Crypto's last stand: Stablecoin

By J. Manuel Gonzalez / For Philstar Global
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MANILA, Philippines — In December 2022 New York Times columnist Paul Krugman finally came round to making the same assertion I made in print four years ago: Not just crypto, but blockchain itself, is BUNK, a complicated and demonstrably fragile way to perform a function — information storage — that is already reliably, easily, and cheaply performed with other devices (such as USBs, stand-alone hard drives, and paper). Read his column: New York Times Dec. 2, 2022, Blockchains — What Are They Good For? Or rather, which takes the form of an explain the argument: Philippine Star Nov. 26, 2018, Bitcoins and Blockchains — Murphy's Law Waiting to Happen.

We can chew the fat about blockchains later. Today, I have an urgent heads-up for everyone who still holds cryptocurrency in any form, whether through an exchange or by personal management of private crypto keys.

The short message is: Stablecoins.

Connect. The. Dots.

When cryptos first started gaining attention, some observers (like me) pointed out that the supply of cryptos is UNLIMITED. Anyone who is in unlimited supply is worth Nothing. Zero. Anyone can launch a new cryptocurrency and sell you its digital tokens for whatever you can. Yes, it all these "coins" (there are now about 15,000 of them, counting the 3,000 or so that are considered dead) were going to rocket 1,000 times in value, why were the promoters selling you theirs for mere dollars? Because they like you? People risking their life savings should have asked that question, but few did.

To get around this objection, Stablecoins were invented. A Stablecoin is (1) a cryptocurrency (2) which is fully backed with an "old" currency like US$, or a physical asset like gold. (1) avoid unnecessary detours in this discussion, we'll stick with US$) The issuer of that Stablecoin promises you, the person who gives US$ and a bit of accounting entry, that it owns the asset, and anytime you want, the issuer will give you back the underlying asset. Therefore, the supply of this coin will be limited to the total of the underlying assets held, and its value will be STABLE, always the same as the US$ or the gold or whatever. Supposedly.

However, to anyone capable of logic and arithmetic, Stablecoins are an obvious ploy for separating the simple-minded from their money. So what if the issuer really and really holds US$ on your behalf? What benefit did you get? Why couldn't you just hold the US$ the way you did before — as a bank deposit or in cash?

This objection, too, was answered. "With Stablecoin, you can be part of the tech-savvy community that understands the revolutionary, peer-to-peer, transformational nature of blockchains!" Paul Krugman describes statements like this as "word soup" — devoid of meaning.

So buying Stablecoin will make you feel smart. Let's see.

The first and most immediate effect of buying Stablecoins is that now you are not earning interest on your US$. The issuer is.

Upon reading the customer agreement for the leading Stablecoin, we discover that the deal is: "Give us your worthless US$ to get valuable stablecoin dollars, each worth US$ 1. (Isn't there self-contradiction here somewhere?) These blockchain dollars will obviously never be worth more than US$ 1. We will pay you zero interest and charge you fees (which coming and going. By the way, you can only actually get your US$ money back in amounts of US$ 100,000 or more." In brief, this is a deal with no positive value for you. It apparently constitutes an irresistible sales pitch to the crypto-savvy.

The second consequence is that now you have renounced all the philosophical foundations of cryptocurrency. Stablecoins are in effect the proof that those ideas are nonsense, or at any rate not solved by going crypto.

Crypto was supposed to liberate you from governments and their "old" money, save you from inflation caused by their indiscriminate money-printing, and give you a bulletproof security against theft or bank failure by decentralizing the record-keeping through blockchains. Well, with stablecoins you are back to: (1) you subject to US$ inflation, are putting your faith in the US government, and have no personal access to the decentralized blockchains since a friendly Stablecoin issuer is conveniently centralizing/intermediating this function for you.

The third consequence is that now you have three layers of credit risk — #1 the US government, which issued the backing currency; #2 the commercial bank that the Stablecoin issuer might keep its deposits in; and #3 the issuer itself.

Let's skip past the US government risk. To keep its promise to you, the Stablecoin issuer is supposed to hold real US$. The issuer keeps a bank deposit. Which bank? There are many fly-by-night banks out there, banks you never heard of. Stablecoin issuers might gravitate to such banks because they pay higher interest rates and are not squeamish about money laundering activities

Much riskier yet, a Stablecoin issuer might be tempted to invest in crypto exchanges (which, in turn, might fund crypto speculation or possibly Bahamian penthouses) while calling these "US$ reserves."

