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# STABLECOINS IN THE MONETARY SYSTEM OF THE FUTURE £

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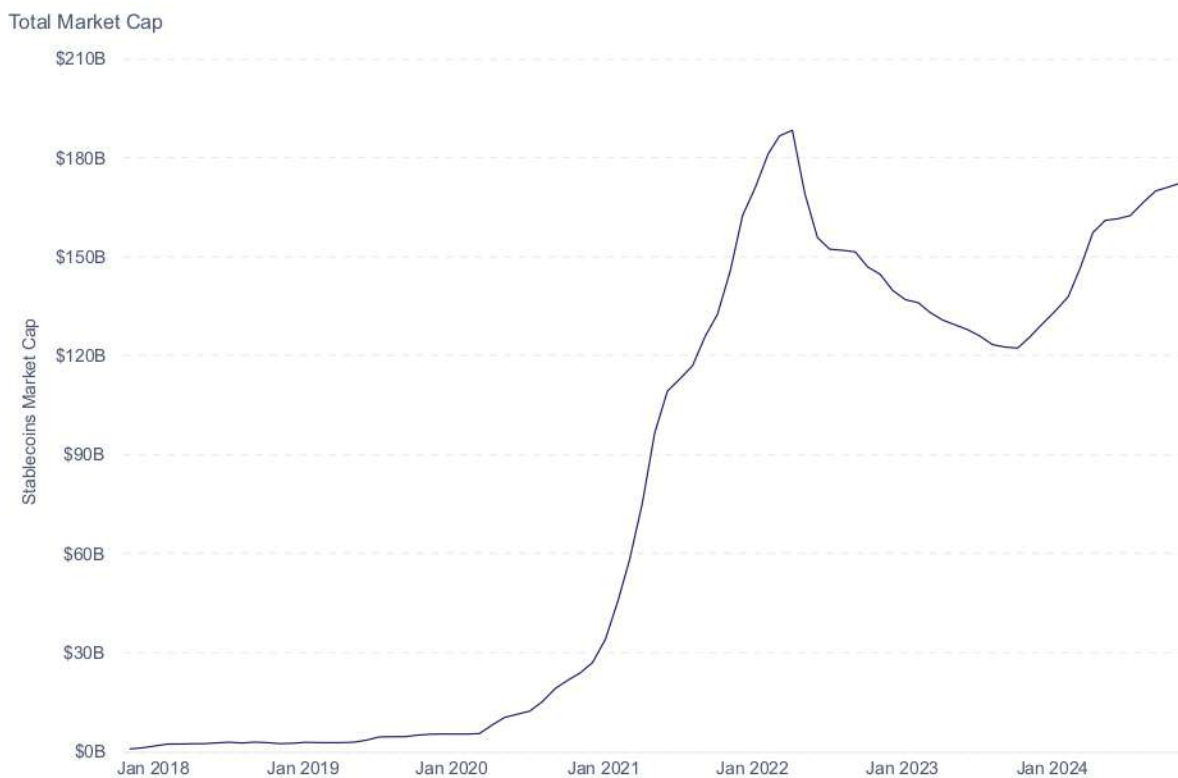
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## Introduction

