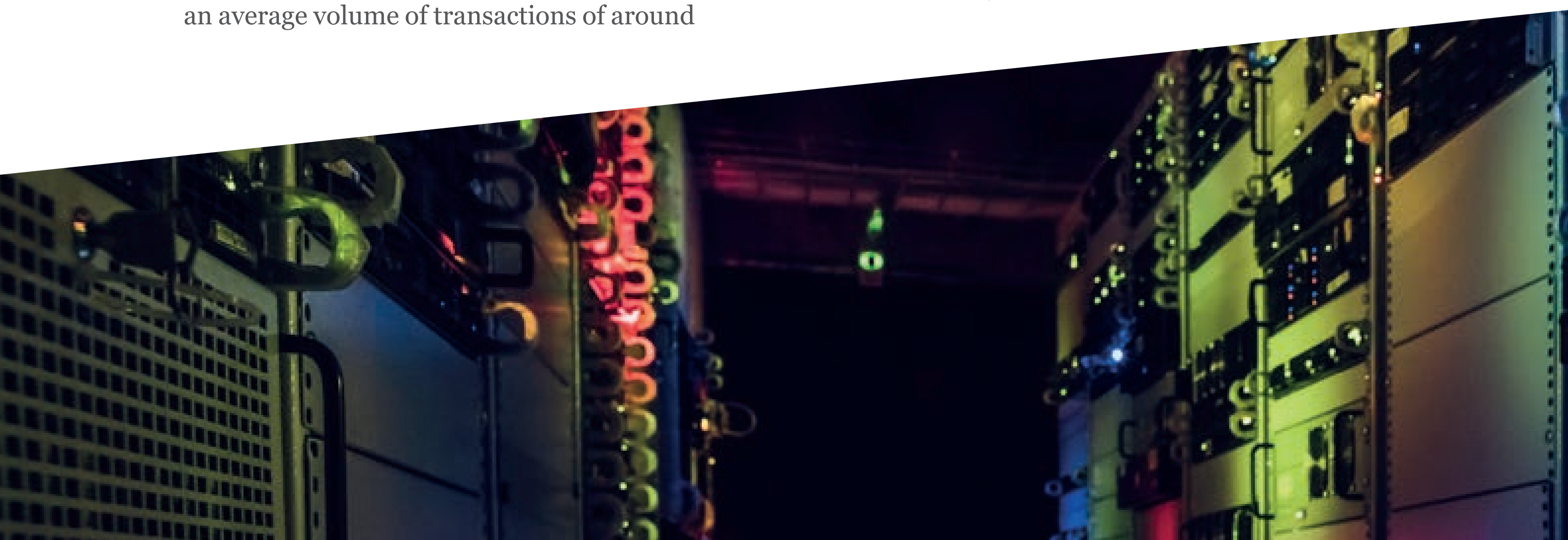
Notwithstanding its apparent growing popularity, some fundamental concerns have been raised. Can stablecoins deal with the volume of transactions that will be required of them if they are to become mainstream? Stablecoins currently operate with an average volume of transactions of around €13.5 billion per month, but Europe alone sees in excess of €44 trillion go through retail payment systems every year. Over 50% of stablecoins use the Ethereum network, which can only process 15 transactions a second; this will inevitably inhibit stablecoins' ability to scale up.

There is also the matter of reach. The crypto space still continues to have a barrier to entry. Many feel that they need to be tech-savvy to be involved or that it is too dangerous to use or that it just isn't that useful. As such, despite growing volumes, it is still quite a long way off from being able to attract a critical mass.

Will it take off?

The announcement of Facebook's Libra coin in June of this year could have a huge impact on the future of stablecoins. Facebook's 2.4 billion users gives Facebook an unparalleled network of consumers to generate scale. Libra makes blockchain and crypto more accessible and if it is adopted as many expect, it will be possible to carry out everyday transactions with Libra. Furthermore, Libra runs on the Libra Blockchain, which is able to process 1,000 transactions a second, which would also alleviate concerns over processing at scale.

Libra is just one example of a crypto asset in the form of stablecoins that is drawing attention. Walmart has recently announced that it is following suit and with large corporations investing in these projects, there is scope for stablecoins really to take off.



What does the future hold?

Whilst there is still a long way to go, stablecoins should have an interesting future. Many consider Libra to be the tipping point where we will see a wide scale adoption. All eyes will be on Libra to see how they manage it and it will be interesting to see who else will join in and create their own product.

However, the key question will be the regulatory environment. It may well be possible to scale up stablecoins and there may very well be use cases but this will mean very little without having the approval of the regulators.

Regulators are concerned and it could end up with them taking a hard line approach as wide scale adoption of stablecoins could threaten monetary sovereignty. French Finance Minister Bruno Le Maire and German counterpart Olaf Scholz have been openly critical of Libra for example, citing that it is a danger to consumers and could pose a systemic risk. Mark Carney of the Bank of England on the other hand stated that he has an open mind on the utility of Libra, noting that payments systems across the world are currently highly unequal with some being free and fast and others being expensive and slow.

Whilst the threats of a corporation encroaching on sovereign activities has brought regulators to their feet in defence, the core concerns centred around the need for modernisation of the monetary system has not fallen on deaf ears, with calls for the European Central Bank to 'accelerate its thinking on a public digital currency'.

This battle is one that is just beginning and will be long fought. There will be a long scoping process that will go to the core of what stablecoins are offering and therefore how they should be treated. In the meantime, central banks will push their own solutions through in a bid to take back control. Whatever the outcome is, one thing is clear, there is an interesting new dialogue developing in cryptocurrency and there is a sense that we are at a point of inflection in its narrative.

John Salmon
Partner, London
T +44 20 7296 5071
john.salmon@hoganlovells.com

Lavan Thasarathakumar
Business Consultant, London
T +44 20 7296 2278
lavan.thasarathakumar@hoganlovells.com