BY MATTHEW WELLS

Stablecoins and Financial Stability

The United States has introduced a new stablecoin regulatory framework, but concerns over the cryptocurrency's place in the global economy remain

Signed into law in July 2025, the Guiding and Establishing National Innovation for U.S. Stablecoins (GENIUS) Act was a huge step forward for the cryptocurrency industry. The bipartisan legislation marked the federal government's first effort at creating a regulatory framework for cryptocurrencies and signaled that crypto had finally achieved a status and size worthy of the government's attention.

Stablecoins are digital assets used primarily as currency to buy and sell other cryptocurrencies, such as bitcoin, on blockchains, which are decentralized electronic ledgers. Traditionally, they are viewed as "private money" that has been pegged one-to-one to a state-issued currency, typically the U.S. dollar, although others have been pegged to the euro, the Japanese yen, and the Swiss franc.

While few people use stablecoins to pay for conventional goods and services, the technology is expanding rapidly. The SWIFT payment system is transitioning to the blockchain, allowing banks to settle transactions with stablecoins, and large companies such as PayPal have developed their own stablecoins. Walmart, Amazon, and several large financial institutions are also exploring their potential.

The GENIUS Act gives banking regulators, including the Federal Reserve, oversight authority over the entities that issue stablecoins. However, the law leaves it to those regulators to decide what rules to create and how to implement them. Further, increases in stablecoin demand may impact other sectors of the economy, such as the Treasury market and the global demand for dollars. All these carry potential implications for the stability of stablecoins, as well as the Fed's efforts to maintain a safe and secure financial system.

STABLECOIN FUNDAMENTALS

Customers wanting stablecoins pay money through their bank accounts, credit or debit cards, or other payment systems to an entity issuing them. With those stablecoins in hand, users can make purchases or investments wherever they are accepted. When users want to "cash in," they take whatever stablecoins they have, which could have increased or decreased in number, back to an issuer, where they collect dollars back at a one-to-one rate.

Two of the most popular stablecoins in the crypto space are tether and USD Coin. Unlike dollars, which are fiat currency (that is, their value is derived from the government's declaration of their value), they and other stablecoins are backed or collateralized by a range of assets (or reserves), especially cash or U.S. Treasurys. In theory, these reserves can be easily liquidated to pay any customer seeking to redeem stablecoins for dollars.

The GENIUS Act addresses these dollar-pegged and reserve-collateralized stablecoins specifically, but there are other types of stablecoins that fall outside of the act's definition. Crypto-collateralized stablecoins, for example, are still pegged to a currency but are backed by other digital assets such as ethereum, making them less stable because of the greater volatility of their reserves. Another example includes algorithmic stablecoins, which attempt to maintain a consistent dollar-pegged value through automated adjustments in value relative to other digital currencies.

Stablecoins are used primarily as an immediate and secure medium of exchange for blockchain-based transactions, particularly the buying and selling of other cryptocurrencies. Unlike traditional payment systems, which can take days to fully settle transactions, stablecoin transactions are settled at any time of day on the blockchain almost instantaneously through "smart contracts," where the terms of the transaction are written into the code.

Beyond their speed on the blockchain, another benefit of stablecoins is their global reach. They can be used anywhere in the world, including areas where dollars are difficult to acquire. Coupled with the ease with which a user can move stablecoins in and out of crypto markets, their use can reduce the costs and frictions associated with remittances or other international transactions. For individuals in developing countries with persistently high inflation, stablecoins may also be a way to save money that is insulated from swings in the domestic currency.

In a February 2025 speech, Fed Gov. Christopher Waller similarly noted that for some users, stablecoins might also serve as a store of value. Relative to the other, more volatile crypto assets, stablecoins are low risk, "which allows traders to move out of risky positions into safe ones where the safe asset price is known and stable," he argued. Most stablecoin transactions — more than 80 percent — occur outside of the United States.

To date, these benefits of speed and availability have mostly been enjoyed by individuals active in the cryptocurrency marketplace rather than the average consumer. According to the Fed's most recent Diary of Consumer

Payment Choice, only 3 percent of respondents said they used cryptocurrency as a form of payment in the last month. However, the annual transaction value of stablecoins exceeded $27 trillion in 2024, surpassing that of Visa and Mastercard combined. Further, stablecoins' current market capitalization is about $267 billion, and Citigroup projects it will grow to between $1.9 trillion and $4 trillion by 2030. Treasury Secretary Scott Bessent made a similar claim in November, suggesting it could reach $3 trillion in coming years. Motivated by that growth, and its potential implications for the economy, Congress passed the GENIUS Act.

A NEW REGULATORY FRAMEWORK

The GENIUS Act grants banks, nonbanks, and even nonfinancial institutions with approval from state or federal regulators the ability to issue stablecoins to the public. Under the act, the Office of the Comptroller of the Currency regulates federally qualified issuers with over $10 billion in stablecoins in circulation. If the issuer is a subsidiary of an insured depository institution, such as a bank, it is regulated by the appropriate federal banking agency. All issuers with less than $10 billion in circulation would be regulated at the state level. Regulators would be responsible for conducting annual audits and ensuring compliance with existing anti-money laundering and sanctions requirements.