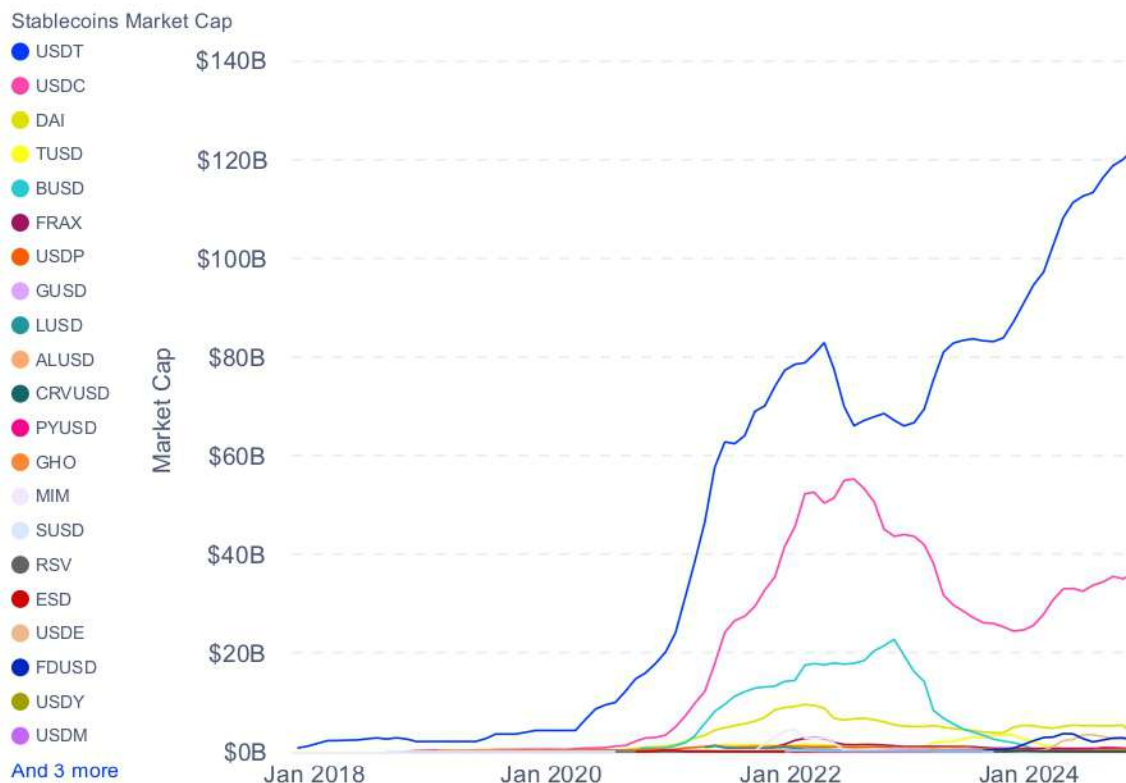
Stablecoins are digital assets designed to maintain a stable value by pegging them to a reserve asset like fiat currency, commodities, or other cryptocurrencies. Their role in the monetary system has been evolving and is poised to grow in significance.

A roundtable held during the Point Zero Forum in July 2024, titled 'Stablecoins in the monetary system of the future', took a deep dive into this asset. It provided a stocktake on the general landscape of stablecoins, addressing significant changes in the past year and considering what it would take to scale and grow the stablecoins industry beyond 2024.

The growth of stablecoins signifies a monumental achievement within the cryptocurrency realm. The market cap for stablecoins has grown considerably, increasing from \$122 billion in October 2023 to \$157 billion in April 2024. Among stablecoin providers, Tether (USDT) has captured a significant market share, exceeding \$100 billion and accounting for over 70% dominance in the stablecoin market. This exponential growth underscores the increasing significance of stablecoins in the broader digital currency landscape. Surpassing market capitalisation of over \$150 billion is a testament to the growing adoption and acceptance of stablecoins.



Market cap growth of stablecoins from 2018 to 2024. Source: ITB Stablecoins Insights Perspectives



An optimistic sentiment generally pervaded the speakers whilst equally yielding some serious concerns. There is a sense that traditional banking will work complementarily to stablecoins issuers, but the regulatory landscape appears uncertain, hindering broader collaboration between issuers and traditional banking players. A lack of a global framework, standardised terminology and protocols seem to top the list of issues to resolve to scale and grow.

## Background

Current use cases fuelling demand for stablecoin (not exhaustive) include:

- The facilitation of digital payments, like fast and low-cost cross-border transactions, bypassing traditional payment and settlement systems. Stablecoins provide a way for individuals and businesses without access to traditional banking services to engage in the digital economy, something particularly relevant for emerging markets.
- Decentralised Finance (DeFi): Stablecoins provide liquidity in DeFi ecosystems, enabling lending, borrowing, and trading activities without the volatility associated with other cryptocurrencies. In addition, they can serve as collateral for various DeFi applications, contributing to the growth of decentralised financial products.

- **Cryptocurrency trading:** Traders use stablecoins as a stable store of value and a medium of exchange to move between volatile cryptocurrencies and fiat currency equivalents. Many cryptocurrency exchanges offer trading pairs with stablecoins, increasing trading efficiency and reducing volatility risks.
- **Settlement instrument:** Stablecoins can be used as a means of payment of clearing and settling securities' transactions.

## Significant changes in the last year

### Product innovations:

- 1) **Algorithmic/Synthetic Stablecoins:** Unlike traditional stablecoins backed by reserves of fiat or commodities, algorithmic stablecoins use smart contracts to automatically adjust supply based on demand to maintain price stability. Examples include Ethena and DAI. These stablecoins represent a shift towards decentralised monetary policy, reducing reliance on centralised reserves. While algorithmic stablecoins are still being explored, there is a shift to a more robust, transparent and secure models, of which synthetics stablecoins appear more promising, especially in the DeFi ecosystem
- 2) **Programmable Money:** Stablecoins integrated with smart contract platforms enable programmable money, where transactions can be automated based on predefined conditions. This innovation is pivotal for decentralised finance (DeFi) applications and for the development of new products to accelerate adoption of stablecoins in more traditional economic sectors.
- 3) **Multi-Collateral Stablecoins:** MakerDAO's DAI are backed by various assets, reducing risk and enhancing stability compared to single-collateral stablecoins. This approach provides greater flexibility and resilience in maintaining the peg to fiat currency. Tether, for example, has the XAUt stablecoin, which has gold as an underlying asset.

