Dogecoin. Bitcoin. Tether. New cryptocurrencies are popping up seemingly daily, as the market cap of cryptocurrency has skyrocketed to over $2 trillion, with over 6000 coins available to purchase (Ossinger 2021). These coins are no longer just used by obscure internet communities, as they were back in 2008 when the first cryptocurrency was invented. They are now an important part of the economy, where hedge funds, billionaires, and aspiring investors alike have staked their money.

The appeal of this type of investment is clear: it is a decentralized currency, it is unregulated, and it appears to be growing at an astronomical rate. However, taking a closer look reveals some striking vulnerabilities that, if left unchecked, could have serious economic consequences.

Traditionally, crypto has been almost entirely decentralized. This means that currencies are not controlled by any one government or entity, and are rather controlled and monitored by everyone who owns them. Many coins exist on a digital ledger, a tracking system that is split up among many computers, and is thus almost impossible to defraud. Consequently, these coins utilize a concept called mining that allows investors to gain more coins. Mining occurs when people solve complex mathematical problems, which validate past transactions, and keep the ledger secure and accurate. This rewards miners with coins, further disincen-
tivizing fraud (Doyle 2021).

Despite their security, investors and regulators alike are concerned about crypto’s stability. The value of any coin at a given time is almost entirely determined by the market, resulting in large swings in value. In order to solve this problem, some crypto companies have introduced the concept of a stablecoin. Instead of being tied to investor valuation, stablecoins are instead tied to a fiat currency, like the dollar, euro, or yuan. They are not mined, and are rather purchased on exchanges. In order to back up the cryptocurrency, stablecoin companies hold fiat currency, debt, or other assets that they can liquidate in the case that investors sell off their coins (Hayes 2021).

Unfortunately, these coins are not as stable as advertised. Since they are unregulated, the backing of these coins is not actually 1:1 with the coins they issue. Additionally, rather than using fiat currency, government bonds, or other assets that are essentially risk-free, many companies instead back up their coins with less stable assets, like corporate debt. It is significantly more profitable and less expensive for companies that manage stablecoins to use.

Ordinarily, this would not pose too much of a threat to the economy, but as these coins grow, the risk compounds. Stablecoins now have a market cap of $120 billion, most of which has accrued in the last 12 months. At the same time, stablecoin companies have only increased their reliance on risky assets. (Smialek 2021).

In fact, Tether, the largest of the stablecoins, was fined by the New York Attorney General, and as part of a settlement with the state, is no longer allowed to do business with citizens of New York. The settlement came out of a fraud case, where New York Attorney General Letitia James alleged Tether lied about the amount and stability of their reserves (Stankiewicz 2021).

The dangers of backing up these coins with risky assets cannot be overstated. In the case of an economic downturn, when the dollar starts to fall, investors may want to sell off stablecoins to recoup their investments. The owner of the coin would then have to sell off corporate debt, sending shockwaves through the rest of the economy. A major selloff in corporate debt is what allowed the housing market crash to spill over into the rest of the economy.

The Federal Reserve, Not-So-Stablecoin: The Need for Cryptocurrency Oversight

By Thomas Gill
headed by Jerome Powell, and the Treasury Department, headed by Janet Yellen, have both been heavily researching and debating ways to regulate and ensure stablecoins live up to their name. In fact, on November 1st of 2021, the Treasury Department released a working group report that outlined three separate regulatory steps the government could take in order to limit the risks stablecoins pose to the economy.

The first is to require insurance on deposits. Unlike banks, the assets held by stablecoin companies are not insured by the Federal Government. Because of this, a run on stablecoins has a high risk of selloffs and spillover, as many people may doubt that their coins still had value backing them up. Thus, if some people start to sell their stablecoins, it could quickly spiral out of control. A federal insurance system would treat stablecoins as a bank. This would limit any potential fear-induced run on stablecoins (President’s Working Group 2021).

The second is to subject wallet providers to more oversight. Some wallet providers may wish to lend stablecoins out to other customers, or engage in other such risky behaviors. Since there are no existing regulations, they would be allowed to do so. Additionally, they may choose to not have any liquid assets backing up the coins, as they did in New York. Ensuring certain capital requirements are met can allow any potential stablecoin run to protect consumers from losing everything (President’s Working Group 2021).

The third is to force stablecoins to restrict their connections with commercial entities. If a stablecoin worked too closely with a company, a stablecoin could have a lot of power, given that they could easily access credit and customer data. These regulations already exist for banks, and thus implementing them would prevent a new economic threat from arising (President’s Working Group 2021).

As stablecoins and cryptocurrencies rise in prominence, it is critical we protect the economy from the risks of such unregulated assets. Congress must consider and implement regulations, as recommended by the Treasury Department, to avoid economic disaster. We have seen the risks of unregulated banking in the Great Recession. New technologies that act as a psuedo-bank do not change these risks. Regulation is key to avoiding the mistakes of the past.

Works Cited


