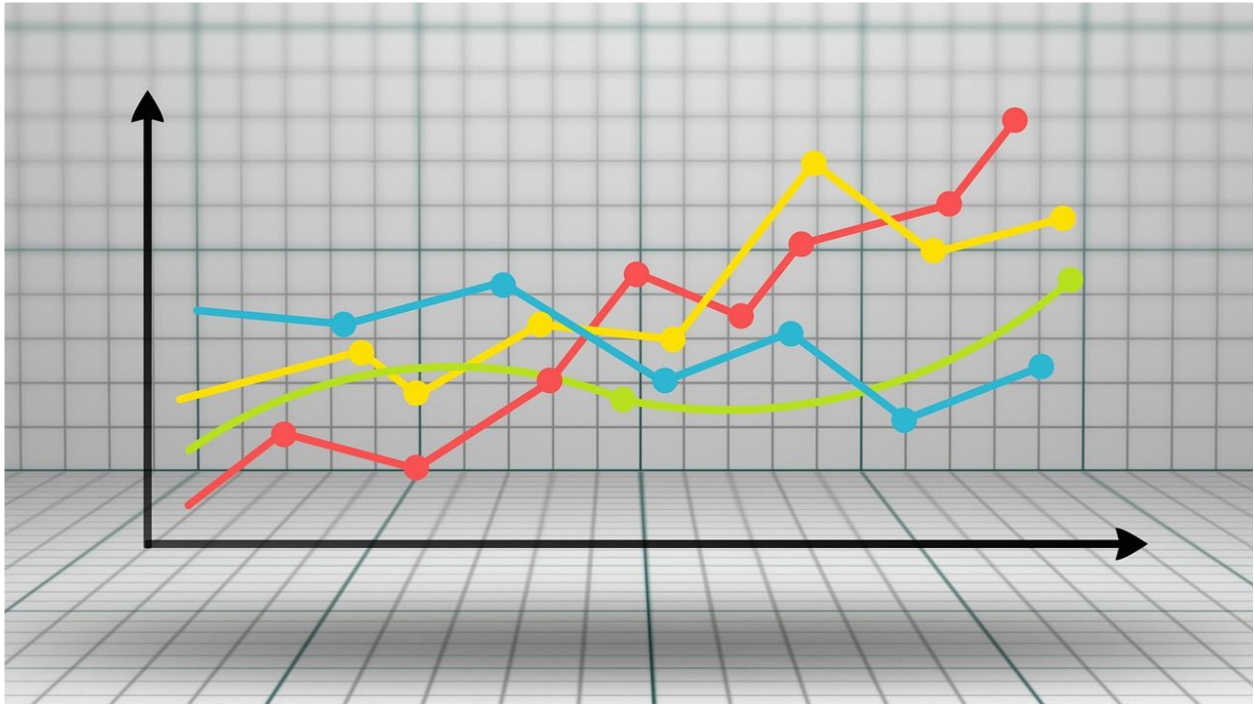
Title: Stablecoins: What They Are and Why They Matter

Subtitle: Stability is a valuable thing in volatile cryptocurrency markets.



For many cryptocurrency enthusiasts and investors, there is only one word that adequately describes the market: volatile.

And while volatility is responsible for many of the cryptocurrency market's biggest wins, it's also responsible for its most traumatic losses. But there is another crucial reason why cryptocurrency developers are interested in hedging their bets against volatility.

Regulation is one of the main challenges that cryptocurrency has yet to adequately resolve on a large scale. Until a robust regulatory solution for cryptocurrency is in place, volatility is likely to remain part and parcel of the crypto experience.

But what if there was a way to develop cryptocurrencies that protect themselves against volatility? What if they could regulate their own volatility? Enter stablecoins, a cryptocurrency that has price stable characteristics and is meant to hold a stable value.

The secure promise stablecoins offer has left investors looking to them as an answer to the problems of 2018's cryptocurrency crash - let's examine the positives and negatives of what this form of cryptocurrency has to offer.

Stablecoins Tie Their Value to Collateral

There is an essential difference between decentralized cryptocurrencies like Bitcoin, Ethereum, and stablecoins. Where decentralized cryptocurrencies earn their value solely through use and speculation, stablecoins are tied to some kind of real-world value independent of those factors.

This makes them far less likely to suffer from serious crashes, but it also controls their climb in value by discouraging speculation. There are limits to how stable any currency can be – a perfectly stable currency would never appreciate or depreciate in value – but there are ways to limit the disastrous effects of a Wild West-style market where anything goes.

Many stablecoins look to traditionally stable investments and create digital variants on cryptocurrency markets. A cryptocurrency developer can technically do this by simply purchasing securities on a one-to-one basis for every token user's purchase.

This is why some cryptocurrency professionals use the term *tokenized securities* to refer to stablecoins. The idea remains that the security itself is a real-world commodity and that its ownership is represented through a cryptocurrency system.

This makes stablecoin trading somewhat similar to commodity trading - when a commodity trader purchases a quantity of crude oil, gold, or live cattle, he or she has no intention of ever actually coming into possession of that commodity.

Instead, the commodity is collateral for the specified value of the transaction. This allows traders to enter into futures contracts, where two parties agree to purchase a commodity at a specific price and time.

Complex derivatives and financial instruments are not yet part of the stablecoin ecosystem, but they soon could be. This is what [CoinFLEX]() plans on doing, and its implementation will be a signal that stablecoins occupy a recognizable niche as digital commodities ready for trading.

Stablecoin Risks

While the point of stablecoins is to reduce risk due to volatility, they do come with their own set of concerns. First and foremost is the mechanism that ties each coin to a traded security.

Tether is one of the most well-known and popularly traded stablecoins, but it is facing increased scrutiny by regulators. Although Tether claims that all of its holdings are backed by a single U.S. dollar, there is little evidence to [support that claim]().

Regardless of whether Tether is making good on its promise to tie the coin’s value to collateral, the same argument goes for the vast majority of stablecoins. Traders should be wary in situations where there is nothing to stop a dishonest stablecoin provider from simply *saying* that their coins are backed by security and then doing nothing about it.

This situation would be the cryptocurrency version of a Bernie Madoff-style Ponzi scheme, where a scam artist misrepresents an investment fund’s backing and simply collects money from people. Cryptocurrency traders still need to do their due diligence and make sure their coin providers are fulfilling their half of every purchase.

Stablecoins Play an Important Role in Cryptocurrency Markets

In the world of investment trading, there are low-risk, low-return securities like U.S. Treasury bonds, and there are high-risk, high-return securities like real estate and leveraged exchange-traded funds. Professional investors always recommend diversifying your portfolio to include some of both.

Since the emergence of Bitcoin in 2009, the cryptocurrency ecosystem has largely been of the high-risk, high-return variety. Stablecoins play a critical role in protecting cryptocurrency traders from more volatile investments and providing much-needed balance when considering riskier trading opportunities.