



IMPORTANT DIFFERENCES BETWEEN STABLECOINS AND BITCOIN

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INTRODUCTION

Ever since the introduction of Bitcoin and other forms of cryptocurrency, there has been a wide range of digital assets added to the market. The main reason for the creation of these new properties is to upgrade the traditional financial systems. A new player in the financial markets is stablecoins. These digital currencies maintain their value by attaching themselves to an underlying reserve asset like fiat currency. Reserve assets are commodities, monies, and financial capital held by monetary authorities. Doing so helps to maintain issues like trade imbalances or fluctuations in foreign exchange while restoring confidence in traditional financial markets.

Stablecoins derive their purpose by reducing the volatility of cryptocurrencies and sidestepping the need to convert digital currency to fiat money. Notice that fiat-based stablecoins are centralized and considered off-chain, and their stability is based on 1:1 of token liabilities with their matching asset. Usually, a third-party caretaker, such as a bank, acts as a bridge between the traditional finance world and cryptocurrency.



Centralized VS Decentralized Stablecoins

One of the big misconceptions about stablecoins is that they are decentralized. The fact of the matter is that some are and some are not. There are two primary reasons for the price stability of many stablecoins. Backed by fiat currencies, some of them are centralized. Almost all fiat currencies worldwide are regulated by controlling authorities, like central banks. Fiat currencies are usually secured to underlying assets like forex reserves or gold. This aspect prevents wild swings in the value of the centralized stablecoins, which is why so many of them are popular among conservative investors.

Stablecoins are centralized sheltered fiat that has collateralized off-chain assets. Token liabilities are backed 1:1 by their associated assets, as mentioned earlier, and this is done either directly or by a third-party bank or other financial institution. Two leaders of stablecoins are Tether (USDT) and USD Coin (USDC), which is a collaboration between Coinbase and Circle. Other centralized stablecoins are Binance USD (BUSD), True USD (TUSD), Pax Standard (PAX), and the Gemini Dollar. Recently, JP Morgan launched its stablecoin called JPM Coin, and Facebook is currently working with partners on its centralized stablecoin called Diem. Tokenized stablecoins are essentially IOUs stored on a blockchain. By pegging (tying the currency to a medium of exchange, like currency or gold), supply and demand are maintained along with the redemption mechanism. Users mint stablecoins by depositing fiat into the stablecoin custodian to retrieve fiat currency back when needed. Because there are high levels of liquidity, inconsistencies in the peg are nominal and rare.

The way centralized financial institutions profit from the process is by the yield created by fiat held in reserve in addition to redemption fees or the minting process. However, minting and redemption costs can be high due to other custodial issues like compliance, operational, and auditing expenditures. There are also other concerns, such as expensive and slow connections to complex legacy banking systems. Despite these issues, centralized stablecoins are popular because they are relatively new to the market and easy to understand and use.

There are two different kinds of non-custodial stablecoins on the market today; crypto-collateralized and algorithmic stablecoins. Crypto-collateralized stablecoins base their trade-in and minting methods with on-chain status and incentives in order to maintain their peg. This model of stablecoin is issued by Dai (DAI), EOSDT, WBTC, or sUSD (SUSD), creating a blockchain inherent alternative that displays the properties of a censorship-resistant, decentralized network. Considering how volatile the cryptocurrency market is, these brands achieve their stability by letting lenders generate interest from borrowers.



A good model of this is MakerDAO's issued stablecoin DAI. Decentralized stablecoin DAI is generated by locking collateral into MakerDAO's smart contract. Collateral value locked into the collateralized debt position must exceed 150% of the DAI used to create it. However, if a position becomes undercollateralized, the assets secured into the contract get sold to pay back the DAI made. When this happens, there are penalty fees, plus a 13% liquidation fee. It could be said that DAI is a decentralized loan that has the backing of the collateral it collects. In order to access this collateral, a user must pay back the DAI which was generated plus the stability fees.

Algorithmic stablecoins are the other type mentioned earlier. These stablecoins sidestep the collateralization process, relying on smart contracts and complex algorithms to control price stability. Ampleforth (AMPL), Frax (FRAX), and Terra (UST) are some examples of popular algorithmic stablecoins. These work by issuing new tokens during periods of low supply and burning them when the demand is too low. Initiating these actions helps manage market conditions and peg maintenance like a balancing act.

The complex nature of developing algorithmic stablecoins has left a wake of failed projects, and their value is dependent on more demand in the future. They also have a reputation of being vulnerable during unpredictable market downturns and oracle smart-contract hacking. Without the safety regulations that decentralized and collateralized stablecoins offer, algorithmic stablecoins will appear untenable in the future.