### Market dynamics:

- 1) A notable event in the stablecoin sector in 2023 was PayPal's launch of its own stablecoin, PayPal USD (PYUSD), in August. This move marked a notable entry by a major non-crypto company into the stablecoin market. PYUSD, issued by Paxos Trust Company, is backed by the U.S. dollars, short-term U.S. Treasuries, and similar cash equivalents. It has rapidly gained traction with partnerships from firms like BitPay and Xsolla.
- 2) The de-pegging incident of the Magic Internet Money (MIM) stablecoin was another critical event. MIM fell to \$0.86 following a smart contract exploit on its issuer, Abracadabra Money, which led to a loss of approximately \$6.5 million. Despite this setback, MIM's market cap remained stable around \$60.2 million. The total market cap exploded to \$138 billion in 2024.



- 3) Banks and large financial institutions are increasingly exploring the use of stablecoins (in many cases issued on private, permissioned networks) for faster and cheaper cross-border transactions, liquidity management, and integration into traditional financial systems. Key examples include JPMorgan's JPM Coin and Banking Circle's EURI, the latter interestingly being available on open exchanges like Binance.
- 4) The growth of DeFi platforms has significantly increased the demand for stablecoins, as they are often used as a medium of exchange, collateral, and yield-generating assets within DeFi ecosystems. This demand has driven innovation in stablecoin designs and expanded their use cases beyond mere payments.
- 5) Stablecoins are increasingly used in emerging markets for remittances, savings, and as a hedge against local currency volatility, driving adoption and innovation in these regions. Initiatives in countries with unstable fiat currencies or limited banking infrastructure showcase stablecoins' potential to enhance financial inclusion.
- 6) The collapse of Silicon Valley Bank in 2023 illustrated the danger of concentration risk for stablecoin issuers – holding reserves in a limited number of banks increases an issuer's vulnerability. Since this incident, policy discussions have focused on building stablecoin frameworks that encourage diversification of reserve assets across multiple institutions, cap the level of reserves that can be held at a single institution, and require reserves to only be held at banks after appropriate levels of due diligence.

## Regulatory landscape:

One of the most promising regulatory developments for stablecoins has been the progression of the Clarity for Payment Stablecoins Act in the United States. This bill, which aims to integrate stablecoins into the traditional financial regulatory framework, passed out of the U.S. House of Representatives Financial Services Committee in 2023 with bipartisan support. The act would require issuers to hold reserves in U.S. dollars, government securities, or fully collateralised repurchase agreements, bringing greater transparency and security to the market. As of 2024, there are continued discussions in both the House and Senate on stablecoin legislation, but it is unclear whether a stablecoin bill will materialise before the end of this Congress in January 2025.

In Europe, the Markets in Crypto-assets (MiCA) regulation is another major milestone. MiCA aims to create a harmonised regulatory framework for crypto assets, including stablecoins, across the EU. This legislation will enforce liquidity requirements, cap daily transactions for non-euro and non-European currency denominated stablecoins, and provide clear redemption rights for stablecoin holders, promoting consumer protection and market stability. MiCA's provisions related to stablecoins went into effect on 30 June 2024.

The UK Treasury published a policy statement defining fiat-backed stablecoins and outlined plans to legislate them, aiming to ensure these digital assets maintain a stable value referenced to fiat currency. This includes changes to payment legislation that would allow retail payments with stablecoins, even those issued outside the UK. The BOE will regulate systemic stablecoins, which are considered significant enough to impact financial stability. Meanwhile, the FCA will oversee the broader crypto sector. This dual regulatory approach aims to ensure both market stability and consumer protection.



## The future of stablecoins

Mainstream financial integration seems undeniable. Stablecoins could increasingly bridge the gap between traditional financial systems and the emerging digital finance ecosystem, facilitating smoother integration. The rise of wholesale CBDCs might see stablecoins playing a complementary role, offering private-sector innovations alongside government-backed digital currencies for interbank settlement.

Stablecoins can revolutionise the global payments system – particularly around remittances – by offering a cheaper, faster, and more transparent way to transfer money across borders. As more businesses accept stablecoins, they could become a standard medium of exchange in global e-commerce, reducing reliance on traditional banking systems.

Stablecoins can provide financial services to unbanked and underbanked populations, enhancing financial inclusion. They can facilitate microtransactions and micropayments, enabling new business models and economic opportunities in developing markets.

