Effect of a Soft Landing on DeFi

By: www.ProfitableInvestingTips.com

After more than a year of the US Federal Reserve raising interest rates, inflation is down substantially. There were many predictions of a big rise in unemployment and the economy falling into a recession. Neither has happened. The Fed may have pulled off the difficult task of raising interest rates, driving inflation down and ending up with an economic **soft landing**. This is significant for folks working in decentralized finance as it was the series of Fed rate increases that brought on crypto winter and caused the collapse of many DeFi businesses. Just what will be the effect of a soft landing on DeFi?

What Is a Soft Versus a Hard Economic Landing?

A classic hard landing of the economy occurred in the 1980s. Inflation raged throughout the 1970s. The Federal Reserve under chairman Paul Volcker raised interest rates to 20%. You can compare that to the Fed having raised rates to 5.25% today. The Fed succeeded in stopping inflation. It also caused a recession. It lasted only from 1981 to 1982 but was the worst economic downturn since the Great Depression. Unemployment went up for the next seven years. The Fed went at the task of fighting inflation much more gradually this time around with quarter and half a point rate increases. The result appears to be a soft landing with employment strong and only a mild recession if one happens at all. Thus, a soft landing does not lead to a severe economic recession which is the point in regard to decentralized finance.

Why Did Higher Interest Rates Cause Crypto Winter?

Despite claims to the contrary, the world of cryptocurrencies which includes decentralized finance is tied to the greater financial world. The worst inflation in four decades, the Fed raising rates, and the prospect of a recession scared investors. The stock market fell and so did the crypto market. We found out that Bitcoin tracked up and down with the Nasdaq stock exchange. While crypto was supposed to be a hedge against inflation, it was not. While interest rates rose, the US dollar went up against virtually all other fiat currencies and against cryptocurrencies as well. This was part of the puzzle.

Irrational Bets on Crypto Going Up Forever

What caused the demise of many DeFi businesses were business plans that depended on a continuing increase in value of Bitcoin and the rest against the dollar. Borrow dollars, convert to crypto, use the crypto for business purposes, profit in crypto, and convert now-more-valuable crypto back into cheaper dollars to pay back the loan. So long as this sort of business plan worked it was lucrative. Yes, crypto at the base of DeFi was volatile but the trend was ever upward. Then a year of Fed rate increases drove the value of the dollar up and the values of Bitcoin and the rest down.

Economic Stability and Decentralized Finance Businesses

The original purpose of Bitcoin had nothing to do with financial speculation or with how Bitcoin went from being worth less than a penny to being worth tens of thousands of dollars. It had to do with doing business via the internet without interference by middlemen taking a cut. One benefit of crypto winter for DeFi has been the wholesale demise of algorithmic stablecoins and the survival of stablecoins backed by hard currencies.

The task of central banks like the US Federal Reserve is to maintain a stable currency. By doing so, businesses can make contracts payable in dollars, yen, euros, or British pounds. When payment comes due, with a stable currency there are no surprises such as there were in DeFi during crypto winter. The financial stability that will come with a soft economic landing will make business more predictable in the DeFi world as well as in traditional finance. This will be the effect of a soft landing on DeFi.

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