Crucially, issuers would be required to hold at least one dollar's worth of reserves for every stablecoin issued. Those reserves mostly come in the form of cash, insured and uninsured deposits, short-term Treasurys, repo agreements, and central bank reserve deposits. However, these issuers would be exempt from the regulatory capital requirements that currently apply to banks, and this holds true even if the issuers are banks engaged in regular banking activities.

Stablecoins are not defined as securities or commodities under the legislation, meaning they are not federally insured and do not have the same protections as traditional bank deposits. In other words, there is no government-backed guarantee a user would be able to get cash back when they want to trade back in their stablecoins. Issuers, as of now, also do not have access to the Fed's lending facilities.

Proponents of stablecoins argue that government insurance and access to the Fed are not necessary because the assets designated as collateral by the GENIUS Act are highly liquid, and issuers are required to hold as many dollars in reserve as they have stablecoins in circulation. While this would seemingly guarantee stablecoin holders could redeem their coins for cash whenever they choose without any difficulty, not all policymakers or observers agree it would be that easy.

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He identified several points of vulnerability in those assets. In addition to the potential for some consumers to mistakenly assume all stablecoins — not just those covered by the GENIUS Act — carry the same level of stability, he pointed out that other dollar-pegged assets have not always been able to maintain that one-to-one value. Money market mutual funds, which are listed as one class of asset that can be used as collateral, "broke the buck" in 2008 following Lehman Brothers' bankruptcy and experienced strains again in March 2020 at the outbreak of the COVID-19 pandemic.

Uninsured deposits, another acceptable reserve asset, were also a risk factor that precipitated the March 2023 banking stress associated with the failure of Silicon Valley Bank and others. The legislation also allows for any medium of exchange authorized by a foreign government to be used as collateral via repo agreements, which until recently in the case of El Salvador included the highly volatile bitcoin.

The GENIUS Act prohibits issuers from paying out interest to individuals holding their stablecoins. If stablecoins paid interest, they would have to be treated — and regulated — like securities rather than simply forms of payment. The legislation does, however, allow stablecoin exchanges, known as Virtual Asset Service Providers, to offer "rewards" to users who choose to buy and sell cryptocurrencies or conduct other transactions on their platforms. This creates a potential loophole, as these exchanges, if authorized by regulators, can also be part of the same entity issuing a stablecoin. The platform/issuer can then use the dollars traded for the stablecoins to purchase other assets, likely Treasurys to back the stablecoins, and then pay out rewards to customers with the proceeds from those investments.

Barr noted this area of concern, suggesting issuers "have a high incentive to maximize the return on their reserve assets by extending the risk spectrum as far out as possible. Stretching the boundaries of permissible reserve assets can increase profits in good times but risks a crack in confidence during inevitable bouts of market stress." To hedge against

this possibility, stablecoin issuers are required to publish monthly reports on the composition of their reserve assets, a move intended to give stablecoin holders increased confidence in the issuer's liquidity.

PARALLELS TO THE FREE BANKING ERA

Barr's argument implies that stablecoins are only as stable as the assets backing them. The United States first established a banking system with a national currency backed by Treasury bonds during the Civil War. Prior to that, in the free banking era from 1836 to 1863, states conducted banking supervision and regulation, and banks issued their own currencies. (See "When Banking Was 'Free,'" *Econ Focus,* First Quarter 2018.) Those paper notes had to be collateralized through state and federal government bonds, and capital and reserve requirements were inconsistent across states.

This meant the country's economy operated with competing, private currencies. It was difficult for currencies in one part of the country to be redeemed in other parts, and it was often done at a discount; for example, the farther away from the bank issuing the note, the steeper the redemption discount. It wasn't unusual for citizens to question the collateral backing the various banks' notes, leading to regular bank runs and failures.

One can draw parallels between the free banking period and today's stablecoin landscape. First, as of early June, there were 233 stablecoins available on the crypto market. Numerous digital service platforms market themselves as spaces where private companies can create, manage, and distribute their own stablecoins. Bank of America, JPMorgan Chase, Citigroup, and Wells Fargo are considering the idea of a jointly issued stablecoin, as well as their own individual ones.

As was the problem with free banking, some economists question whether consumers will always maintain confidence that they can redeem stablecoins for cash on demand at the promised one-to-one rate. The large banks may be able to issue coins that no one will doubt, but the stablecoin marketplace includes platforms and issuers that are not banks at all, as well as international operators outside the jurisdiction of U.S. financial regulators.

Should one stablecoin issuer experience a run where customers doubt its ability to pay back dollars on demand, it is possible others would too, especially if they are all backed by similar assets. This could lead to a crisis that extends beyond the stablecoin space and impacts the wider financial system.