## What would it take to scale?

- 1. Regulatory landscape:** Future roles will heavily depend on regulatory frameworks. Stablecoins might face stricter regulations to ensure financial stability, consumer protection, and compliance with anti-money laundering (AML) and know-your-customer (KYC) requirements. As regulations become clearer, stablecoins might see increased adoption by institutional investors and traditional financial institutions.
  - a.** Advanced economies have an important role to play in encouraging greater harmonisation of stablecoin frameworks globally and preventing further fragmentation. Groups like the G7 and G20 can advocate for more consistent approaches to stablecoins, mitigating the risk of regulatory arbitrage and supporting the development of sound policies that protect consumer interests and financial stability. Global bodies may seek to promote key standards for stablecoin issuers, including regular disclosures of reserve backing, mandatory audits, diversification of reserve assets across multiple institutions, and expectations around what constitutes high-quality reserve assets.
- 2. Appropriate market infrastructure:** Advances in technology could enhance interoperability between different stablecoins and other digital assets, creating a more seamless financial ecosystem.
- 3. Building trust from a consumer perspective and the broader value chain like merchants:** As digital assets, stablecoins are vulnerable to cybersecurity threats, necessitating robust security measures. Consumers still need to learn to trust stablecoins. The stability of stablecoins depends on the robustness of their reserve assets and the transparency of their backing mechanisms. This is particularly true in the underserved and unbanked communities.





- 4. Monetary policy implications:** Widespread use of stablecoins could impact traditional monetary policy and the ability of central banks to control money supply, interest rates, and protect the payment system. Developing information sharing regimes among central banks and other regulatory bodies to monitor risks to the payment system may help mitigate this.
- 5. Bolstering cybersecurity defences:** Collaboration between industry and governments to develop cyber standards and risk management protocols, and to encourage regular stress-testing of technical infrastructure can help mitigate cybersecurity vulnerabilities as they relate to stablecoins.
- 6. Programmable money use cases:** Leveraging the programmability of stablecoins will enable new products and services to be built for traditional sectors of the economy, solving pain-points and increasing efficiency with smart contracts.
- 7. A common architectural model to foster interoperability of digital assets:** The convergence and interoperability of various digital assets, including stablecoins, tokenized deposits, and CBDCs, are essential to maximise the benefits and widespread adoption of tokenized assets. To date, efforts have largely focused on specific use cases, typically centred on individual platforms. Valuable lessons can be drawn from the adoption of internet protocols, which, between the 1970s and 1990s, evolved to be technology- and vendor-agnostic.

The adoption of a 7-layer model, known as the OSI (Open Systems Interconnection) model, later complemented by the more widely adopted TCP/IP protocol suite, allowed stakeholders to focus on specific aspects of interoperability across computer systems. Instead of requiring a full technology stack for communication between two computers (a mindset that currently dominates digital asset platforms), technology providers only needed to ensure interoperability with the layers directly above and below their own. This approach fostered flexibility and encouraged innovative collaboration.

In recent years, the question of "What is the TCP/IP equivalent for digital assets?" has emerged as crucial to promoting interoperability. This has led to proposals such as the 4-layer model described in the IMF's "ASAP: A Conceptual Model for Digital Asset Platforms" (Budau and Tourpe, 2024), which serves as an architectural guide. This model has informed the recently published "Global Layer 1" paper by the Monetary Authority of Singapore (MAS), which aims to set a foundation for cross-platform interoperability in the digital asset ecosystem.



## Stablecoins are here to stay

Stablecoins have emerged as significant players in the evolving monetary system, offering many potential benefits and challenges. They have a role in enhancing financial inclusion by providing low-cost, accessible financial services, especially in regions with limited banking infrastructure. Their digital nature makes them suitable for cross-border transactions, remittances, and microtransactions. As the digital era continues to grow, stablecoins offer a means of stable value transfer, reducing the volatility seen in other cryptocurrencies like Bitcoin or Ethereum. This makes them more practical for everyday transactions, both for consumers and businesses.

Much of the success, however, depends on how they will be regulated, and the balance struck between fostering innovation and ensuring stability. Financial institutions are increasingly integrating stablecoins into their operations, recognising their potential for reducing transaction costs and improving settlement times. Stablecoins also play a crucial role in the growing DeFi ecosystem, providing liquidity and enabling a range of financial services, such as lending, borrowing, and trading. Stablecoins, if widely adopted, could shift the balance of power between major currencies and create new dynamics in global finance, although this is not foreseeable anytime soon.

Stablecoins are likely to become more integrated into the monetary system, and their evolution and success, will depend on regulatory frameworks, market acceptance, and the responses of traditional financial institutions and central banks.



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