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# Stablecoin Regimes Are Digital Currency Boards

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## Stablecoins 101

Stablecoins are a fast-growing digital asset class with over $150 billion in market value. They are a special type of cryptocurrency, created to ensure a stable value between the digital and fiat worlds. This role could not be filled by cryptocurrencies such as Bitcoin (whose supply is generated by an algorithm with no underlying assets or revenue flow) due to the high volatility of their value.

Stablecoins are built in various public or private blockchains, which allow their users to transact, hold or trade digital assets. Their growing uses include payments, remittances, trading and settlement, lending, and even as safe assets in period of turbulence. Critically, the supply of a stablecoin is – in most cases – fully backed in value by assets in a reference fiat currency or by a commodity. This essentially implies that stablecoins operate as part of a currency board system.

## Why Were Stablecoins Created?

The motivation behind the stablecoin structure is similar to the motivation behind currency boards in the fiat world: credible exchange rate stability. The exchange rate is the price of one economy's currency in terms of another. While bilateral exchange rates can fluctuate wildly at times, there is in many cases a desire on the part of policy makers for exchange rate stability. Currency boards operate for the Hong Kong dollar (linked to the US dollar) and the Brunei dollar (pegged to the Singapore dollar). For background, a full typology of exchange rate regimes has been published by the IMF.

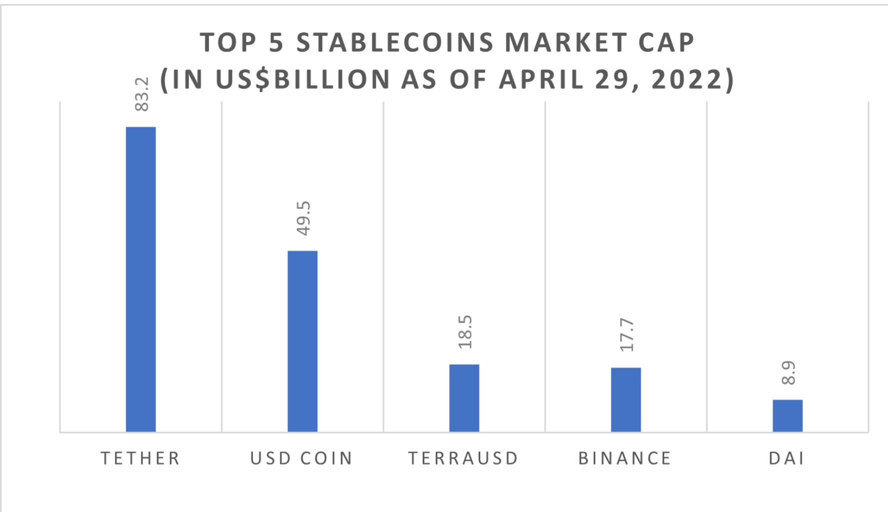
This exchange rate stability line of thinking carries over to the digital world. In essence, the price of a digital currency (such as Bitcoin), which is expressed in US dollars, can be thought of as an exchange rate. A rising value for Bitcoin means that it is appreciating against the US dollar, and vice versa. The price of Bitcoin has been volatile relative to other currencies as well as other asset classes. While some agents may want to hold a digital currency that moves significantly against the US dollar, including for speculative reasons, other agents may want more predictability and stability. Thus, the demand for stablecoins.

Within the world of fixed exchange rates, currency boards are a mechanism to credibly fix the value of a currency. Stablecoin regimes aim to replicate the credibility of a currency board in the digital world.

This equivalence can be seen by looking at the characteristics of various stablecoins on Coinbase. These digital coins trade at a fixed rate typically of one-to-one against their reference asset. Many stablecoins are fully backed by US dollars or their equivalents, while some are backed by gold or even by other cryptocurrencies. Some issuers such as Binance offer both "floating rate" cryptocurrencies and stablecoins.

## Importance of the Backing Portfolio

The backing portfolio in a currency board – and stablecoin regime - is key. This structure adds extra credibility to a fixed exchange rate regime by backing the entire local currency "narrow" money supply with high quality and liquid foreign reserves, typically US Treasury bonds. This backing portfolio ensures that the local money supply cannot be changed without a corresponding change in the backing portfolio, thereby ensuring the value of the currency. The IMF has an excellent summary.




Source: www.coinmarketcap.com.

As with currency boards, the credibility of stablecoin pegs will ultimately depend on the issuer following the rules. Put alternatively, a stablecoin is only as credible as its issuer. These rules relate to the value, transparency, and liquidity of the backing portfolio. For maximum credibility the issuer needs to be able to redeem its stablecoins for the backing asset on demand, at par and at any time.

## Thoughts on the Future of Stablecoins

What can go wrong? Currency boards have encountered problems when the local currency is not fully backed by hard assets, sometimes causing a (rational) run on the currency. The same concerns carry over to stablecoins, as evidenced with recent concerns around Tether. This suggests that – to become mainstream - some form of regulation around the operations of Stable coins is likely in the future.

More fundamentally, the future of stablecoins is unclear given the interest of the US authorities in eventually issuing some type of digital US dollar. But that is a story for another day.