"Smaller companies planning to issue stablecoins under the GENIUS Act to be regulated by one of the states may face market resistance," says Michael Bordo, an economist at Rutgers University. "Unless there is perfect information about the backing and complete confidence in it, holders may want to discount the stablecoins or avoid them completely, as was the case under free banking in the United States."

Yale University economist Gary Gorton expresses similar concerns, particularly due to the difficulty in regulating a transnational market. "Let's suppose that one of the exchanges out there collapses because of fraud. Now everybody's a little suspicious of these exchanges, and many aren't even based in the United States," he says. "That's the kind of thing that would cause everybody to run."

Should one stablecoin issuer experience a run where customers doubt its ability to pay back dollars on demand, it is possible others would too, especially if they are all backed by similar assets. This could lead to a crisis that extends beyond the stablecoin space and impacts the wider financial system. In a recent paper co-authored with Jeffery Zhang of the University of Michigan Law School, Gorton argued this outcome is consistent with the nature of short-term debt. Stablecoins are a form of that debt, and because of the laws of supply and demand, their values should fluctuate as the values of the assets backing them fluctuate.

"If one issuer gets in trouble and its stablecoin holders all run on it and ask for cash, it can sell Treasurys and give them the cash," says Gorton. "But in a systemic event, 500 issuers are under siege and they all sell their Treasurys, and the price of Treasurys goes way down."

Gorton and Zhang argued such a failure is in keeping with the pattern of systemic crises over the past 200 years, and the solution is not to outlaw stablecoins but to provide a safer alternative where "no one should have an incentive to produce information about the backing for the money (i.e., the banks' assets); and everyone should know that no one has an incentive to produce that information." In other words, a stablecoin that is truly stable is one that is accepted at par, anywhere and at any time, no questions asked. Gorton says that a digital currency issued by a central bank would meet these criteria.

THE ROAD AHEAD

Skeptics and supporters alike agree that stablecoin adoption is likely to increase in the coming years. An important question, however, is whether it will attract new users looking for a new form of payment. Certainly, stablecoins offer the advantage of instant transactions, and merchants might have incentive to adopt them to replace credit cards, which currently assess transaction fees between 1.5 percent and 3.5 percent for each purchase. (See "Should Credit Card Fees Be Regulated?" p. 18.) However, it may be possible to achieve the benefits

of quicker settlements and lower fees with existing payment rails, such as FedNow, raising the possibility that internal U.S. demand may be limited.

In a recent speech, Fed Gov. Stephen Miran acknowledged that stablecoins' future growth may lie outside the United States. "Because GENIUS Act payment stablecoins do not offer yield and are not backed by federal deposit insurance, I see little prospect of funds broadly fleeing the domestic banking system," he said. "The real opportunity in stablecoins is to satiate untapped foreign appetite for dollar assets from savers in jurisdictions where dollar access is limited."

This increased global demand for stablecoins could precipitate increased demand for U.S. Treasurys. Stefan Jacewitz, an economist at the Kansas City Fed, suggested in a recent report that there is still a way to go for any increased adoption of stablecoins to make a meaningful difference in the economy. Circle, the largest U.S.-based stablecoin issuer, currently holds 43 percent of its assets in Treasurys. If all other issuers held that same percentage in Treasurys, it would amount to about $125 billion, which is less than 2 percent of the $6 trillion in outstanding Treasurys.

However, if the projections of increased adoption materialize, Jacewitz acknowledged the possibility that "it could lead to a substantial redistribution of funds" and potentially increase demand for Treasurys such that the increase in stablecoin issuers' Treasury holdings could outpace the decrease in bank holdings. A 1 percent decrease in bank Treasury holdings — and an accompanying 1 percent decrease in bank lending — translates to a $325 billion reduction in loans into the economy, Jacewitz estimated.

The American Bankers Association and other banking organizations point to this potential for deposits to leave the banking system in calling for regulators to limit the ability of stablecoin issuers and platforms to pay out rewards. The crypto industry disagrees, arguing that banks fear competition, and banks could incentivize their depositors to stay by raising their deposit rate, something they did when they first competed with money market mutual funds.

While there is widespread agreement on the potential for stablecoins to serve an important function for cross-border transactions, concerns about their soundness and stability remain, and they are not just theoretical. Circle held $3.3 billion of its approximately $40 billion in reserves at Silicon Valley Bank when it collapsed in 2023, and its inability to access those reserves triggered a fall in the value of its USD Coin from the one-to-one ratio to below 87 cents on the dollar. In that case, the federal government stepped in and made whole all of Silicon Valley Bank's depositors, including Circle, which restored its dollar peg.

Bordo argues that in the wake of the free banking era, it still took years of costly bank failures to get to the point where policymakers acted upon the realization that stability in the banking system required much more government intervention, supervision, and regulation than had existed. He notes, "There are always new entities that are going to figure out a way to be outside the regulatory net," and stablecoins will not be any different.

As with any new financial innovation, the Fed will continue to study stablecoins to ensure that their benefits can be enjoyed by those who want to use them while maintaining overall financial and banking stability. **EF**

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