Bitcoin's successor? More consistent values might make 'stablecoins' a safer cryptocurrency option

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Bitcoin has plunged from a high of almost US$20,000 in December 2017 to as low as US$3,675. So it's understandable that some cryptocurrency users might be looking for more stability. With the future of Bitcoin and other cryptocurrencies uncertain, a possible new solution known as "stablecoins" has emerged. This cryptocurrency aims to hold its value better than others, which could offer investors more stability.

Cryptocurrencies are digital tokens that act as a form of currency, effectively allowing people to perform transactions without a bank or intermediary. Most cryptocurrencies have no intrinsic value, and get their price from what others will pay. This, alongside price speculation from those hoping values will rise, has led to significant price volatility in cryptocurrencies.

Unlike other cryptocurrencies, stablecoins aim to maintain their worth better by being redeemable for something else of tangible value, like regular fiat currencies such as US dollars, or even gold.

The stablecoins' underlying asset (the monetary value that investors expect it to trade at) would normally be deposited with a trusted bank. If people are confident they can redeem these coins in exchange for said currency, and that the issuer has sufficient reserves for all coins in circulation, the price of the stablecoin shouldn't fall below the underlying asset value.

Tether is one popular stablecoin option, currently worth US$1. Akarat Phasura/Shutterstock

The most widely used stablecoins are Tether, TrueUSD and USD Coin, which bind their value to the US dollar. Tether experienced some short-term volatility, fluctuating between $0.989 and $0.95. TrueUSD has held stable, but USD Coin has had slight instability – though even its biggest drop still remained within 1.8% of the dollar. Compared with other cryptocurrencies, then, stablecoins have remained stable.

But there's nothing technical keeping the price of stablecoins at a fixed value. If people lose confidence that the issuer has enough assets reserved to honour the value of all coins if

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redeemed, it could lead to significant price variations. The price could also rise if demand outstrips supply of a stablecoin.

Why are stablecoins becoming popular?

The recent crash of Bitcoin and other cryptocurrencies, alongside inconsistent trading prices across exchanges, have influenced the perception that cryptocurrencies are unpredictable. The idea of a cryptocurrency with a fixed value has understandable appeal, especially among those wanting to make purchases with cryptocurrencies.

Cryptocurrency exchanges are also moving away from interacting with banking systems because of heightened regulatory interest and attention in cryptocurrency operations. In some notable cases, exchanges have even had their funds frozen by banks. This has led some popular cryptocurrency exchanges to no longer allow transactions between cryptocurrencies and real money. So, in order to buy on these exchanges, people need existing cryptocurrencies – making stablecoins a good option for starting out.

Will computer algorithms maintain stability?

Seigniorage-based stablecoins are the latest development. These use computer algorithms to control the stablecoin's availability by buying and selling it automatically based on real-time prices, ideally keeping the coin's price stable. If prices rise, coins from reserves would be made available to buy, which increases supply and reduces price. If the price falls, the algorithm can buy back coins (using other cryptocurrencies held in reserves) to reduce supply and increase the price.

But if supply increases too rapidly, the algorithm won't have sufficient funds to buy back enough coins to stabilise the price. This could cause the value to plummet, especially if people lose confidence in the coin issuer. However, this can also happen to regular fiat currencies, not just stablecoins, as currencies are only valuable if others will accept it – otherwise, it significantly loses worth.

The future

Stablecoins might present a solution to short-term volatility, provided the currency backing its value remains stable in worth. But they won't fix confidence losses, especially if the value of the stablecoin's reserved assets is questioned. If the ability to redeem this currency is at risk, the stablecoin's price will likely fall.

Seigniorage-based cryptocurrencies may handle limited volatility if they have enough reserves to control supply with algorithmic buying and selling. But this still requires people to willingly hold or accept the coin. Flash price crashes that occur when lots of a cryptocurrency is sold in a short time are not unheard of, showing the real potential for extreme volatility due to large transactions.

There's also a significant premium for using stablecoins to purchase other cryptocurrencies. At time of writing, it cost almost US$118 per unit more to buy one Bitcoin using Tether than US dollars, despite both supposedly having the same underlying value. If the market saw stablecoins as a solution to cryptocurrency volatility, the price would be the same as it is with cash.

While stablecoins might reduce the amount of risk buyers see in cryptocurrency, especially related to price instability, it's unlikely they'll actually be used more generally.

Using stablecoins for day-to-day transactions has many challenges, especially if the system can't make more coins available if demand increases. Stablecoins also aren't protected by the compensation schemes some cash bank accounts are, making it unlikely most people will replace their cash accounts.

Read more: You may not actually own your Bitcoin – legal expert

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Regular cryptocurrencies also offer potentially higher returns than stablecoins, which appeals to risk-takers. Major investment banks are also exploring ways to take advantage of cryptocurrencies' price volatility, as this creates more opportunity for profit and will attract investors.

This isn't to say stablecoins have no future. People living in countries with unstable local currencies could use stablecoins to digitally hold a more stable foreign currency. However, while stablecoins could be more secure than real currencies in some situations, the values will still fluctuate if people lose confidence in their worth.

Despite the volatile market, cryptocurrencies like Bitcoin remain popular with investors and ordinary people hoping to become Bitcoin millionaires. While stablecoins might seem a shrewd alternative, it's unlikely people will trade their chance to earn millions for security.