Which Crypto Will Dominate DeFi?

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When we recently asked what is DeFi good for, we noted that financial transactions and loans may be easier and more accessible through decentralized finance. We also noted that this system will depend on cryptocurrencies and the blockchain. While Bitcoin is the best known cryptocurrency it is not necessarily the winner in the race to dominate the world of decentralized finance. Which crypto will dominate DeFi? The first key to this issue that borrowing money with cryptocurrencies can be risky.

Crypto Fluctuation and Borrowing Risk

As we noted in our article about borrowing with cryptocurrencies, you might borrow one Bitcoin in April of 2022 when it was worth about $35,000 and then have to pay back a year later when it could have climbed back up to the $65,000 range. Thus, you would have borrowed $35,000 and then owed $65,000 plus interest. A way to skirt this potential dilemma would be use stablecoins. A stablecoin is a cryptocurrency that is backed by a traditional currency like the dollar are backed by that currency as a reserve asset. These cryptocurrencies allow one to obtain the benefits of decentralized finance without the risk of paying back twice or three times what you borrow after just a few months.

Three Types of Stablecoins

Stablecoins come in three classes based on how they work. They are fiat-collateralized, crypto-collateralized, and algorithmic or non-collateralized.

Fiat-Collateralized Stablecoins

These are the stablecoins that are backed by the dollar or other reserve currency or by gold, silver, or a commodity like oil. The majority use the US dollar. The reserves have custodians who are independent and undergo routine audits. Both Tether (USDTUSD) and TrueUSD (TUSDUSD) are valued equal to the US dollar and are backed by deposits in dollars.

Crypto-Collateralized Stablecoins

This class of stablecoin is backed by another or more than one other cryptocurrency. Because the other cryptocurrency tends to price volatility the stablecoin is “over-collateralized.” This necessitates holding as much as three times as much crypto in reserve than if the reserve were held in dollars. DAI (DAIUSD) uses Ethereum (ETHUSD) as a reserve and it is pegged to the US dollar.

Algorithmic, Non-Collateralized Stablecoins

This class of stablecoin uses an internal programming mechanism to adjust the supply of tokens in the system.

These systems are automated and are meant to function like a central bank buying and selling their currency to adjust its value. The system is meant to be a reliable stablecoin but only provides a first approximation.

Real World Non-Collateralized Stablecoins

Four algorithmic stablecoins are functioning actively in the real world, Terra, Aave, Chainlink, and Clover Finance. Terra has the Chai payment system which is used by thousands of South Korean merchants. It can also be used for loans. Aave accepts interest bearing deposits and provides loans but it is not a stablecoin so it carries a volatility risk. Chainlink is an algorithmic system with smart contracts. Clover Finance is newer and smaller and solves some of the problems related to getting to use the DeFi system. In the end it could be someone like Clover Finance that dominates DeFi simply because they make the system easier to use for normal people.

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