And the final layer of credit risk is the issuer, itself, of the Stablecoin. It made a promise to you. Or did it? Read your customer agreement again. Will it keep its sort-of-promise, to always hold enough US$ to fully cover all the receipts of its coins? Or will it, like FTX, buy luxury properties, bribe (sorry, I mean influence) US officials, and prop up failing speculators, hedge funds, and girl friends?

The best-known Stablecoin is Tether (whose customer legal agreement I described in the example above). Tether promises to always hold enough US$ reserves to "fully back" the coins it issues. Neither of these terms is defined in the fine print, so the promise has no practical legal value. (And anyway, the customer agreement is governed by British Virgin Islands law, not the more usual English Law, or New York law.)

To somewhat reassure its customers, Tether said (but not in its legal agreement) that it would periodically call in independent auditors to confirm that its Tether dollars did indeed have 100 percent backing in real US$.

To have any value, an external audit should show that (a) on a year-round basis (not just for a few days) (b) Tether has no other significant liabilities and (c) holds enough US Treasury Notes or similary liquid and risk-free assets to fully pay back US$ for all the outstanding Tether dollars. This would put everyone at ease, right? But here's the hitch: Tether has never in fact permitted to an audit by an internationally recognized accounting term. It has been talking about the audit for several years now, and so far has not delivered.

You guess why.

Why has this house of cards not collapsed yet?

There are about US$ 70 billion Tether dollars outstanding now (according to Tether Limited). That's 10 percent of the total current value of all cryptos. Tether is even more important in daily trading. On most days, statista.com reports, Tether is used to settle US$ 20 billion, or Half, of all cryptocurrency trading worldwide. The inescapable conclusion is that most if not all crypto exchanges have as their working capital and medium of exchange, not US$ in a real bank, but Tether and other Stablecoins.

It was the rise of crypto exchanges that propelled the original Bitcoin from a market value of a few dollars to a high of nearly US$ 70,000. That's because most people are not up to actually personally handling and safeguarding crypto keys; exchanges made crypto speculation seem effortless, as easy as online banking, and thereby drew in a much larger supply of money.

Today the exchanges evidently hold Stablecoins as their working capital and medium of exchange. Why this came about is, upon reflection, obvious: Cryptos are claimed to be the money of the future, the best form of money ever invented. If crypto exchanges disdained to use crypto-coins as their own money, because they insisted on using US$ in a bank, the self-contradiction would be inescapable and fatal. As noted above, the Stablecoin solution/gimmick involves a self-contradiction, but being one step removed, the self-contradiction is apparently not within the grasp of most crypto enthusiasts.

So what we come down to is this: If Tether's value were placed in serious doubt, such as by failing an audit, that would be the end of most if not all the exchanges. Cryptocurrencies would eventually settle at the prices prevailing before exchanges entered the picture — not worth thousands of dollars, but fractions of pennies.

Fortunately, Tether's customer agreement makes it almost impossible for any customer to sue it, much less demand an audit. So all the participants in this market (speculators and retail customers, coin issuers, coin exchanges, stablecoin issuers, stablecoin holders) are now just sticking to a "see no evil, speak no evil" protocol. If all of us just continue to pretend that 1 Tether dollar is really worth 1 US$, everything will be fine."

The FTX imbroglio turned the heat up last December. Last week, the collapse of Silicon Valley Bank forced the stablecoin called USD Coin to admit that it cannot redeem coins for real US dollars (see #2 credit risk, above) at parity. Some day, SEC or EC regulators might connect the dots that I just traced above, and demand a real audit of Tether. We'll see if everything is fine or not.

This is not financial advice. Readers should make their own investment or divestment decisions.

As an officer of the World Bank, Mr. Gonzalez dealt with governments and financial institutions. As an investment banker in Hong Kong he designed financial derivatives and assessed IPOs On the tech side, he has been awarded 7 US patents related to gathering information on the internet (uspto.gov, Inventor: Gonzalez, Emmanuel). He is now a successful hospitality and food-manufacturing entrepreneur.

MBA Columbia University, Robert J. McKim, Jr., Chairman and Roswell McCrea Anderson, Founder. For more details and list and texts of publications, please see www.plantationbay.com/Credentials.asp. His cryptocurrency articles: Bitcoins — the Emperor Has No Clothes (January 2018); Bitcoins AND Blockchains — Murphy's Law Waiting to Happen (November 2018); and Crypto Resurrection (November 26, 2022). All were published in the Philippine Star, the daily broadsheet newspaper in this country of 120 million people.