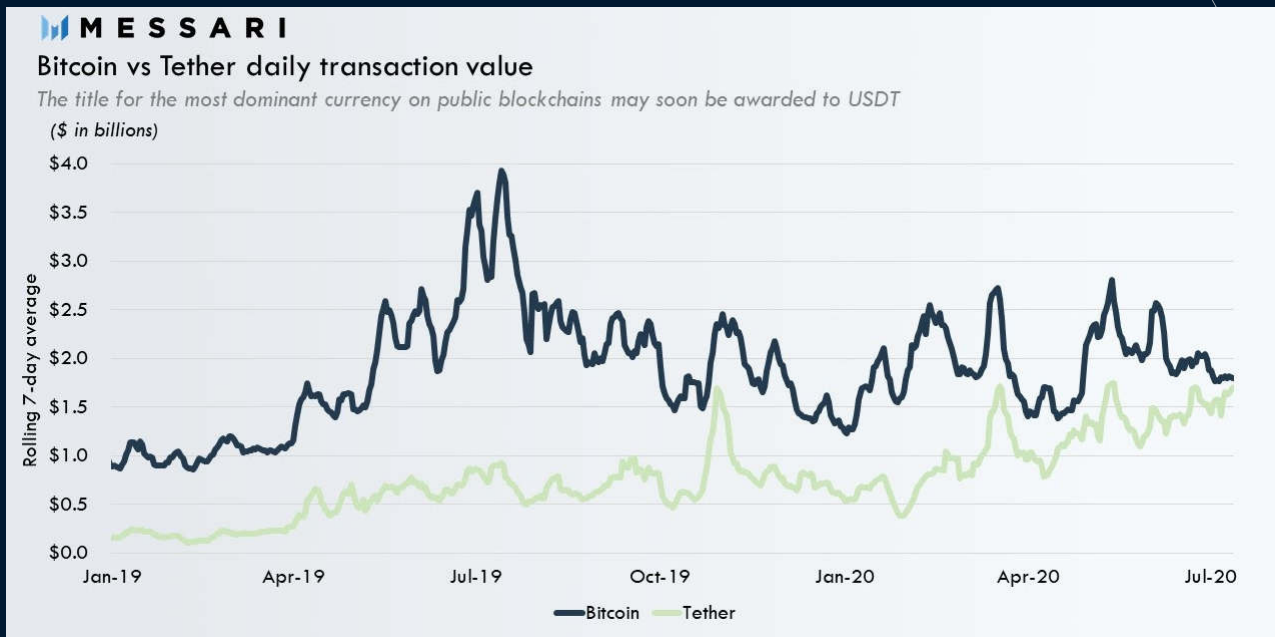


Comparing Stablecoins to Bitcoin

To better understand the difference between stablecoins and the crypto-industry standard, Bitcoin, it would be advantageous to understand how Bitcoin operates. Bitcoin bases its price fluctuations on apparent storing of value, whereas fiat currency is based on centralized institutions and policies. Bitcoin's design is where its value lies. Unlike fiat currencies, assets can be added or subtracted from Bitcoin.

Also, Bitcoin has a scarcity factor since only 21 million Bitcoin (BTC) will be created. For this reason, Bitcoin has intrinsic value, similar to digital gold. Since it is created and managed by governments and banks, fiat currency is centralized and its value is always under government control. It is managed constantly for maintaining better growth, inflation, and high employment by investing in capital resources. For this reason, unregulated Bitcoin takes different swings during economic changes that affect fiat.





Sometimes the value of a stablecoin can eclipse Bitcoin
Image courtesy of Messari

Another difference between stablecoins and Bitcoin is the way Bitcoin transfers and stores its value. The concept of "store of value" is wise to consider in this comparison. It is how an asset can be productively used in the future with a reasonable amount of predictability. Because it is not centralized, Bitcoin's value is more difficult to predict next to stablecoins because of its decentralized nature, and because Bitcoin is not regulated, it is limited on how its value is transmitted. However, this could change over time, making the possibility of transferring value, property, and objects with Bitcoin straightforward and more competitive with stablecoins.

One Other Option to Consider - CBDCs

Regulators and policymakers around the world have begun exploring concepts of Central Bank Digital Currencies. (CBDCs). These efforts are fueled by Bitcoin's growing popularity and digitization in payment systems that can be used without third-party interference. It would also eliminate the need or logistics of using physical cash. Since the intervention of Covid-19, improving stimulus distribution was discussed considerably by government regulators. These so-called "central bank digital currencies" are synonymous with or replacements for cryptocurrencies like Bitcoin.

Central Bank Digital Currency still in its Infancy

Status of central bank digital currencies in Europe

- Pilot programme
- In Development
- Research
- Inactive

Date: 27.07.2021
Source: Atlantic Council

statista

Image courtesy of Statista

CONCLUSION

Even though Bitcoin is an industry leader in cryptocurrency, it is clear that alternatives like stablecoins will eat some of its market share. One of the reasons for this is stablecoins have solutions to some of the concerns that Bitcoin presents. As an investor, it is important to consider and weigh the concerns of your financial plans. It should be noted that where there are concerns and confusion in which coin to invest in, it is wise to seek the help of a professional.



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